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COMMODITY FUTURES TRADING COMMISSION

PUBLIC MEETING ON
CANTOR FINANCIAL FUTURES EXCHANGE

Hearing Room 1000
1155 21st Street, N.W.
Washington, D.C.

Tuesday, August 11, 1998

The above-entitled matter convened,
pursuant to notice, at 2:02 p.m.

BEFORE:

- BROOKSLEY BORN, Chairperson
- BARBARA PEDERSEN HOLUM, Commissioner
- JAMES E. NEWSOME, Commissioner
- DAVID D. SPEARS, Commissioner
- JOHN E. TULL, JR., Commissioner

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P R O C E E D I N G S

CHAIRPERSON BORN: I would like to call this meeting to order.

It is my very great pleasure to welcome James Newsome to the Commission. He was sworn in yesterday as a Commissioner, and for the first time in nine months, the Commission has had a full complement of Commissioners.

Commissioner Newsome received his B.S. degree in food and resource economics from the University of Florida in 1982. He received his M.S. degree in agriculture from Mississippi State University in 1985. He became an instructor of animal science at Mississippi State University after graduation. In 1989, he was appointed Vice President of both the Mississippi Beef Council and the Mississippi Cattlemen's Association. Since 1997, Commissioner Newsome served as Chairman of the Mississippi Agribusiness Council.

We are really delighted to have you with us, Commissioner, and I want to welcome you, not only on my own behalf but on behalf of all the Commissioners.

COMMISSIONER NEWSOME: Thank you.

CHAIRPERSON BORN: This is an open meeting of the Commodity Futures Trading Commission concerning the application of Cantor Financial Futures Exchange, or CFFE, to be designated as a contract market in U.S. Treasury bond, 10-year-note, 5-year-note, and 2-year-note futures contracts.

The Commission has convened today to permit the CFFE and interested members of the public an opportunity to appear before the Commission to provide oral and written statements and to respond to questions from Commissioners. A transcription of the meeting will be entered into the Commission's public file.

The CFFE represents a joint venture between the New York Cotton Exchange, an already designated contract market, and Cantor Fitzgerald, an interdealer broker in the U.S. Treasury securities market. Pursuant to an agreement between the New York Cotton Exchange and Cantor Fitzgerald, the New York Cotton Exchange would provide all of the CFFE's regulatory services, including compliance, surveillance, disciplinary, and arbitration

responsibilities. Cantor Fitzgerald would supply the Exchange with a computerized trading system that would match and execute CFFE trades. All CFFE trades would be cleared and settled by the Commodity Clearing Corporation, which is wholly owned by the New York Cotton Exchange. The CFFE itself would be owned by the New York Cotton Exchange and its members.

The Commission received the CFFE's initial application on January 8, 1998, and the CFFE has supplemented its proposal with subsequent submissions. The Commission published the CFFE's proposal for two separate public comment periods, during which it received a total of 30 comment letters from 26 different commenters. Many of these comments have been thoughtful and of valuable assistance to the Commission staff in considering the CFFE proposal.

The participants in today's meeting represent a cross-section of views that have been expressed in written comments filed with the Commission. We thank each of you for taking the time

to attend this meeting and to share your views with us.

The first person to present an oral statement will be Joseph J. O'Neill, President, Financial Products Division of the Board of Trade of the City of New York, Inc.

MR. YOUNG: As a matter of clarification, I just have two quick questions. First, I'm not clear what the procedures are today and whether it will be appropriate for members of the panels to ask questions of each other at an appropriate time. We never got clarification on that.

And second, I don't know if anyone on the other side intends to use any overheads, but I'm not sure what the overhead would be projected on that would be--I don't know if it's supposed to be projected back there or how we're supposed to handle that, but I just thought, before we started, if you could--

CHAIRPERSON BORN: Let me say that there will be a period after all the oral statements are made during which Commissioners will ask questions. We will inquire as to what the projector will be

projected upon and try to get that question answered by the time it's your turn to speak, Mr. Young.

MR. YOUNG: Thank you.

CHAIRPERSON BORN: Joseph O'Neill?

BOARD OF TRADE OF THE CITY OF NEW YORK, INC.

MR. O'NEILL: Thank you, Madam Chairperson and Commissioners. We thank you for providing us the opportunity to discuss our proposal to establish and operate a marketplace for the electronic trading of futures contracts involving U.S. Treasury securities. The Commission staff throughout the approval process has proven to be professional, hard working, and very good at what they do, judging by the depth and number of questions they have asked.

While our formal submission was submitted to the Commission in January of 1998, we began talking to and working with the Commission immediately after the agreement between the New York Cotton Exchange and Cantor was reached on September 8, 1997.

I'd like to make five points today. First, the process has been thorough and exhaustive and we

believe that all of the questions of the staff have been answered.

Second, the CFFE will bring innovation and competition to the U.S. Treasury futures market.

Third, the system to be utilized by the CFFE is proven to be reliable, efficient, and its ability to ensure a fair and equitable marketplace to all participants.

Fourth, the structure of the Exchange and the extensive technology-based surveillance methods will provide an unprecedented level of oversight in Exchange markets.

And fifth, it is time now for the CFTC to approve the application and encourage innovation and progress in U.S. markets.

Dialogue with senior staff in the Division of Trading Markets began in September of 1997, and by November 5, 1997, the first draft of Cantor Financial Futures Exchange, Inc.'s bylaws and rules were submitted to the CFTC. During November 1997 and December 1997, the staff discussed the project with us and raised certain questions which were responded to orally and which resulted in a letter on December

12, 1997, from the Commission comprising 84 questions and subparts. On January 6, 1998, the Exchange answered the CFTC's questions, along with providing exhibits.

Notice of CFFE's application was published in the Federal Register on February 3, 1998, for an initial comment period scheduled to end April 6, 1998. That comment period was later extended to April 27, 1998.

Daily dialogue continued with senior staff, resulting in numerous trips to Washington and visits by the CFTC staff to New York, where they were able to review the system in operation on several occasions.

Then on April 7, amendments to the bylaws and rules were submitted. On May 6, 1998, we received an additional 112 questions from the CFTC. By May 21, 1998, responses to all of the questions were submitted. Another letter was received from the Commission on June 11, 1998, consisting of 37 questions and subparts. On June 18, 1998, responses were submitted to the 37 questions and subparts, along with numerous exhibits, including revised

bylaws, associate membership applications, terminal operator agreements, and risk disclosure statements.

After the Exchange submitted the additional materials requested by staff, the Commission announced in the Federal Register that the CFFE application would have a second public comment period beginning July 1, 1998, and ending July 16, 1998.

As a result of the ongoing dialogue and review, we sent another letter to the Commission on August 4, 1998. This letter responded to the outstanding issues raised by the staff.

The review process has been thorough and complete. The staff has been diligent and focused. It is now time for the Commission to approve the application.

CFFE is a joint venture owned by the New York Board of Trade and its members, which combines the strength of two outstanding financial institutions, the New York Cotton Exchange, now a part of the New York Board of Trade as a result of a merger with the Coffee and Sugar Exchange, and Cantor Fitzgerald.

The New York Cotton Exchange has a long history. It was founded in 1870. Its 128 years of existence establishes it as the second-oldest futures exchange in the United States. An exchange stays in existence for 128 years because it provides a fair and equitable marketplace and it keeps pace with the ever-changing marketplace.

The Exchange has an outstanding record of developing new products. The Exchange's formula for success has been to empower representatives of the industry involved in a new product. The practice began in 1933 with the establishment of the Wool Associates and has continued with the creation of the Citrus Associations, FINEX, NYFE, FINEX Europe, and now CFFE.

Cantor, which was established over 50 years ago as an innovative participant in the world's capital markets, is the largest interdealer broker of cash U.S. securities. It was the first to put tradable prices on the screens, which it did in 1972. Cantor introduced a proprietary speedy distribution system to deliver tradable real-time prices to customers in 1986. It introduced CFTS system to the

cash Treasury in 1996, ushering in the era of electronic trading in the U.S.

