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November 29, 2004

COMMENT

Via Electronic Mail

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

Re: Regulation 1.38 and Guidance on Core Principle 9

Dear Ms. Webb:

We understand that the comment period for Regulation 1.38 and Guidance on Core Principle 9, initially described in a Federal Register release (the "Wholesale Trading Release") on July 1, 2004 by the Commodity Futures Trading Commission ("CFTC" or the "Commission"), closed effective August 30, 2004. Nonetheless, after that date the Commission has received additional comments on the Wholesale Trading Release. In light of the additional comments, U. S. Futures Exchange, LLC ("Eurex US" or the "Exchange") would like to supplement its original response.[1]

Wholesale Trading - Generally

Wholesale transactions are somewhat of a hybrid between exchange-traded and OTC derivatives. They are transacted off the exchange, but the transactions occur pursuant to exchange rules, are reported to the exchange, and are formally cleared. Such transactions fulfill an integral role within the derivatives marketplace since, under certain circumstances, it is not possible to execute certain large exchange-traded derivative orders, by virtue of their size, at a quality price through the electronic order book or on a trading floor. In contrast, the related OTC derivatives market, while perhaps more accommodating of the size of the transaction, fails to offer the benefits inherent on exchange traded markets, namely the execution and clearing of large transaction under exchange rules. To address this issue, some exchanges permit sophisticated parties[2] to execute certain large transactions by means of pre-trade negotiations in order to minimize the significant price impact of such a large order. This allows appropriate parties to fully transfer large risk positions in one transaction, avoiding the potential of price slippage during its execution that may occur if exposed to the order book or the trading floor.

Inter-Connectedness of Derivatives Markets

The analysis of wholesale transactions should occur within the context of the entire scope of risk management instruments, which commonly includes exchange traded derivatives such as futures and options, wholesale transactions which are a hybrid of exchange-traded derivatives, and over-the-

[1] See letter dated August 30, 2004 from Eurex US to Jean Webb.
[2] At Eurex US, the parties to a wholesale transaction must be Eligible Contract Participants as defined by the Commodity Exchange Act.

counter ("OTC") derivatives. These types of derivatives are substantially inter-related and inextricably intertwined.

One example of inter-connectedness is how the futures and options markets operate in conjunction with each other. Without futures markets, the options on the futures market would not exist. In addition, it is quite possible to duplicate a futures position in the options market

Another example of inter-connectedness is the reliance of the OTC market on, and indeed use of, the regulated futures market for price discovery. For example, numerous OTC bilateral "form" contracts, such as the Master Agreement prepared by the International Swaps and Derivatives Association ("ISDA") provide that the "floating" price in a swap agreement comes from a regulated futures exchange, or a DCM.[3] As stated by Neal Wolkoff, former Chief Operating Officer at the New York Mercantile Exchange ("NYMEX") before the United States Senate:

> "Because the settlements [on the NYMEX] reflect actual trades, and not market sentiment, they are *relied upon heavily* by the energy industry as benchmarks for many physical *and OTC contracts.*"
>
> <u>See:</u> Testimony of Neal L. Wolkoff, Chief Operating Officer at the New York Mercantile Exchange before the United States Senate Committee on Agriculture, Nutrition and Forestry, July 10, 2002 at 2 (emphasis added).

Accordingly, because the OTC market is frequently relying on the futures market for pricing data, it is not unreasonable to conclude that the futures market is the tail wagging the OTC dog. More specifically, we submit that the OTC market utilizes futures' exchanges central order books to price their transactions.[4] This conclusion was supported by the President's Working Group's *Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (2000)("*PWG Report*") which determined that, unlike futures, "prices established in OTC derivatives transactions do not serve a significant price discovery role," *PWG Report at 16.*

In a similar vein, wholesale transactions rely on futures markets for pricing, but they also rely on exchange rules and processes to reduce counterparty trade risk and the legal risks. It is the position of Eurex US that wholesale transactions complement the price discovery function of the futures markets. In fact, permitting wholesale transactions is a recognition that the market occasionally has a need to execute large transactions that cannot be transacted on exchange without significant price slippage. In return, the parties to the wholesale transaction report the size and price of the trade to the futures market. As a direct result of the wholesale transaction, the parties may also find it necessary to hedge their risk using the futures market, adding to exchange volume.

