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Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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Re: Proposed Rules for Trading Off the Centralized Market
69 F.R. 39880 (July 1, 2004)

COMMENT

Dear Ms. Webb:

The Board of Trade of the City of Chicago, Inc. ("CBOT®" or "Exchange") appreciates the opportunity to respond to the Commodity Futures Trading Commission's ("Commission") proposal to amend its rules concerning trading off the centralized market, and to add guidance on contract market block trading rules, as part of its ongoing efforts to update its regulations in light of the Commodity Futures Modernization Act of 2000 ("CFMA") and its administrative experience.

Introduction

The Commodity Exchange Act ("Act"), both before and after the CFMA amendments, and Commission Regulations, have consistently been designed to ensure that U.S. designated contract markets ("DCMs") are open, competitive, and transparent. For example, Core Principle 9 of the CFMA requires that DCMs must provide a market and mechanism for executing transactions that is "competitive, open, and efficient". Similarly, Regulation 1.38(a) has long set forth the general rule that on DCMs, futures and futures options trades must be executed by open and competitive methods. Competitive trading in a transparent environment, whether floor-based, or electronic, results in markets that are fair to all market participants and are able to provide accurate price discovery and effective hedging opportunities. Historically, the Commission has recognized very limited exceptions to the requirement that DCM transactions must be executed openly and competitively. In those instances, non-competitive trades have only been permitted in accordance with written exchange rules that have been submitted to, and approved by, the Commission. Regulation 1.38(b). The Commission's long-standing guiding principle, in approving such rules, has been that any such transactions must ". . . not operate in a manner that compromises the integrity of prices or price discovery on the centralized market." (*See* Proposed Appendix B to Part 38, paragraph (a)(2)(iii)).

One of the Commission's primary functions and reasons for being is to ensure the integrity of the markets it regulates. The other is to ensure that customers are protected.

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These responsibilities are especially important in the context of the regulation of DCMs, since they are open to all types of customers, and serve a price discovery function that affects major portions of the economy. In order to adequately protect both the customers who trade on DCMs, and the integrity of the prices of the products traded on DCMs, it is crucial that block trading and other transactions off the centralized market remain the exception and never become the rule.

Regulation 1.38

When the Commission adopted its Part 38 rules to implement the CFMA's Core Principles applicable to DCMs, it explicitly retained the applicability of Regulation 1.38, while it exempted DCMs from numerous other specific regulations. Regulation 1.38, by its terms, only permits trading off the centralized market pursuant to exchange rules that have been approved by the Commission. The Commission has now proposed to modify Regulation 1.38 to explicitly permit DCMs to self-certify any new rules or rule amendments that relate to trading off the centralized market. This proposal is consistent with Section 5c(c) of the Commodity Exchange Act ("Act").[1]

However block trading, if not appropriately limited, has the serious potential to divert liquidity from the competitive marketplace, widen bid-ask spreads, and inhibit the ability of the centralized market to operate as a transparent and accurate price discovery mechanism. In recognition of this fact, the CBOT anticipates that the Commission will carefully review any certified rules permitting block trading to ensure that the Commission agrees with the certifying DCM's conclusion that such rules comply with the Act and Regulations. The CFMA did not limit the Commission's authority to request that a DCM change any of its rules relating to the form or manner of execution of trades, in order to protect market participants or to ensure the fairness of the market, nor did it limit the Commission's authority to institute proceedings to alter or amend any such DCM rules, pursuant to Section 8a(7) of the Act.

Furthermore, in the exercise of the Commission's oversight authority, it may require that a DCM demonstrate its compliance with Core Principles at any time. Commission Regulation 38.5(b). Therefore, the CBOT expects that the Commission will monitor the implementation of any DCM's block trading rules, on an ongoing basis, to ensure that any such practices do not hinder the proper functioning of the centralized market. Specifically, the Commission must ensure that block trading remains a narrow exception to the general requirement that trades be executed in a transparent manner. If transactions executed off the centralized market were permitted to become a significantly large percentage of all transactions executed on any particular DCM for any individual

[1] Section 5c(c) of the Act, as amended by the CFMA, permits registered entities to implement any new rule or rule amendment upon providing a certification to the Commission that the rule or amendment complies with the Act and Commission regulations, unless the rule amendment materially changes the terms and conditions of enumerated agricultural contracts and will be applicable to delivery months with open interest.

contract, the centralized market could cease to serve any meaningful economic function. Moreover, it can be anticipated that the harmful effects of such a situation would spill over to any other DCM that lists the same or a related product.