Average daily volume at Cantor is about \$50 billion. On October 27, 1997, the system comfortably handled almost \$125 billion. The trading system is designed to handle 100 transactions per second.

Now, how do we divide up the responsibilities? The Exchange assumes total responsibility for the regulatory, supervisory, surveillance, clearing, and administrative functions. The CFFE board and Cantor have no oversight as to disciplinary or clearing.

Cantor's role and primary responsibility will be for contract design, marketing, trading systems, and have sole responsibility for providing the personnel to operate the interactive matching system that makes up the Exchange.

The Exchange's submission is innovative. When approved, it will be the first full-time electronic futures exchange in the United States. It will bring efficiency and improved price discovery, lower costs, and will be a quantum leap forward in surveillance and audit capabilities. We believe that

this eventually will lead to lower funding costs and improved market efficiencies.

While the submission in aggregate is exciting and innovative, it is merely the combination of three tried, true, and tested components: An established and respected exchange, a successful contract, and a proven trading system.

The Exchange will feature an innovative electronic matching algorithm which has been used in the cash market since 1996, which has been explained in detail in a submission to the Commission and reviewed extensively by the staff. The purpose of this process should not be to debate the merits of one market system versus another, but rather to ensure that the new and innovative system is fair, anonymous, and equitable for all market participants, that the public is protected in its utilization of the system.

I would hasten to point out that the single-price auction system on which CFFE is based is the fairest and most efficient system in the market today. The CFFE ensures that every trade through the system is visible to the market at all times. That

means that every customer, every market participant, and every regulator knows where the market is at all times. Because of its technology base, the CFFE provides the highest level of surveillance and scrutiny available in a marketplace today.

The compliance and audit functions will be carried out by experienced professionals who will be on site. They will be able to review each step of a trade, from the moment that a TO, terminal operator, picks up a phone, through order entry, trade matching, checkout, and clearing via tape recorded conversations, computer analysis, and a log which captures each keystroke from the TO. Finally, the system will be operated by terminal operators who will be registered with the NFA and are under the jurisdiction of both the Exchange and the CFTC.

As the Commission is aware, we have been in constant dialogue with the Chairperson, Commissioners, and staff concerning this project since September of 1997. We believe we have fully answered all questions raised by the staff. We believe this application has received the most scrutiny of a contract market in the history of the

CFTC, as evidenced by the fact that there have been 99 days of public comment, and in the Commission's 23-year history, this is the first meeting of this nature ever to be held.

The Chicago Board of Trade and Amex both have a proposed or an actual system which is competitive to what we are trying to do. Chicago Board of Trade, feeling threatened by the competition, has thrown every obstacle possible in our path to delay or prevent our Exchange from entering into a competitive marketplace.

We demonstrated to the Commission that all safeguards, regulatory steps have been taken to ensure a fair and equitable marketplace. Now, let us let the users decide. Accordingly, approval should be granted at this time without any further delay. Thank you very much.

CHAIRPERSON BORN: Thank you very much, Mr. O'Neill.

Our next speaker will be Peter F. Karpen, Managing Member of Diversified Investment Management, L.L.C. Mr. Karpen?

DIVERSIFIED INVESTMENT MANAGEMENT, L.L.C.

MR. KARPEN: Good afternoon and thank you for permitting me time to comment on the CFFE's contract application, at least from the perspective of an end user. It is especially pleasing to see Commissioners Tull and Holum again, to meet Chairperson Born and Commissioner Spears and also to congratulate Commissioner Newsome on his recent appointment.

It may be helpful to begin with a description of my background, which encompasses many vantage points of the futures industry. As the Chairperson pointed out, my name is Peter Karpen and I am currently managing member of Diversified Investment Management, which is a registered commodity pool operator in Connecticut, and also the general partner of Diversified Capital Investment Fund.

After receiving an MBA in 1975, I began my professional career as a runner and phone clerk on the CBOT and also the CME. Thereafter, I became a member of both Exchanges, President of a New York-based broker-dealer's FCM, and managing director of a

large CTA. During this time, I served on two CFTC advisory committees, many Chicago Exchange committees, and on the boards of the Futures Industry Association and the Futures Industry Institute. I was elected Chairman of the FIA in 1994 and served during the bearings crisis in 1995.

I have testified before both houses of Congress, provided comments before the Brady Commission, and as Chairman of the FIA, helped coordinate the industry's global task force on market integrity following the bearings event. Currently, I am a public director of the New York Board of Trade and an arbitrator for the NFA.

My comments are brief and focus on three areas: Customer protection, customer benefits, and market competition. As you will hear, the CFFE offers substantial improvements in the manner that business is presently conducted. I'd like to begin with customer protection.

As we know, contract markets must provide end users with efficient regulatory market and financial environments. Broadly speaking, this means that customers should be protected from fraud and

abuse, treated equally, and ensured that trading and clearing mechanisms are financially sound, especially when market and credit risk events occur.

The CFFE, as proposed, meets these standards. First and perhaps foremost, it will be a regulated entity, falling under the auspices of the CFTC, NFA, and New York Cotton Exchange and subject to their respective rules and regulations.

Second, using Cantor's time tested trading algorithms and electronic trading platform, the CFFE will provide an accurate and verifiable audit trail for its entire trading session. Time and sales reports will become more reliable and front running discouraged.

Third, equal and fair access to the markets will be maintained through price and time priorities. Liquidity providers will be rewarded with momentary exclusivity.

Fourth, market and credit events that place clearing houses, intermediaries, and end users at risk will become more manageable. The CFFE will be able to identify, assess, and isolate net market exposure in a timely fashion. Thus, risk management

information will be more readily available to assist regulators, clearinghouses, intermediaries, and end users during market emergencies.

There are also many benefits for customers. The CFFE will provide many positive attributes. First, in no particular order, and certainly not inclusive, the CFFE will provide greater anonymity for customers. For example, their respective clearing firms will not be revealed to the market throughout the entire trading and clearing process.

Second, prices and quantities traded will be displayed instantaneously and at the price that clears the market at that time.

Third, the CFFE trading system is designed to lower transaction costs by reducing the chain of the order flow and by charging only the aggressor.

Fourth, trade differences will quickly surface, allowing out-trades to be resolved with minimal dislocation.

And fifth, price risk takers, which Cantor refers to as aggressors, will have priority.

Finally, the last point I'd like to mention has to do with market competition. One major benefit

for end users from the CFFE's contract application submission has been the quick reaction by its more established competitors to consider changing the way they do business. Market participants who have been clamoring for years for exchanges to reduce transaction costs, improve audit trails, manage members' capital more efficiently, and lower their operating expenses are now seeing these concerns addressed.

For example, the CBOT plans to put before its membership a proposal to trade interest rate contracts electronically during regular open outcry trading hours. If approved and trading migrates to the electronic platform, a large percent of the CBOT's overall volume will finally have an accurate and verifiable audit trail.

The point is that competition, both here and abroad, encourages exchanges to develop new and more efficient ways to do business. This interaction ultimately improves the regulatory and financial integrity of the marketplace. It is imperative to the overall health of the futures industry that the

Commission endorses this type of competition. Thank you for your time.

CHAIRPERSON BORN: Thank you, Mr. Karpen.

Our next speaker is Bruce Weber, Assistant Professor of Information Systems at the Leonard N. Stern School of Business at New York University. Mr. Weber?

NEW YORK UNIVERSITY

LEONARD N. STERN SCHOOL OF BUSINESS

MR. WEBER: Thank you, Chairperson Born. I am a professor at New York University's Stern School of Business. I have been a business school faculty member at NYU since 1992 and have also taught at the Wharton School and the London Business School. My teaching includes courses on financial information systems as well as market structure and trading courses for MBA and executive students.

My comments today will be brief. I've focused pretty much on the market structure and the trading mechanism that is part of the Cantor Financial Futures Exchange and have studied it fairly close and wrote a paper on it that was submitted early in the comment period which summarizes my

views. It's a 20-page paper, so I won't go into all of the detail that's presented there. But what I want to do is explain why I'm excited about the application that the CFFE has put into the Commission and give you some sense of the benefits that I see arising out of it.

