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Office of the Secretariat

August 13, 2010

Kathleen M. Cronin, Esq.
General Counsel and Corporate Secretary
CME Group, Inc.
20 South Wacker Drive
Chicago, Illinois 60606

Re: Chicago Board of Trade Rules and Interpretations Prohibiting the Exchange of Futures for Futures

Dear Ms. Cronin:

This letter concerns the Chicago Board of Trade's ("CBOT") self-certified Market Regulation Advisory Notice RA0907-1, issued on October 19, 2009.[1] In that notice, CBOT stated that its rules do not permit the execution of (i) Exchange of Futures for Futures ("EFF") transactions; or (ii) what it characterized as "contingent and transitory trades," including matched pairs of block trades used to transfer positions from one exchange to another. In subsequent submissions to Commission staff, CBOT has justified its action on the ground that, in its view, such transactions are not supported by the Commission precedent; further, prohibition against such transactions is consistent with the Commodity Exchange Act ("CEA" or the "Act") and Commission regulations.

The Commission has reviewed the record in this matter and, as discussed below, supports staff's conclusion that ELX's EFFs, when used solely to liquidate and establish look-alike futures positions on different designated contract markets ("DCMs"), are not wash or fictitious trades prohibited by the Act. The Commission has concluded further that neither the CEA nor Commission regulations prohibits (i) EFF trades or (ii) matched block trades used to transfer positions from one exchange to another exchange with a different clearinghouse. Moreover, the Commission has concluded that Core Principle 9 (Execution of Transactions) neither prohibits nor mandates the implementation of rules, in accordance with Regulation 1.38, respecting the acceptance of EFFs or any other non-competitively executed transactions. The Commission has directed staff separately to analyze the Core Principle 18 (Antitrust Considerations) claims that

[1] CBOT Market Regulation Advisory Notice RA0907-1 (October 19, 2009)—Rule 538; Subject—Prohibition of Exchange of Futures for Futures (EFF) Transactions. On October 29, 2009, CBOT separately self-certified its amendments to Rule 534 (Wash Trades Prohibited) and a related advisory clarifying certain aspects of the prohibition on wash trading (together with Market Advisory Notice RA0907-1, "Advisory"). The Advisory stated that the only prearranged trades permitted on the exchange are block trades made pursuant to CBOT Rule 526 and three types of Exchange for Related Positions ("EFRP"): Exchange for Physical ("EFP"), Exchange for Risk ("EFR"), and Exchange for Options for Options ("EOO").

have been made in connection with this matter, and accordingly no inferences should be drawn in that regard from any statements in this letter.

Background

ELX Futures ("ELX") was designated as a contract market ("DCM") on May 22, 2009, initially to trade various U.S. Treasury contracts that are "look-alikes" to Treasury contracts traded at CBOT. Shortly thereafter, ELX filed a request pursuant to Commission Regulation 40.5 for approval of a rule authorizing participants on ELX to carry out EFF transactions ("ELX EFF rule"). ELX has stated that its EFF rule is intended to enable market participants to establish positions in futures contracts on ELX while concurrently liquidating futures positions on another DCM that lists look-alike contracts or, conversely, to establish positions on another DCM that would replace look-alike contracts liquidated on ELX. (Currently, ELX and CBOT are the only DCMs that list U.S. Treasury futures contracts.) The Commission approved the ELX EFF rule on October 6, 2009; CBOT issued its Advisory on October 19, 2009. On October 30, 2009, the Commission's Division of Market Oversight staff requested a written statement from CBOT addressing, among other things, its rationale for not allowing EFFs while permitting other types of off-centralized-market transactions, and demonstrating how the Advisory and CBOT Rule 538 comport with DCM Core Principle 18 (Antitrust Considerations). In response, CBOT asserted that both the exclusion of EFFs from CBOT Rule 538 and the prohibition on matched block trades is warranted because such trades are prohibited wash or fictitious sales under Section 4c(a) of the CEA. CBOT further stated that its prohibition of EFFs is consistent with DCM Core Principle 9 and Commission Regulation 1.38.[2]

In a January 22, 2010 letter to CBOT (the "January 22 staff letter"), Commission staff advised the exchange that the CEA and Commission regulatory precedent do not support much of CBOT's position. Specifically, staff concluded that CBOT mischaracterized the requirements of the CEA with respect to both (i) the prohibition of EFF trades and matched block trades that are used to exchange a futures position on one exchange for a futures position on another exchange that has a different clearinghouse as wash or fictitious trades in violation of the CEA; and (ii) the prohibition of matched block trades as impermissible contingent and transitory trades. In light of its conclusions, staff requested that CBOT provide further justification for its Advisory. In a responsive letter dated February 8, 2009, CBOT (1) stated that staff failed to address the "long-standing Commission precedent" on wash and fictitious trading cited by CBOT in its November 16 letter; (2) expanded upon its position that its refusal to permit EFF transactions is justified by DCM Core Principle 9 (and suggested that ELX's EFF rule is not supported by Core Principle 9[3]); and (3) asserted that its actions comport with Core Principle 18 and with antitrust jurisprudence.