Current Regulation 1.38(b) specifically identifies exchanges of futures for physicals as one of the types of transactions that may be executed off the centralized market. In recent years, DCMs have also adopted rules permitting exchanges of futures for swaps, exchanges of futures for options, and exchanges of futures for derivatives as markets have evolved, and the CBOT agrees with the Commission's proposal to explicitly recognize exchanges of futures for derivatives within its regulatory framework.

The CBOT suggests two further amendments to Regulation 1.38(a) with respect to transactions on the centralized market. The Exchange notes that the Commission has proposed to update this provision by deleting the reference to "in the pit or ring or similar place". However, the Commission's proposed amendment retains "in a place provided by the contract market." Since an electronic trading platform is not technically a "place", the CBOT suggests the expansion of this phrase to read: "in a place *or through an electronic system* provided by the contract market." The CBOT also suggests the removal of the word "regular" as a modifier of "hours prescribed by the contract market for trading in such commodity or commodity option." At the CBOT, "regular trading hours" is a defined term for certain purposes, and does not include all trading hours, e.g., the modified closing call, or certain overnight electronic trading hours. (See CBOT Regulations 1007.02 and 1008.01).[2]

Appendix B to Part 38 – Guidance for Compliance with Core Principle 9

The Commission has proposed a significant expansion of its guidance for compliance with Core Principle 9, in large part, to separately and specifically address transactions off the centralized market. In particular, the Commission has proposed to set forth comprehensive block trading standards that would constitute acceptable practices, by adopting elements of various DCMs' current block trading rules, which have previously been approved by the Commission.

The Commission's proposed guidance regarding trading off the centralized market contains a much greater degree of specificity than the guidance that the Commission has provided with respect to many of the other Core Principles. Although the proposal is identified as guidance regarding acceptable practices, which Appendix B to Part 38 generally treats as non-exclusive "safe harbors", its provisions are so detailed that they appear more like the type of prescriptive regulations that the Core Principles were designed to replace.

[2] This language also appears in paragraph (a)(1)(i) of the proposed guidance for compliance with Core Principle 9 in Appendix B to Part 38.

However, the mere fact that the Commission has found it necessary to include so much detail in its proposed guidance in this area, makes it clear that the Commission is well aware of its need to ensure that block trading remains the exception and not the rule, and to ensure that license is not given to DCMs to permit the role of block trading to expand to the point where it is likely to compromise the fairness of such markets and their effectiveness as vehicles for price discovery and risk transfer. The CBOT believes that this level of detail is normally not appropriate for Core Principle guidance. However, the CBOT expects that the Commission would consider the various elements that it has discussed in the proposed guidance, as appropriate, when it reviews any block trading rules that DCMs may submit to the Commission, either by certification or with a voluntary request for approval. The following discussion addresses certain of these elements upon the assumption that they should and will be important considerations during the Commission's review of a DCM's block trading rules, whether or not they are specifically set forth in Appendix B to Part 38 as Core Principle guidance.

The Commission must ensure that any DCM that permits block trading does so only under very limited circumstances, to permit eligible contract participants (or CTAs or investment advisors with substantial assets under management) to execute large orders that they would not otherwise be able to fill in the open market. If such circumstances are too broadly defined, and trading off the centralized market becomes more prevalent than necessary to serve this limited purpose, DCMs will cease to effectively and efficiently serve their price discovery and risk management functions, and market integrity will be compromised.

The Commission has appropriately recognized that there should be a minimum size for block transactions that is sufficiently large that it could be expected to " . . . affect the quality of the transaction price due to the significant impact of such a large order on the centralized market". If a market participant is equally likely to obtain a fair price on any centralized market, there would be no legitimate justification for a block trade. If an order could be filled by open and competitive means in any DCM's centralized market, a block trade should not be permitted solely for convenience, or because a particular DCM desires to stimulate activity or increase the diversity of trading in its marketplace, by providing a non-transparent trading venue.