First of all, the market structure that they're describing, I think, takes very good advantage of the computer technology that's available today. The market structures that you see in many exchanges today developed historically at a period of time when technology was not as advanced as it is today, either the telecommunications technology or the communication technology. Today, we can exploit the power of the computer to provide, in some cases, trading mechanisms that are more advantageous for participants than prior market structures built before computer technology was at the state it is today.

The point I'd like to emphasize is that the Treasury futures market is a very competitive market with very sophisticated participants. My sense is that they should be left to decide which trading

mechanism benefits them. I have data that indicate there's about \$200 billion that trades a day in the cash market for Treasuries and about a third that trades as futures contracts. The participants, therefore, are trading very large sizes, and having an additional choice of trading mechanism, I think, will benefit the market.

We teach our MBA students that in a competitive market, what you want to do is differentiate your product. The CFFE has a differentiated trading mechanism. Its trading rules are different than those that exist on established exchanges, and in spite of that, it's a proven technique from the cash market. So I think they're offering a different trading mechanism with slightly different rules, but I believe the end users will benefit from these differences and that they've designed the trading rules and the technology around those trading rules to benefit the final end users of their system.

The principle that their trading system is built around is to reward the participant who comes into the CFFE first with the best bid or the best

offer. So what they're really offering is a mechanism for rewarding the participant that comes in and shows a better price than exists prior to their showing up in the market. By rewarding these liquidity providers, I think they will contribute to market quality in the Treasury futures market in a way that will be very beneficial to market quality and to participants in the market.

I think that the Commission ought to proceed with the approval of the application and I'm quite confident that the market will benefit from the competition that the CFFE will bring to trading in Treasury futures contracts and I think it should do a good job of exploiting the computer technology that is available today to improve the quality of this market.

CHAIRPERSON BORN: Thank you very much, Mr. Weber.

Our next speaker is going to be David Yeres, who is a partner at the law firm of Rogers and Wells and is appearing on behalf of the American Stock Exchange. Mr. Yeres?

AMERICAN STOCK EXCHANGE

MR. YERES: Thank you, Chairperson Born.

I'm here today on behalf of the American Stock Exchange, or Amex, as it's known, to comment on this joint venture between certain affiliates of Cantor Fitzgerald, L.P, who I'll call the Cantor Group, and the Cotton Exchange. The application that has been submitted by this joint venture through the new entity, called the Cantor Fitzgerald Futures Exchange, which I'll call the Cantor Exchange, is a novel one and Amex is very grateful for the opportunity to present the Commission with its views.

With your permission, we ask that the prepared text of this statement, as well as Amex's April 3 and July 15, 1998, comment letters be made a part of the record of this meeting. I will depart from the text of the statement.

CHAIRPERSON BORN: Have you provided that to the secretary, Mr. Yeres?

MR. YERES: Yes, we have.

CHAIRPERSON BORN: Thank you.

MR. YERES: Let me begin with the obvious point. Why is the Amex here today? The Amex, as you

may know, is a national securities exchange registered by the Securities and Exchange Commission. In its securities market activities, Amex has been involved in a number of innovative products. It is the primary market for listed equity securities as well as a market for equity options, equity index options, and equity derivatives. Amex has been the nation's foremost innovator in structured derivative securities and index share securities.

But more to the point, Amex has a wholly-owned subsidiary, which is called the Amex Commodities Corporation, or ACC. That subsidiary was designated by this Commission as a contract market in U.S. Treasury securities in 1989. That designation has not, as yet, been utilized. However, the ACC is now in the process of developing a fully electronic marketplace for U.S. Treasury securities. Consequently, Amex is keenly aware of and interested in any action by the Commission that may affect or will potentially affect the marketplace.

Amex strongly supports the goals of permitting innovative futures markets to compete freely and fairly with traditional pit trading

markets. Furthermore, Amex supports the objective of prompt regulatory review and action on meritorious proposals.

In that respect, Amex commends the Commission for its openness to innovative market mechanisms as well as for the speed with which it has addressed novel issues, as reflected by its handling of this very application to date.

Amex's support for the Commission's process does not, however, extend to the merits of the application itself. Amex's principal point in this regard is that the Cantor Group is, in the structure of this new market, seeking to sidestep important regulatory accountability for its central role.

Amex believes that it is unnecessary and inappropriate to sacrifice these accountability safeguards which are contained in the Commodity Exchange Act in order to pursue innovation. To the contrary, Amex maintains that market innovation and these various CEA protections may and should go hand in hand without compromising core standards.

At its heart, the Cantor Exchange does not truly propose an innovative trading system, we

believe. The proposed telephone order delivery, manual order handling, electronic order matching systems have been available for many years in securities markets. The true innovation of the Cantor Exchange is not the trading system. It is the ownership structure that insulates the Cantor Group for responsibility for its actions or inactions in operating what amounts to a proprietary market.

Amex believes that for this and other reasons that I will mention, the application does not meet the CEA standards for approval. In any event, the application is materially incomplete and should, we submit, be completed and put out for comment once again before contract market designation is reconsidered.

Turning to the application itself, which includes several filings by the Exchange, including one as recently as last Wednesday or Thursday, I believe, it's clear that the nominal contract market, the Cantor Exchange that will be owned by the Cotton Exchange and its members, is a virtual shell and that it lacks the traditional attributes of a futures

market. Rather, it is the Cantor Group that is at the heart of the proposed market.

According to the Cantor Exchange filings, one of the Cantor Group companies, Cantor Fitzgerald Securities, or Cantor Securities, acting through its employee terminal operators, will be the exclusive access provider to the proposed market. It is Cantor Securities that will select and hire, promote and supervise and compensate these terminal operators who will handle all order flow to the new exchange.

The very same company will operate and control the computerized trade matching system. Real-time order and trade data appears also to be owned and controlled and distributed by the Cantor Group, although I must admit the Cantor Exchange filings are unclear on this point and we would suggest that it be appropriate for clarification to be obtained by the Commission.

Finally, another Cantor Group company, CFFE L.L.C., will appoint a majority of the Cantor Exchange board.

Accordingly, the Cantor Group is not a simple service provider. Rather, it so completely

controls market access, market information, order handling, systems personnel, and corporate governance that it is more of an owner-operator of a proprietary trading system. Neither or none of the key Cantor Group companies, however, would be designated as a contract market, since they are not seeking to be designated, nor registered under the Commodity Exchange Act in any capacity whatsoever.

Furthermore, as we understand the application, none of these companies would be members subject to the jurisdiction of either the Cantor Exchange or the Cotton Exchange.

The application and the filings do require a registration, and as you are no doubt aware, that is the registration of the terminal operators who are proposed to be registered as floor brokers. While this is a step in the right direction, it is patently not enough, because the terminal operators are merely functionaries, employees employed by the Cantor Group, Cantor Securities. As mentioned before, they will be hired, compensated, et cetera, by Cantor.

Thus, under the application, the terminal operators are being treated, we believe, in a manner

that is incorrect, as though they were independent agents and not, in fact, what they are, which is employees and agents of Cantor Securities. By doing this and by not registering Cantor Securities under the Act, the application creates a regulatory blind spot where neither the Commission nor the Exchange, or either of the Exchanges, has jurisdiction, and that is over the Cantor entities that will control the market and particularly employ the terminal operators.

This need not be, and it would not take significant restructuring or reapplication to change this. The Commission already has a well-established statutory basis to require registration of Cantor Securities and that is Section 1 of the Commodity Exchange Act, which defines an introducing broker. An introducing broker, as you are all aware, is defined as a person who solicits and accepts orders for futures trades without holding margin or other cash deposits.

If we think about the Cantor filing, and I believe the Cantor product as it has been described this morning, that is exactly what the terminal

operators will be doing, and as employees of the Cantor Security Company, the appropriate registration would be that of introducing broker.

If that were to occur, if this Commission were to require that, Cantor, which is already registered through Cantor Securities in the securities markets, would merely register with this Commission under this regulatory scheme, which we think is wholly appropriate, since the Cantor Group is now entering your domain and jurisdiction in the commodity futures area.