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[2] Letter dated November 16, 2009 from Kathleen M. Cronin, General Counsel, CME Group, to the Commission's Division of Market Oversight (CME November 16 letter).

[3] *See, e.g.*, "[T]he Treasury complex at both CBOT and ELX are liquid markets and there is no legitimate reason to permit a non-competitive transaction without any economic substance that will cause sudden, in explicable changes in open interest." Letter dated February 8, 2010 from Kathleen M. Cronin, General Counsel, CME Group, to the Commission's Division of Market Oversight.

Commission Precedent Does Not Support CBOT's Contention that EFF Transactions and Matched Block Trades are Unlawful Wash or Fictitious Trades

An EFF is a privately-negotiated, prearranged two-legged transaction wherein one party establishes a futures position on a particular DCM and simultaneously liquidates positions in futures on the same underlying commodity on another DCM, while a second party is the counterparty to both transactions. CBOT stated in its Advisory that the only prearranged trades permitted on the exchange are block trades made pursuant to CBOT Rule 526 and three types of Exchange for Related Positions ("EFRP") made pursuant to CBOT Rule 538: Exchange for Physical ("EFP"), Exchange for Risk ("EFR") and Exchange of Options for Options ("EOO"). In correspondence with staff, CBOT stated that the exclusion of EFFs from CBOT Rule 538 and the prohibition on matched block trades used to transfer positions from one exchange to another are warranted on the ground that EFFs are prearranged, matched trades that involve no market risk: in short, wash sales prohibited by Section 4c(a) of the CEA. The Commission believes this analysis is erroneous.

As staff explained in its January 22 letter,[4] exchanges of futures for a commodity or a derivatives position are considered *bona fide* if they include, among others, the following elements: separate but integrally-related transactions involving the same or a related commodity, with price correlation and quantitative equivalence of the futures and cash (or derivatives) legs, actual transfer of ownership of the commodity or derivatives position, and both legs transacted between the same two parties. In 2002, the Commission approved the New York Mercantile Exchange's ("NYMEX") Basis Trade Facility,[5] which enabled traders to liquidate Brent Crude Oil futures contracts at the International Petroleum Exchange, then immediately establish the same quantity of Brent Crude Oil futures on the NYMEX, using a block trade. The Commission's approval of both NYMEX's Basis Facility and ELX's EFF rules affirmed that the subject trades are consistent with the criteria listed above for *bona fide* EFPs, EFSs and other such trades, and that the rules would not violate the Act or its regulations.

While the "long-standing Commission precedent" cited by CBOT accurately reflects the Commission's jurisprudence on wash trading, the exchange's reliance on those cases is misplaced. Commission jurisprudence does not support CBOT's assertion that EFFs categorically produce a wash result and cannot provide the basis for an argument that ELX's EFFs are unlawful wash trades under the CEA.

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[4] Although Section 4c(a) of the CEA prohibits "fictitious sales," that term is not defined in the Act. The Commission has held that "the central characteristic of the general category of fictitious sales is the use of trading techniques that give the appearance of submitting trades to the open market while negating the risk of price competition incident to such a market." *In re Collins*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 at 31,902-903 (CFTC Apr. 4, 1986). CBOT appears to contend that a matched pair of block trades is an unlawful fictitious trade because both trades are "contingent and transitory." The January 22 staff letter fully addressed this contention.

To the extent not specifically referenced herein, the Commission incorporates by reference the staff's January 22 letter.

[5] *See* May 2, 2002 letter from Jean A. Webb, Secretary of the Commission, to J. Robert Collins, Jr., NYMEX president, with notification of the Commission's approval of NYMEX Rule 621D.

Section 4c(a) of the CEA makes it unlawful for any person to offer to enter into, enter into, or confirm the execution of a transaction that is "of the character of, or is commonly known to the trade as, a "wash sale." *In re Gimbel*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,213 at 35,003 (CFTC Apr. 14, 1998), *aff'd as to liability* 872 F.2d 196 (7th Cir. 1989); *In re Goldwurm*, 7 A.D. 265, 274 (CEA 1948). Such transactions create the appearance of submitting trades to the open market while negating the risk of price competition incident to such a market. *In re Citadel Trading Co. of Chicago, Ltd.* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,082 at 32,190 (CFTC May 12, 1986).

A threshold question in a wash sale analysis under the CEA is whether the transaction at issue has achieved a wash result. The factors that indicate a wash result are (i) the purchase and sale; (ii) of the same delivery month of the same futures contract; (iii) at the same (or similar) price. *In re Gilchrist*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,993 at 37,653 (CFTC Jan. 25, 1991) (citations omitted) (although the transactions resulted in an intended financial nullity, they were not wash sales because they were not transactions in the same futures contract).