The Commission has proposed that a transaction size that is greater than 90 percent of the trades in a relevant market would be an acceptable minimum block size, stating that the relevant market would include the subject futures or options market, any related derivatives market, and/or the underlying cash market, as appropriate. The CBOT agrees that a DCM should consider the size of the trades in "any related derivatives market", including any other DCM that lists the same or a similar product, in determining an acceptable minimum block size. The Commission has further suggested that 100 contracts would be an acceptable minimum block size for markets where relevant transaction data is unavailable. The CBOT believes that there may be instances where 90% could be too high or not high enough, or 100 contracts could be too low. Rather

than relying upon arbitrary percentages or numbers of contracts, the Commission should review a DCM's minimum block transaction size in light of the necessarily limited function of block trading in an otherwise open and competitive market. In other words, the minimum block size should be designed to encompass only those orders that are so large that they would be likely to move the market on any DCM that lists the relevant product or its equivalent, to the extent that the customer could not obtain a fair price or would not be able to obtain a fill at all.

The CBOT agrees with the Commission's position that block trades must be made at a fair and reasonable price, taking into account the size of the block and the price and size of other trades in relevant markets. Moreover, it is appropriate that relevant markets should include the contract itself, the underlying cash markets and other related futures markets. The Federal Register release accompanying the Commission's proposal states that fairness and reasonableness could be based upon the circumstances of the market or the parties, including a participant's "legitimate trading objectives," as an alternative to the price and size of other trades in relevant markets, as long as the participant retains appropriate documentation to justify an off-market price. 69 F.R. at 39882. By contrast, the language of the proposed guidance states that the determination of fairness and reasonableness could take all of these factors into account, in the conjunctive, rather than in the alternative. This inconsistency may have been inadvertent. The CBOT believes that any "circumstances of the market or the parties to the block trade" alone, without any relationship to the price and size of other trades in relevant markets, would not be sufficient to justify a conclusion that a price was fair and reasonable.

Moreover, while the rules of several exchanges permit consideration of the circumstances of the parties, in addition to, but not instead of, any of the other cited factors, they make no reference to the circumstances of the market,[3] which appears to be an expansion proposed by the Commission at its own initiative. It is unclear what "circumstances of the parties" or "circumstances of the market" could be relevant considerations in determining whether a block trade price is fair and reasonable. For example, one exchange's rule provides that when determining a fair price for a block trade, a member should consider, in addition to the prevailing price, the volume and liquidity available on the regular market, and the "general market conditions".[4] Although these factors may be relevant to whether a block trade may be necessary to ensure a fair price, it is not clear how they would be relevant to whether a particular block trade price is fair. The CBOT believes that there are no circumstances of the parties or circumstances of the market, which would justify obtaining any price through the execution of a block trade, if the parties would be able to obtain a fair and reasonable price on any centralized market that lists the relevant product.

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[3] See CME Rule 526.D; NYBOT Rule 4.31(a)(iii); and CFE Rule 415(c).
[4] NQLX LLC Rule 419(e)(1).

The CBOT also believes that the price of a block transaction should not affect conditional orders in the centralized market, and that block execution prices should not be taken into consideration in the determination of settlement prices. In either instance, the block price, if considered, would compromise the integrity of prices and the price discovery function of the open and competitive market. [5]

The CBOT agrees with the general principle stated by the Commission that trades off the centralized market (just like trades on the centralized market) must be arm's length transactions. However, the Exchange does not believe that the Commission should specify any detailed circumstances under which such transactions between affiliated parties will be presumed to have been conducted at arm's length. An individual DCM should be given the flexibility to either define its own such circumstances, or to always treat the arms' length nature of such transactions as a question of fact that it will determine in the exercise of its surveillance function.[6]

Exchanges of futures for commodities or derivatives

The Commission has also proposed to publish guidance with respect to exchanges of futures for commodities or derivatives positions, based upon elements currently contained in various exchange rules relating to such transactions, and based upon the essential elements for bona fide EFPs outlined in the Commission staff's 1987 EFP Report ("1987 Report").