Registration is significant, as this Commission well knows. Courts have often called registration the kingpin of the CEA regulatory machinery. This Commission has been, if anything, vigilant about prosecuting failures to register, and only by getting a registration from the Cantor Securities Group can this Commission be assured that it will have the right to suspend or revoke that registration, obtain by regulation information about management, or other continuing information.

But perhaps the most important point is, without that registration of the Cantor Securities

Company, it will be free from the duty to supervise. The duty to supervise, which was imposed by this Commission in 1978 as a key customer protection, applies to all Commission registrants. Any futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator registered with this Commission will have the duty to supervise those who are employed. That is the duty that must fall, we believe, most appropriately, on Cantor Securities in respect to the terminal operators who it will, again, hire, supervise, compensate, et cetera.

While perhaps supervisory obligations might be unnecessary in a fully electronic market where there was no significant human intervention, that is not the case here. It is clear that the Cantor proposal involves significant human intervention on the part of the terminal operators. These terminal operators will be operating on the private premises of Cantor. They will not be in public view. They will not be operating in an open outcry trading pit in which their competitor brokers might be inclined to point out violations. They will not be subject to

any kind of pit supervisory committee and they will not be subject to competition from other brokers, since the Cantor Group is the sole access provider to the Cantor market.

For these reasons, there is good reason to require a duty to supervise, and the only way we think that can be fully accomplished would be through registration of Cantor Securities as an introducing broker.

There are a variety of other issues that arise in connection with this application. I would like to touch on just a few of them. And in each of these cases, I am merely suggesting that the application leaves open a question which Amex believes to be an important question on which clarity, we believe or submit, should be had by the Commission before it reaches a conclusion on this application.

First, the August 4 filing by Cantor, which I referenced earlier in my discussion, includes a new provision, and that provision is Rule 301-A, which says that the terminal operators, who I mentioned just a few moments ago, will, for purposes of the

Cantor rules, be treated not as the agents of their employer, Cantor Securities, but rather as the agents of the Cantor Exchange.

That is a quite ambiguous statement. One reading of that statement is that under the rules as approved by this Commission, if it should so approve them, the employer of these terminal operators would not be liable as employer under a vicarious liability where respondeat superior theory, as set forth in the CFTC's core statute, the Commission Exchange Act. We believe that clarification should be had on this point in the rules, and if, in fact, there is any doubt that these employee terminal operators will be agents of Cantor Securities for purposes of vicarious liability, the record should be open for additional comments on that point.

Another fundamental point left unclear is how the Cantor Exchange reconciles two facts that appear in their filings. The first, that the terminal operators will be permitted to solicit orders and market for the Exchange, and the other, also in the filings, that the terminal operators will not be permitted to give advice.

Clarification, we believe, is necessary on this, because normally, we would expect that the act of soliciting and marketing necessarily compromises the act of giving advice. If there is some clear distinction that is going to be made concerning the terminal operator's ability to give advice, market, or solicit, we think it should be clear on the record, and again, provide the possibility of public comment.

The Commission completed just in the last two weeks a rule enforcement review in respect to the Cotton Exchange, which, as you recollect, is obligated to provide the enforcement and compliance functions of the new Exchange. That review, as you know, stated that the Cotton Exchange presently has, and I quote, "a diminished ability to perform its self-regulatory responsibilities." It says that this is caused by the loss of a number of compliance staff investigators. The review recommends that the Cotton Exchange come back within 60 days with a report that explains how it will beef up its staff.

Even if the Cotton Exchange was a very well-staffed compliance and surveillance group,

taking on a new market in a new contract, using a new trading method, supervising terminal operators who are going to trade both securities and futures markets at the same time would be a formidable task. We believe that the Commission should await the report from the Cotton Exchange as to how it will beef up its compliance staff before it considers this application for designation.

Insider trading is a concept that doesn't normally apply in futures. However, from time to time, people talk about insider trading when they really mean self-dealing, that is, providing information or trading on information of a customer.

The Cantor Exchange is going to utilize terminal operators to get the entire flow of orders. Those terminal operators, therefore, will be the single greatest reservoir of potential insider information. The Cantor Exchange has set up what we think is a very rational scheme to deal with that, that is, to create a firewall and those terminal operators are not permitted to pass information about customer orders over the firewall.

The rule is good, but the question is how will it be policed? The Cantor Group, which is diagrammed on one of the exhibits to the Cantor August 4 submission and which was attached to my prepared statement, looks like it includes about two dozen companies with a variety of relationships, many of those companies being partnerships, no doubt having multiple partners.

Amex believes that the policing of this wall is critical and that if the Commission wishes to go forward on this application, it would be well served if it received from the Exchange a plan in advance as to how it intended to police this Chinese wall and what resources it had to police these Chinese walls.

There are a variety of other points that are raised in the prepared statement, but I realize I have utilized essentially all of my time and I appreciate your indulgence. I will bring this to a close.

Amex and other commentators have identified numerous deficiencies, we believe, with the proposed Cantor Exchange. These go beyond those that I have

described here today. A variety of commentators have also identified numerous unanswered questions regarding the Exchange.

In Amex's view, the known deficiencies, coupled with significant unknowns, warrant rejection of the application, or at least a finding that is materially incomplete at this time and a request for Cantor to provide additional information.

Thank you again for your indulgence and your attention and the Amex and myself are available to answer any questions you may have.

CHAIRPERSON BORN: Thank you very much, Mr. Yeres.

The next speaker will be Mark Young, a partner at the law firm of Kirkland and Ellis, who is appearing on behalf of the Chicago Board of Trade and I think now is the time to make the screen available. It hadn't been made available up until now because of the need to disrupt the audience.

MR. YOUNG: I apologize. I didn't mean to disrupt the audience.

CHAIRPERSON BORN: Let me say that the people who are having to move could bring their

chairs and sit up here in front so they can watch the projection.

MR. YOUNG: These transparencies are going to be a huge disappointment to this crowd after all this.

[Laughter.]

MR. YOUNG: First, I'd like to apologize, Chairperson Born, to all of the members of the audience who have had to relocate as a result of this.

CHAIRPERSON BORN: Well, I think that--hang on just a minute. Why don't we bring some of the chairs up here in front so that the people who have been dispossessed can see this.

Without objection, we will take a ten-minute recess to reconnoiter.

[Recess.]

CHAIRPERSON BORN: I ask that everyone please come to order and resume their seats. Would anyone who is not going to resume their seats please go out into the hall, because we are going to resume.

Mr. Young, please proceed.

CHICAGO BOARD OF TRADE

MR. YOUNG: Thank you very much. Just in case anybody forgets, my name is Mark Young. I'm a partner in the law firm of Kirkland and Ellis. I'm here today representing the Chicago Board of Trade.

I want to thank the Commission for providing us and others with this forum today. It's not exactly what we asked for in petitioning the Commission a few weeks ago, but we're hoping that through this hearing and this process, better understanding will come about of this application and perhaps we can start talking from a common set of operative facts about the issues relating to this application.

Before I begin, I want to make it clear, and just to create a bridge to what was said before the break, I want to make it clear that the Chicago Board of Trade is in favor of customer protection. The Chicago Board of Trade is in favor of customer benefits. The Chicago Board of Trade is in favor of market innovation. And the Chicago Board of Trade is in favor of fair competition, and fair competition, as this Commission knows well, is something the

Commission and the Board of Trade have talked about for a long time.

Our Chairman, Pat Arbor, frequently testifies before Congress on the issue of fair competition and talks about issues relating to regulatory parity. The interest of the Board of Trade is to make sure that all markets compete by the same rules and that's why we're here today. The issue today is whether the Cantor Exchange complies in all pertinent respects with the applicable laws.

Now, on May 6, the CFTC staff sent a letter to the New York Cotton Exchange and the Cantor Exchange indicating that as a result of the comments received, substantial substantive issues had been raised about the Cantor Exchange application.

Today, we'd like to focus on five of those substantial substantive issues in the time allotted and we have prepared both a copy of the issues presented as well as a summary of the Board of Trade's position on those issues to the Commission for inclusion in the record. I understand that that material has been provided to the Secretariat and will be made a part of the record of this hearing.