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[3] The 2000 ISDA Supplement utilizes prices from regulated futures exchanges. For example:

> 7.1(a)(xii)(G)(2) "NATURAL GAS – HENRY HUB – NYMEX" means that the price for a Pricing Date will be that day's Specified Price per MMBTU of natural gas on the NYMEX of the Henry Hub Natural Gas Futures Contract for the Delivery Date, stated in U.S. dollars, as made public by the NYMEX on that Pricing Date.

[4] Indeed, in support of this proposition, at least one U.S. futures exchange has sued an OTC platform for use of – and reference to – its prices. <u>See, e.g., New York Mercantile Exchange v. IntercontinentalExchange, Inc.</u> No. 02 CV 9277 (Southern District of New York)(2002).

Wholesale Trading – Eurex US Experience

Currently, Eurex US offers wholesale trading on its US Treasury products. In establishing its wholesale trading rules and processes, the Exchange abides by the requirements of Core Principle 9, to provide a competitive, open, and efficient market and mechanism for executing transactions.

Competition results from the financial risk transferred through the transaction. Furthermore, the pricing of such transactions results from the negotiation of the two competitive, sophisticated parties. It should be noted, as well, that while some may argue that wholesale transactions detract from the price discovery function of exchange-traded contracts, such an argument is contradicted by a recent study by Jana Hranaiova, Michael Haigh and James Overdahl. The study concluded that, based on review of empirical data, "block transactions do not affect price discovery in the centralized market."[5] Moreover, Hranaiova, Haigh and Overdahl conclude that block transaction prices are closely linked to prices in the central market. Id.

Openness or transparency results from the reporting of wholesale transactions to the Exchange. In addition, Eurex US utilizes an algorithm to ensure that wholesale transactions on its platform fall within a certain range of the market, generally not exceeding 0.1 percent of the range of the day's high and low prices. Eurex US Rule 415(g)(i). This rule is in contrast to the more liberal application of wholesale trading pricing ranges at other U.S. futures markets, such as the CME, which uses a more subjective "fair and reasonable" standard. CME Rule 526(D).

Moreover, not only do wholesale trade counterparties benefit from the ability to execute large transactions without price slippage, certain efficiencies are also realized through clearing, which reduces counterparty credit risk, and the fact that such transactions occur pursuant to Exchange rules, which reduces legal risks.

CME and CBOT Offer and Encourage Wholesale Trading

While some of the commentators would have you believe that Eurex US is the only exchange in the United States that offers wholesale trading, the facts bear out a different reality.

The Chicago Mercantile Exchange (CME) features wholesale trading in almost all of the products that it lists and espouses the benefits of wholesale trading on their website as follows:

"Benefits [of a block trade]

- Ease of a privately negotiated trade.
- Convenience of negotiating a trade with a designated and appropriate counter party.
- Offers greatest possible latitude in executing a Eurodollar future or option transaction.
- Security of a trade cleared by the CME® Clearing House.
- Designed to assist institutional trading needs."

See: http://www.cme.com/clr/clring/printerFriendly/tradeprac/blocktrade1413.html

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[5] Jana Hranaiova, Michael Haigh and James Overdahl, "Do Block Trades Harm Markets?" Futures Industry at 29 (May/June 2004).