The CBOT does not believe that it is necessary for the Commission to include specific guidance regarding EFPs or exchanges of futures for derivatives in its Appendix B to Part 38. EFPs have been in existence in the futures industry for decades. On January 26, 1998, the Commission issued a Concept Release on the Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,211, in part to solicit comment to assist the Commission in determining whether rulemaking was appropriate with respect to EFPs, in light of changes in the marketplace in the ten years since the 1987 Report had been issued. The Commission specifically requested comment regarding whether the elements and indicia of a bona fide EFP that had been articulated in the 1987 Report should be codified in the Commission's regulations or refined in any way.

On June 10, 1999, after considering all of the comments received in connection with its Concept Release, the Commission issued an Advisory on Alternative Executive, or Block Trading, Procedures for the Futures Industry, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,656. The Commission did not propose to codify any specific

[5] Several exchanges' rules include similar provisions. See CBOT Regulation 331.05(b); CME Rule 526.E; NYBOT Rule 4.31(a)(iv); and NQLX LLC Rule 419(g)(5).
[6] For example, in the context of EFPs, the CBOT has taken the position that where the parties to an EFP involve the same legal entity, same beneficial owner, or separate legal entities under common control, the burden of proof will be on the parties to demonstrate that the EFP was a legitimate arm's length transaction.

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requirements for EFPs. If the Commission did not find it necessary to incorporate any further definition of the elements of a bona fide EFP into Regulation 1.38 prior to the adoption of the CFMA, there does not appear to be any need to specifically address such requirements in Core Principle guidance at this time.

Moreover, although the Exchange does not disagree with those elements that the Commission has specified as acceptable contract market requirements for EFPs or exchanges of futures for a derivatives position, the summary form in which they are stated could be misleading, unless read in conjunction with the 1987 Report and/or the Commission's Concept Release. For example, the proposed guidance states that the transfer of ownership should involve "separate parties." Although it is not obvious from a reading of the proposed guidance, the 1987 Report and the Concept Release make it clear that separate profit centers of the same legal entity, which are under separate trading control, may qualify as "separate parties".

It should also be noted that the CBOT has adopted a clarification to the stated requirement that the futures and cash legs of an EFP must be transacted between the same two parties, which was certified to the Commission on August 22, 2003. Specifically, CBOT Regulation 444.01B was amended to explicitly permit a member firm to facilitate, as principal, the cash component of an EFP on behalf of a customer, provided that the firm can demonstrate that the cash commodity transaction was passed through to the customer that received the futures position as part of the EFP transaction. Although the CBOT does not believe it was the Commission's intent, the proposed guidance, as written, could be read to imply that this might not constitute an acceptable practice.

The Exchange does not see any compelling reason for the Commission to address the elements of an exchange of futures for a commodity in Appendix B, especially when the summary nature of such a description (which is generally appropriate for Core Principle guidance) might create ambiguities that do not exist when read in the context of existing Commission pronouncements.

Conclusion

U.S. Designated Contract Markets exist in order to provide open, competitive and efficient markets that promote transparent price discovery, effective risk transfer, and fairness for all market participants. Congress and the Commission have both recognized that there is nevertheless a limited role for trading off these centralized markets. The principles that guide DCMs which choose to adopt rules for block trading, and that guide the Commission in its oversight role, must be designed to ensure that such trading is only permitted to the narrow extent that is necessary to meet a legitimate market need that no competitive marketplace is able to fulfill. Block trading must never be permitted to supplant open, competitive and transparent trading for any product on any particular DCM, because it could compromise accurate price discovery, hedging effectiveness, and

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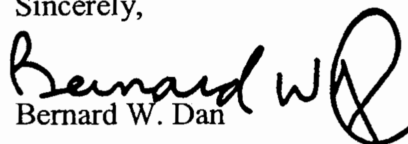
fairness in the centralized market of that DCM, as well as any other DCM that lists similar or related products.

The CBOT appreciates the opportunity to provide comments on the Commission's proposal. If you have any questions regarding these comments, or wish to discuss this matter, please feel free to call Anne Polaski, Assistant General Counsel, at (312) 435-3757.

Sincerely,



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