While we've identified five issues, I think it's fair to point out that each of these issues flows in large part from the Cantor Exchange's being a proprietary exchange, and by proprietary exchange, we mean an exchange controlled by a proprietary firm, the Cantor Fitzgerald firm.

The first issue reflects that point very well. The issue is, if a firm is a proven wrongdoer and admittedly committed a disciplinary offense as defined in CFTC Rule 1.63, would it be contrary to the public interest or CFTC Rule 1.63 to allow that firm to control an exchange by appointing eight out of 13 members of the Exchange's board of directors?

In the early years of this decade, the Congress looked at the issue of the qualification and fitness of members sitting on exchange boards. At the same time, the CFTC looked at that issue. The result of the Congressional review was a statutory provision. The result of the CFTC's review is Rule 1.63. It says simply that you can't serve on an exchange board if you've been the subject of a disciplinary offense within three years.

The Cantor Fitzgerald firm was disciplined by the CFTC last year for aiding and abetting fraud. We believe allowing that firm to control an exchange, at a minimum, evidences the very appearance of impropriety that caused the Congress to adopt its statutory provision and the CFTC to adopt Rule 1.63.

To date, we've heard nothing in response to this from either the Commission or the Cantor Exchange. Some explanation is necessary, because if it's sound policy to allow a proven wrongdoer to control an exchange, then why is it sound policy to require a member of an exchange who has committed a victimless bookkeeping violation not to sit on an exchange disciplinary committee or even on an exchange's board?

To approve this application, the Commission must find that it would not be contrary to the public interest or CFTC Rule 1.63 for the Cantor firm to control the Exchange by appointing eight of 13 members of the board of directors.

The second issue relates directly to competition. Is it contrary to the public interest, including the public interest to be protected by the

antitrust laws, for an exchange to bar all floor brokers except the employees of a single firm from acting as floor brokers on the exchange?

That's exactly what the Cantor Exchange is all about. The Cantor Exchange has contracted with the Cantor firm to provide floor brokerage. The only floor brokers on the Exchange are terminal operators. They are employees of the Cantor firm.

We believe that providing that kind of monopoly on floor brokers is a violation of Section 15 of the Commodity Exchange Act. Our belief is based in Commission precedent. Last year, the Commission denied a Board of Trade proposal that would have restricted competition, in the Commission's view, by reducing from seven to four the number of firms that could issue stripping certificates. I believe we talked about that issue in this very room only a short time ago.

Now, we have a proposal in front of the Commission that would say to the over 1,000 floor brokers on the Cotton Exchange and the Coffee, Sugar, Cocoa Exchange, you cannot become a floor broker on the Cantor Exchange. The only people eligible to

become floor brokers in the Cantor Exchange are employees of Cantor Fitzgerald. That kind of exclusive, that kind of monopoly is not compatible with the public interest to be served by the antitrust laws and should be rejected by the Commission.

The third issue also relates to competition. Is it contrary to the public interest, including the public interest to be protected by the antitrust laws, for a new exchange to set floor brokerage commission rates on the exchange, called transaction fees, when the antitrust laws bar all other exchanges from setting even indirectly brokerage commissions?

Now, there's some history behind this issue. Years ago, exchanges used to set or fix commission rates. The Justice Department objected, filed suit, and obtained a settlement decree from the various exchanges, including the Chicago Board of Trade. As a result today, the Chicago Board of Trade cannot set even indirectly brokerage commission rates, and yet under this proposed application, the Cantor Exchange, by setting a transaction fee, which

is one of the forms of compensation for the Cantor firm, would be establishing the brokerage commission rate.

Again, that flows today out of the floor brokerage monopoly Cantor has been provided, but it would be impermissible for the Chicago Board of Trade or the New York Cotton Exchange to say to its members in any of its pits, the floor brokerage for transactions in this pit will be X or Y or Z. Those exchanges can't do it under the antitrust laws. The Cantor Exchange also should not be able to do it.

Issue four runs to the part of self-regulation under the Commodity Exchange Act. Does it violate sections 4(a) and 5(6) of the Act for an exchange to propose that none of the transactions on its new contract market would, and I'm quoting, "be executed or consummated by a member of such contract market," thereby circumventing the Commodity Exchange Act's self-regulatory framework?

As far as we know today, transactions will be executed or consummated on the Cantor Exchange by terminal operators. Those terminal operators are not members of a contract market. As a result, the self-

regulatory protections that are in place for contract markets will not be extended to this floor brokerage activity. By violating this particular provision, it cannot be said, as is required by Section 5(6), that the Cantor Exchange provides for compliance in all respects with the requirements applicable to a board of trade under the Act.

Issue number five relates to open and competitive trade. Is it contrary to the public interest and the open and competitive execution requirement of CFTC Rule 1.38 for a contract market to be designed to allow traders to execute transactions even if a bid or offer superior to such trader's bid or offer would otherwise be available.

CFFE Rule 303(b)(1) allows for trades to be executed even if a bid or offer superior to such trader's bid or offer would otherwise be available. It expressly allows that there are times during the trading process on the Cantor Exchange when an inferior price will be available. We do not believe that is consistent with customer protection. We do not believe that is consistent with customer benefits. We do not believe it is consistent with

the open and competitive requirements of Rule 1.38. We do believe that that rule and its exclusive time provision is designed to facilitate block trading, an issue that the Commission has gambled in a concept release that is currently out for public comment.

We believe this aspect of the Cantor proposal should be folded into the Commission's consideration of the block trading issue across the board. To do otherwise would be to repeat what the Commission did in the foreign terminal area, and I know that Director Greenberger a few weeks ago spoke at an Advisory Committee meeting and explained that a piecemeal approach to that issue was an unfortunate misstep by the Commission. We think approving this aspect of this proposal when you have the block trading issue otherwise teed up for an across-the-board resolution would also be a serious misstep.

Now, on these five issues, each of them combined, or take them independently, we believe are a basis for the Commission to determine, as our colleagues from the Amex concluded, that the application is materially incomplete, or, in our

view, that the application, unless changed, should be denied and urge the Commission to do so.

There is a sixth issue that has already been alluded to by others, but it is a critical issue and we would like the Commission to focus on it. The issue is, would allowing a new exchange to engage in routine and noncompetitive trading practices for U.S. Treasury security futures contracts that are largely identical to contracts already competitively traded on a liquid basis on another exchange cause pricing distortions, market illiquidity, wider bid-ask spreads, inefficient hedging, and increased cost to the Treasury and taxpayers for financing U.S. debt?

You're lucky. I'm not going to address that question. But a few months ago, the Board of Trade asked an acknowledged expert in the area of markets to look at the issue of noncompetitive trading and alternative trading structures. Dr. Mendelson will speak to you about this issue and others that he has analyzed in the context of a study he is doing in relation to the Commission's block trading and noncompetitive rule proposal. That study will be submitted for comment when the comment period

closes, and I understand that is going to be September 1.

In conducting his analysis, Dr. Mendelson came across the Cantor Exchange, and in the context of looking at the Cantor Exchange application, its market structure, its practices, he formed a series of preliminary conclusions that he would like to share with you today.

If you don't mind, Chairperson Born, at this time, I'd like to turn this over to Dr. Mendelson.

CHAIRPERSON BORN: Thank you very much, Mr. Young.

Let me next call on for a statement Haim Mendelson, who is affiliated with the Graduate School of Business at Stanford University.

STANFORD UNIVERSITY

GRADUATE SCHOOL OF BUSINESS

DR. MENDELSON: Thank you, Chairperson Born. My name is Haim Mendelson. I am a professor at the Stanford Business School. I've been teaching at the Stanford Business School for approximately ten years. In the preceding ten years, I've been

assistant professor, associate professor, and full professor at the University of Rochester at the Graduate School of Business.

During these 20 years, I have studied the financial markets, the impact of liquidity on asset returns, the impact of liquidity on the yields on U.S. Treasury securities, and the impact of automation on the liquidity of markets, and the basis for my comments would be some of the work I have done during those 20 years.