EFFs—such as ELX's EFFs—used to move positions from one exchange to another exchange with a different clearing house do not satisfy the second *Gilchrist* factor (same delivery month of the same futures contract) because they do not involve the same futures contract.[6] The U.S. Treasury futures contracts traded on ELX and CBOT, respectively, are not the "same futures contract" because trades executed on ELX and CBOT are not offsetting or fungible. Positions resulting from ELX trades are held at the Options Clearing Corporation, while positions resulting from CBOT transactions are held at the CME Clearinghouse. Because an ELX EFF transaction does not involve the "same futures contracts," such an EFF transaction cannot be said to achieve a wash result under existing Commission precedent.[7]

CBOT's Justifications under Core Principle 9 and Commission Regulation 1.38

In addition to its claim that EFF transactions are wash trades prohibited by the CEA, CBOT separately asserts that its refusal to permit these transactions[8] is justified under DCM Core Principle 9 and Commission Regulation 1.38.

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[6] This conclusion also applies to matched block trades used to transfer positions from one exchange to another exchange with a different clearinghouse.

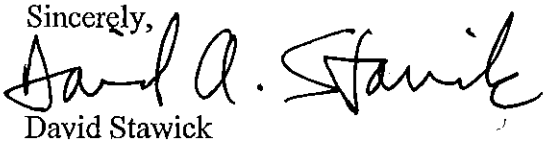
[7] In addition to long-standing Commission precedent, CBOT relies for support on two recent Commission speaking orders that are factually distinguishable: *In re Pinemore, L.P., et al.*, CFTC Docket No. 10-04 (CFTC filed Jan. 28, 2010) (transactions in NYMEX natural gas futures contracts); *In re CIC Banque Credit Industriel D'Alsace et de Lorraine Societe Anonyme* [2007-2009 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 30,675 (CFTC Sept. 27, 2007) (wash sale transactions involving CBOT Treasury Note futures contracts). Both matters involve transactions in the same futures contract on the same exchange. The Commission has never found a wash sale in the context of a transaction involving two different futures contracts.

[8] CBOT does not permit EFFs but does allow other off-exchange transactions, including EFPs and EFSs. CBOT claims that DCM Designation Criterion 3 (Fair and Equitable Trading) "excludes" the use of EFFs but allows EFPs and EFSs. Designation Criterion 3 contains a non-exclusive list of potentially permissible off-exchange transactions, but does not exclude EFFs. Designation Criterion 3 is equally silent regarding the use of EFRs.

Price discovery through open and competitive trading is the cornerstone of futures regulation. Hence, Section 4(a) of the CEA requires that all futures and options transactions take place on the centralized marketplace.[9] Similarly, under Commission Regulation 1.38, futures and options transactions must be executed openly and competitively; any exceptions that detract from open and competitive trading must be fully justified and approved by the Commission.[10] The importance of promoting an "open and competitive'" means of price discovery was expressly endorsed by Congress with the addition of Core Principle 9 to the CEA.[11] In doing so, Congress also granted DCMs reasonable discretion as to how to implement such policy in their markets. A DCM, therefore, has discretion to not permit off-centralized-market trading rules, such as EFFs, based on its market needs and customer expectations. The Commission also affirms, however, that a DCM may permit EFFs under a rule submitted to the Commission in accordance with Regulation 1.38, as ELX has done. The Commission's approval of a DCM's rule implementing EFF trades carries with it the finding that such rule does not violate the requirements of the CEA and Commission regulations, including Core Principle 9 and Regulation 1.38.

In short, neither Regulation 1.38 nor Core Principle 9 compels a DCM to prohibit or mandate off-centralized-market trades. As noted above, the Commission intends separately to engage in a thorough analysis of the exchanges' Core Principle 18 and related antitrust arguments. By separate letter, staff will advise CBOT with respect to the process to be followed in resolving these matters, including the scope and timing of further written submissions addressing these issues.

Sincerely,



David Stawick
Secretary of the Commission

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[9] Section 4(a) of the CEA. Section 4(a) makes it unlawful for any person to enter into a contract for the purchase or sale of a futures (or options) contract "unless such transaction is conducted on or subject to the rules" of a contract market designated, or registered, by the Commission.

[10] Specifically, Commission Regulation 1.38 requires that transactions be executed by open and competitive methods, but permits non-centralized-market trades in certain limited situations if the transactions comply with DCM rules specifically providing for the non-competitive execution of such transactions and such rules have been submitted to the Commission. As the Commission stated in its 2008 Proposed Guidance, the implicit assumption underlying Regulation 1.38 is that "trading should take place on the centralized market unless there is a compelling reason to allow certain transactions to take place off the centralized market." *See* CFTC's 2008 Proposed Guidance at 54009.

[11] Core Principle 9 requires DCMs to provide a competitive, open and efficient market for the execution of transactions. The preamble to recently proposed guidance on Core Principle 9 notes that to ensure that the centralized market remains competitive and efficient and continues to provide a means for price discovery, futures (and options) trading should take place on the centralized market unless there is a compelling reason to allow certain transactions to take place off the centralized market. *Id.*