Furthermore, the CME offers block transactions in different sizes that are comparable to the block sizes offered on Eurex US. For example, Eurodollar futures can be executed as a block trade during the normal business day (7:00 am to 4:00 pm, CST) in amounts of 4,000 contracts or greater in the "front" months, but in 1,000 contracts or greater for "back" month contracts, i.e., years 6-10. Off hours Eurodollar futures can be executed as wholesale transactions in amounts of 500 contracts or greater on CME. T-Bills, another fixed income product, can be executed in a block in 100 contract increments. In addition Russell 1000 and Russell 2000 index futures can be executed on the CME as a block trade in just 50 contract transactions. Id.

The Chicago Board of Trade (CBOT) also provides an off-market facility for the trading of interest rate swap futures. Despite using anti-block trading as a rallying cry in its efforts to raise contributions for its associated political action committee[6], CBOT actually offers and encourages wholesale trading on its homepage as follows:

> "Wholesale transactions offer market participants the convenience of negotiating a large transaction at a single price with a designated and appropriate counterparty, the security of a trade cleared by the CBOT's clearing services provider, the implementation of exchange rules and regulations to insure trade transparency, and alternative means of entry/exit for participation in swap futures."
>
> See: CBOT 10-Year Interest Rate Swap Futures Set New Volume Record, www.cbot.com/cbot/pub/cont_detail/0,3206,1036+14702,00.html (August 29, 2003).

Eurex US points out these facts not to criticize CBOT's and CME's wholesale trading activities. On the contrary, Eurex US applauds their efforts and is pleased that these exchanges have policies on wholesale trading that are similar to those on Eurex US.

Appropriate Minimum Block Amounts

Eurex US is unaware of a universal empirical formula that would determine appropriate minimum wholesale or block trading levels. Generally, Eurex US supports the CFTC's proposed guidance that the acceptable size should "be no smaller than the customary size of large transactions in any relevant markets." Acceptable size, however, also depends on the relevant product or market. This is demonstrated by the differences between the Eurex US Treasury futures and options markets. In connection with Treasury futures, Eurex US has set its levels above the average depth of its market, as reflected in the electronic order book. These levels are commensurate with the proposed Commission guidance principle that the minimum size should be "greater than 90 percent of the trades in a relevant market."

It is incumbent on the Exchange, however, to point out that in connection with options on its Treasury futures, the minimum wholesale trade level is set at an amount that may prove to be somewhat less than 90 percent of the trades in the relevant market.[7] This decision was primarily

[6] The Auction Markets Political Action Committee ("AMPAC"), see, e.g., Letter from C.C. Odom, II to All Member Lessors, Lessees and Clearing Firm Representatives, September 27, 2004 ("Contributions are important in that funds are needed to communicate and educate our legislators. Key issues are fungibility, internalization of orders, crossing of orders, *block trading* and payment for order flow")(emphasis added).

[7] Eurex US' options on Treasury futures markets are nascent and, as a result, the decision process in setting minimum levels has been based strictly on hypothetical, and not actual, experience.

affected by the fact that options transactions, especially option combination trades which can make up close to 50% of the volume on any average day, are considerably more complex than futures trades. Consequently, such trades require greater human intervention, making options markets more conducive to off-exchange trading. Thus, to optimize the options market, it is necessary to promote more off-exchange types of trading, at least until technology can better accommodate such trades on the electronic trading screen.

Summary

Eurex US prefers and encourages that trading in its products occurs in its electronic order book. This is demonstrated by Exchange incentive programs, transactions fees, and the restrictions placed on wholesale transactions. For example, any volume associated with a wholesale transaction in the US Treasury futures products is not considered in the Exchange's market making and revenue sharing programs. High surcharges in addition to the base transaction fee apply to wholesale trades. Furthermore, only ECPs are permitted to perform wholesale trades on Eurex US.

We believe, however, that the financial derivative marketplace is best served by recognizing and supporting the linkages between the various constituencies of the derivatives marketplace, including exchange-traded, wholesale, and OTC derivatives.

We thank the Commission for the opportunity to provide these additional comments. Should you need any help or have any questions, please do not hesitate to contact me at 312.544.1074.

Sincerely,

Satish Nandapurkar
CEO & President

cc: Riva Adriance