In January of this year, the Commission has issued the concept release as part of a comprehensive reevaluation of the regulation of noncompetitive transactions. One of the central aspects of that release is thinking about the framework for regulating block trading in the futures markets, and a Professor Amahoud [ph.] of New York University and myself are working on a report that will be submitted as part of the comment before the end of the comment period for that concept release that studies this issue. As it turns out, that report relates very much to the issues we are looking at today.

The issue of block trading in trading markets is an issue that many markets have been grappling with over a long period of time. The problem is how to balance two competing interests. On the one hand, we have the desire to keep an open and competitive market which is not fragmented. On the other hand, we have the desire to facilitate the execution of block trades.

On the one side of the issue, the open and competitive markets mean that the entire order flow on one side of the market interacts with the entire order flow on the other side of the market. That improves liquidity, improves price discovery, and creates better prices.

What this means, if we interpret it strictly, is that large blocks should interact and compete with the entire order flow without getting any special treatment. This can be done and is sometimes done either manually, by bringing a block down to the floor for an exchange, or electronically, by bringing the block into an order book. Under this approach, and if we accept it strictly, the entire order flow participates in the execution and no

orders are excluded from that execution to benefit the trading of large blocks.

There is another side to the issue and that side has to do with the interests of the parties that trade those large blocks. If, for example, we have two institutions that want to trade a large block with each other, we have two consenting adults on both sides of the trade. They know what they want. They want to do it and they want to exclude everybody else from that exchange and it's very difficult to say no under those circumstances. It's almost impossible to say no if they can go ahead and do it on some other market, because then they want to do it, they have the ability to do it, so they are going to do it.

Different trading markets resolve this problem in different ways. One extreme is represented by the cash market for U.S. Treasury securities, whose procedures are, in fact, the procedures that are implemented with some variations, minor variations, on the Cantor Exchange. The cash market for U.S. Treasury securities is among the least regulated markets in the world. It has very

few rules and traders can basically do anything they want on that market. So that's one extreme.

The other extreme is represented by commodities exchanges like the Chicago Board of Trade, who want to fully preserve the quality of their markets. On the Board of Trade, open and competitive markets is taken very literally and it means that all trades have to be brought down to the Exchange and they have to compete with the entire order flow.

Most trading markets in the world are positioned somewhere in between these two extremes. Typically, they are much closer to the Board of Trade than they are to the cash market in U.S. Treasury securities. They often have some special provisions that allow block trades to be coordinated away from the floor, but ultimately, the idea is that the trade has to interact in some fashion with the order flow on the floor so that the block trading market will not become a separate market, will not become a separate fragment of the market, which has quite a number of negative consequences.

When we have a market that's fragmented, typically, what happens is that the liquidity of that market suffered, and when the liquidity suffers, prices are less informative, the bid-ask spreads are higher, and in the context of the futures markets, the costs of hedging are going to be higher, and as a result, the government will have to pay a higher cost to finance its debt.

A key aspect of this problem is that we cannot separate what is allowed in one market to what we allow in other markets. If one market wants to stay pure, and let's assume it's right, that's the right solution, being pure, you have to break down the entire block down to the flow of the exchange. If you allow another market to have more relaxed rules, if you allow another market to trade that block without having it participate in the rest of the order flow, what will obviously happen is the traders will prefer to go to the other market. So what will happen is that the block trades will migrate and gravitate to the market that gives it the more relaxed rules because that's what traders want

to do, and if there's the ability to do it, they are going to do it.

As a result of that, the market that wants to stay pure will lose order flow and will have an incentive to change its rules and to relax its rules, because it is going to want to preserve that order flow. It is not going to want to lose that order flow. As a result of that, once we allow one market to relax its rules, what will necessarily happen is that other markets will have to follow suit or they lose the order flow.

So what we have here is a trade-off between the short term and the long term. In the short term, traders want to go to the markets which have rules that are more relaxed. They want to have to trade whenever they want to without having any constraints on their trading.

In the long term, this could result in a deterioration of the quality of the markets, because all the markets are going to have to lower their standards and what happens is that we get what is sometimes called the race to the bottom, where each

market tries to match downwards the quality of its execution to accommodate those very lucrative trades.

This is an issue that in the literature is sometimes called liquidity [ph.], and it has been studied in some detail by many researchers, including myself, and will be discussed in some detail in the report that Professor Amahoud and myself will submit to the Commission.

This is a scenario and a situation where regulation has a very important role to play, because the role of regulation in this context is to establish some quality standards that are going to be the minimum quality standards that no market will be allowed to go below. In my view, one of the key roles of regulation is this balancing act between the short term and the long term, because what will happen is that if a market is allowed to relax the rules, all the other markets are going to follow suit.

Now, what should that minimum quality standard be? This is not an easy question, and I think that the Commission's concept release has framed the issues well and we are still working on

trying to present some alternative approaches to addressing those issues. These are very difficult issues and they don't have a unique solution. But as far as I can judge right now, the trading rules of the Cantor Exchange are below what I think are reasonable minimum quality standards for our futures markets.

As we stand here today, we have high quality, efficient, and liquid futures markets and they take the concept of open and competitive market further than many other trading markets, both in the United States and worldwide. Lowering these standards is risky and I cannot imagine why the Commission would want to do it without going through the usual deliberative process.

The Cantor Exchange brings the standards of the cash market in U.S. Treasuries into the futures markets. It's clearly not an open and competitive market. At the heart of the trading mechanism of the Cantor Exchange is the exclusive time, the concept of exclusive time, which, as the name implies, is about the exclusion of orders from trading. It allows

traders to exclude other traders from trading even if they have a better price.

There is a reason for doing that, and the reason is that you sacrifice the pricing in order to allow large blocks to be traded efficiently. What happens in the Cantor Exchange is that we have a mechanism which, by design, is designed to attract large blocks that have a priority of execution once they obtain the beginning of that execution. So the risk that we are facing is that the Cantor Exchange will basically determine and define the de facto standard for block trading in the futures markets before the Commission has actually decided what these standards should be.

Let me make a few comments about the role of automation in futures markets, as well, which is another subject I've been studying for many years. Let me say that all exchanges are ultimately a major user of information technology. That does not make them electronic exchanges. Everybody uses electronics today. The trading pit of the Board of Trade, just like the Cantor Exchange, includes many

elements of automation, but neither of them are actual electronic exchanges.

When researchers, and I believe also practitioners, talk about the electronic exchanges, they are talking about basically what is an exchange in a box, where the entire process is electronic, and there are many exchanges like that today. It's not an unknown concept. But neither the Cantor Exchange nor the Board of Trade trading pit are electronic exchanges, even though they use electronics. When you have 250 people, terminal operators, sitting in a room and shouting at a screen, this does not sound like an electronic exchange to me.

So examples of electronic exchanges would be Globex and Project A and the electronic part of Matif and there are many other examples like that today. It would not include the Cantor Exchange, in my view.

However, to get aside from the semantics of whether something is an electronic exchange or not, let's talk about the substance and the cost-benefit analysis of what we get from the use of electronics. Basically, when we think about how an exchange should

operate, it can operate using human operators, traders, or it can operate using electronics, and let me first say that there is no rule that any electronic exchange is better than any human exchange.

The human-based exchanges have a number of advantages, and specifically two key advantages are the richness of human expression, which no computer system today can actually emulate. It is very difficult, for example, on a screen to actually see the atmosphere on the floor of an exchange. And the second advantage of human-based exchanges is the flexibility of the human mind and the ability to change actions on the spot.

So there are some advantages to human-based exchanges and I wouldn't rule them out in advance and I wouldn't say in advance that they are inferior to electronic exchanges. However, the electronics and computer-based exchanges have substantial advantages, as well, and unfortunately, the Cantor Exchange does not provide us many of those benefits.

One benefit of computer-based exchanges is simply the cost side. We can substitute electronics

for human labor. Human labor is very expensive. Electronics is cheap and its cost is declining all the time, and as a result, whenever we can make that substitution, we can actually reduce cost. On the Cantor Exchange, obviously, we have the terminal operators which are at the core of the Exchange, so we don't have that advantage.

A second important advantage of electronic exchanges is speed. Electrons move much faster than we can move, and as a result, electronic trading can allow us very fast executions in trading. In the case of the Cantor Exchange, what we actually have is a system that, on purpose, slows down the trading process. So we have built-in delays in the system to facilitate the trading of large blocks. So we don't have the advantage of speed.

A third advantage--

CHAIRPERSON BORN: Professor Mendelson?

DR. MENDELSON: Yes?

CHAIRPERSON BORN: You have run over your time by quite a bit. If you could wrap up, we need to have time for the Commissioners to ask everybody questions.

DR. MENDELSON: Okay.

CHAIRPERSON BORN: Thank you.

DR. MENDELSON: I'll limit it to 60 seconds, then. A third potential advantage is innovation, and in the case of the Cantor Exchange, we basically have the trading mechanism that has been adopted from the cash market and manual market which has operated before the Exchange existed in its present form.

There are a number of advantages that the Cantor Exchange can provide, and unfortunately, one of them is basically that it has a first mover advantage in the race to the bottom. What happens is that if the Commission goes ahead and approves this application, what will happen is the Commission will define the de facto standards for block trading while the exchanges are waiting for the Commission to announce what these standards are, and I believe that this is an advantage that the Commission should not provide to the Cantor Exchange. Thank you very much.

CHAIRPERSON BORN: Thank you, Professor Mendelson.

Let us take the screen out of the way and have the participants return to their seats. Again, my abject apologies to those who had to move during the last two presentations.

Thank you all very much for your oral statements. Any written statements that you have submitted to the Secretariat or submit at the conclusion of this meeting will be included in the public record, and with that, I would like to ask whether any of the Commissioners have questions or comments and I would like to first call on Commissioner Tull.

COMMISSIONER TULL: You are going to let me be first?

CHAIRPERSON BORN: Yes.

COMMISSIONER TULL: Madam Chairperson, I have a question and I would hope that I get a chance to ask another question if we are going to take turns, rather than--

CHAIRPERSON BORN: I think we may go around as many times as you want, or if you would prefer, you may ask all your questions now, Commissioner.

COMMISSIONER TULL: I would rather just ask one at a time, because other Commissioners, I am sure, may have the same questions.

CHAIRPERSON BORN: That is fine.

COMMISSIONER TULL: My first question is directed to Mr. O'Neill. I would like to know more and for the record about the organization of the Exchange. I am particularly troubled by the board of directors in that I believe you all name five members and Cantor names five members and three outside directors are named by Cantor Fitzgerald.

I would like to know the roles in the organization specifically for both the Board of Trade, the Cotton Exchange, and Cantor, Joe, if I may.

MR. O'NEILL: Okay. Historically, the New York Cotton Exchange has allowed industry groups to participate very heavily in its affiliate and divisions, in those boards of directors, because the role of the affiliates and the divisions are one of marketing, one of contract design, and in this case, technical support. So any of the vital activities that relate to an exchange, which is administration,

regulatory, clearing, all belong to the New York Board of Trade and the New York Cotton Exchange, of which Cantor doesn't have any voice. They have nobody on the board of directors at all of either of those two organizations.

COMMISSIONER TULL: What about role of the board of directors on the Exchange, I think was really want I want to know.

MR. O'NEILL: The role of the board of directors on the New York--

COMMISSIONER TULL: Cantor. Cantor Fitzgerald.

MR. O'NEILL: It will be marketing, contract design, and technical support. It will not have anything to do with regulation, administration, or clearing. So the vital functions of the Exchange will be in the hands of the New York Cotton Exchange and the New York Board of Trade. Cantor will be basically used as a marketing arm.

We do the same thing in citrus. The majority of the board of the Citrus Associates is orange juice people. The majority of the board of the NYFE is equity traders. The majority of the

board of FINEX is currency traders. So what we do is use their knowledge of marketing in their own industry, and as far as regulation, administration, and clearing, that belongs to the New York Board of Trade and the New York Cotton Exchange.

COMMISSIONER TULL: Thank you.

CHAIRPERSON BORN: Thank you, Commissioner Tull. Commissioner Holum?

COMMISSIONER HOLUM: Thank you, Madam Chair.

Mr. O'Neill, my question to you is, if you could talk a little bit more about the TOs and how they fit in with the regulatory scheme and just talk a little bit about why they are registered floor brokers as opposed to Cantor Fitzgerald being maybe an introducing broker.

MR. O'NEILL: Okay. When we discussed regulation with the CFTC staff, it was felt that all terminal operators should be registered as floor brokers individually. That's a way that the Exchange and the Commission would have direct oversight over the terminal operators. They are the ones that interact with the customers and they're the ones that

we need to talk to and have control and responsibility over.

COMMISSIONER HOLUM: Even though they are on the payroll, they're not on your payroll, right?

MR. O'NEILL: Even though they're not on our payroll, we decided to register with--when we talked to the CFTC--as floor brokers so that we could make sure that every TO was under the supervision and control of the Exchange and the CFTC. So that was the purpose of registering them as floor brokers.

COMMISSIONER HOLUM: And how will that fit in with the NFA? Will each of them be members of NFA?

MR. O'NEILL: Each of them will be members of NFA. The process has already started. As soon as the CFFE is approved as an exchange, then they all will become part of the CFFE Exchange and an NFA registration will go through. So we've done all the preliminary work for each of them at the NFA.

COMMISSIONER HOLUM: Thank you very much.

CHAIRPERSON BORN: Thank you, Commissioner Holum. Commissioner Spears?

COMMISSIONER SPEARS: Thank you,
Chairperson.

I'd first like to thank everyone for attending today and taking time out of their busy schedules to come and visit with us regarding this. I also want to thank all the commenters who submitted comments to the Commission. I think all the comments have been constructive and helpful to our process.

I'd like to follow up on Commissioner Holum's question and address a question to Mr. O'Neill. Would you please elaborate a little about the duty to supervise and then also talk about the compliance process and how the Exchange plans to monitor compliance. Could you also tie that back the comment that was made earlier about the recent rule review that the Commission had of the Commission conducted concerning the Cotton Exchange and your response to that point.

MR. O'NEILL: Okay. A pretty inclusive question. When we talked about the rule review, as most everybody knows, we were going through merger discussions with Coffee and Sugar, clearing when the rule review period was. We have committed and have

satisfied the staff at the CFTC that we do have an ongoing complete surveillance program in place right now, that, I think the note said, that we had two people in our market surveillance department. We have ten people in our market surveillance department. We have an on-site office at the Cantor Fitzgerald. We will be monitoring ongoing calls on a random basis. We will review all calls to TOs and the electronic entry of orders into the system on a random basis. We are going to be present at Cantor. We are going to be watching to make sure everything is done well.

The big advantage we're going to have is that from the time a customer picks up the telephone and calls a TO, that's going to be recorded and timed. So every conversation is going to be recorded, timed, and then when a TO enters that order that's placed during that conversation into the machine, that's also going to be timed. So everything is going to be timed and there's going to be almost a perfect audit trail from beginning to end.

The tapes will be kept for about 120 days and then the hard record will be kept for the Commission required time. So we're going to have probably the most complete, accurate audit trail that exists in the industry today--not probably, we are going to have the most complete audit trail that exists in the industry today.

COMMISSIONER SPEARS: So under your structure, you feel the duty to supervise lies with the New York Board of Trade versus Cantor?

MR. O'NEILL: See, TOs are going to be supervised by the New York Board of Trade and the New York Cotton Exchange, yes.

COMMISSIONER SPEARS: Okay. Thank you.

CHAIRPERSON BORN: Thank you, Commissioner Spears. Commissioner Newsome?

COMMISSIONER NEWSOME: Thank you, Madam Chairperson. I would prefer to defer my time for questions to the more senior Commissioners in the group right now.

CHAIRPERSON BORN: Thank you very much, Commissioner Newsome. Commissioner Tull?

COMMISSIONER TULL: I have another question, if I may, and I don't know who should answer this, since Dr. Mendelson addressed it, if one of the others would rather, but your inference that the Cantor Fitzgerald Exchange was structured for block trading, I wish someone would elaborate on that as to why you see that. I mean, what in the structure makes it that way?

DR. MENDELSON: Sir, one of the key elements of the trading algorithm of the Cantor Exchange is that the first best, what they call the first best, has the ability to exclude others from trading during what is called the exclusive time. During this exclusive time, the first best can then trade additional quantities and additional quantities at the prevailing price.

That design, by its very nature, facilitates the trading of large blocks, and as far as I can see, the main reason for excluding other orders is for a trader who has a large block to be able to trade that large block at a priority, because otherwise, if you don't take large blocks, you don't desire to take advantage of that exclusive time.

So if you want to take a measure which is as extreme as excluding superiorly traded orders from trading, there must be a very strong reason for doing that, and the only reason I can see is to facilitate the trading of large blocks, so that once you acquire the right to trade, you can trade much larger quantities at the prevailing price.

COMMISSIONER TULL: You don't think that the time element in there when that can occur inhibits it at all or enough or--

DR. MENDELSON: I think that the time element there, in fact, makes it easier to trade large blocks because for a period of time, you can actually increase the quantity that you trade and you want to do that only if you have a large quantity. You don't have any incentive to do it if you don't have a large quantity to trade.

COMMISSIONER TULL: All right. Thank you very much.

CHAIRPERSON BORN: Commissioner Holum?

COMMISSIONER HOLUM: Thank you. Mr. O'Neill, back to the terminal operators again. Does CFFE have any liability for the terminal operators?

They are employed by them, but you will be supervising them, is that correct?

MR. O'NEILL: We'll have an oversight role, the same as--well, not the same as the CFTC. As an SRO, we have a supervisory role over terminal operators and any problems, any mistakes that they make, any disciplinary violations they make, they will be responsible for and they will be subject to the same compliance and arbitration rules as any other person that's supervised by the Exchange and the CFTC.

COMMISSIONER HOLUM: As technology is changing the way all of you do business, it's also changing the way that we as regulators attempt to design appropriate oversight. In your judgment, do you think it's appropriate for these TOs, even though they are technicians, for it to be necessary for them each individually to be registered as floor brokers, even though, technically, that's really not what they are?

MR. O'NEILL: Right. Technically, they're just clerks and they get an order and they type it into the machine. The customer that enters the order

can look on his machine and see his order getting typed and can see his quantity as it occurs. So the potential for abuse is very limited, if almost nonexistent.

But I think that we are in a transition phase and that to make everybody comfortable, anybody that enters the order into the screen, we'll license. So is it absolutely necessary? No. But is it important to make people comfortable? Yes. In its perception of reality, yes. So we think that it's fine. We agree with the concept because times are changing and we're in this kind of middle ground as the times are changing.

COMMISSIONER HOLUM: Is this the first time that we've required technicians to register as floor brokers?

MR. O'NEILL: Well, I don't think we've ever had this type of trading system before, so I think it's brand new, and if we're going to err, let's err on the side of conservatism and I think that that's what we've done here.

COMMISSIONER HOLUM: Thank you.

MR. YOUNG: Commissioner Holum, if I could, just to clarify the record--

MR. KOBLLENZ: Excuse me. It was my understanding that there was not going to be a debate, that Commissioners were going to ask questions.

CHAIRPERSON BORN: If Commissioner Holum would like to direct a question to Mr. Young, she is certainly free to do so.

COMMISSIONER HOLUM: Thank you, Mr. Young, what's your opinion on that? Could you answer the same question?

MR. YOUNG: Thank you, Commissioner Holum, for your very insightful question.

[Laughter.]

MR. YOUNG: I just wanted to clarify for the record, so that others were not confused by it, I believe in an earlier answer to your question, there was a reference made to floor members being members of NFA. It's my understanding that there are no floor brokers who are members of NFA, that NFA does handle the registration function for floor brokers, but they're not registered as members of NFA and NFA

has no self-regulatory oversight over floor brokers or floor traders. At least, that's my understanding of the situation.

Second, the notion that the terminal operators are technicians is incompatible with the August 4 submission in which the Cantor Exchange includes a rule identifying as one of the functions performed by terminal operators to be soliciting accounts. I don't believe that in connection with soliciting accounts, people act as technicians. Usually, when they act in the form of soliciting accounts, there are sales practice rules that are applicable to their activity. I don't believe there are any sales practice rules included in the August 4 submission, although I will admit that I haven't completely reviewed the August 4 submission since it was received so recently.

And one last point. I really hoped that this hearing today would improve our dialogue and our understanding of who's doing what, but when we talk about "the Exchange" or "we", I'm never sure whether Mr. O'Neill, with all due respect, is talking about the Cotton Exchange, the Cantor Exchange, the New

York Board of Trade, and I think that I'll try, and I think we should all try, to be very specific about that because it's very unclear and perhaps that's one of the reasons we have this kind of confusion today.

COMMISSIONER HOLUM: Thank you, Mr. Young.

Mr. O'Neill, are the TOs going to be soliciting business and marketing?

MR. O'NEILL: TOs will not be soliciting business. Each TO will be assigned certain customers. If an order appears on the screen, the TO will call one of the customers that they solicit business for and enter in the orders to tell them that there are 50 Marches offered at 20. If that's solicitation of business, well, then they will be soliciting business. But they're not actually salesmen and go around looking for business. They will be letting their customer or their customer group know what orders are available on the screen, because a lot of times, people aren't always watching the screen, especially in slow times.

COMMISSIONER HOLUM: Thank you very much.

MR. O'NEILL: You're welcome.

CHAIRPERSON BORN: Thank you, Commissioner Holum. Commissioner Spears?

COMMISSIONER SPEARS: Thank you. I'd like to ask Mr. O'Neill another kind of wide-open question and it relates to how the TOs are going to operate. Will they be operating in an environment where there also may be employees of the FCM operating, and how do you protect customers from potential conflicts of interest in those circumstances? And then will the TOs be also operating under some kind of incentive and in the same room with other people who may be operating under different incentives and how do you put up the firewalls to ensure the necessary protections of the integrity of the marketplace?

MR. O'NEILL: Well, the FCM will not be located in the same place that the TOs are located. The TOs are located in one room by themselves. FCM, there will be a Chinese wall, a firewall between TOs and the FCM. So there will not be any interaction between the FCM and the TOs.

As far as compensation is concerned, they are employees of Cantor, so that compensation will be determined by Cantor.

COMMISSIONER SPEARS: Okay. Will there be incentive pay for the TOs?

MR. O'NEILL: Not directly. There will be no direct incentive payment to the TOs. There might be for a department if they do well, but not for individuals.

COMMISSIONER SPEARS: Thank you.

CHAIRPERSON BORN: Commissioner Newsome, do you still wish to defer?

COMMISSIONER NEWSOME: Yes.

CHAIRPERSON BORN: Commissioner Tull?

COMMISSIONER TULL: I'm going to change the subject a little bit off of TOs, if I can. I suppose, Mark, that this one probably is addressed to you. Several or some of the comment letters that we received criticized the Cantor Exchange, Cantor's futures exchange, for being a proprietary exchange. I don't know what proprietary means. I don't know how it's defined. I'd like that, if you have an answer. Also, I would appreciate why a proprietary exchange is wrong, what would be the objection to one, if I may. Thank you.

MR. YOUNG: Commissioner, in the context of this application, when the commenters are referring to the Cantor Exchange as a proprietary exchange, they are referring to an exchange that is controlled not by the membership of that exchange but by a single firm that has a private business interest as its focal point.

That business in this case is the Cantor Fitzgerald firm. In addition to controlling the Exchange, or perhaps as a result of controlling the Exchange, that business, the Cantor Fitzgerald business, also has an exclusive right to floor brokerage and trade execution on this Exchange. So it's the combination of those two that cause commentators to refer to this as a proprietary exchange.

Now, what's wrong with a proprietary exchange is a question that I tried to answer in my remarks and I'll try a different way this time. There is no provision of the Commodity Exchange Act that says proprietary exchanges are banned, but proprietary exchanges were not contemplated by the

Commodity Exchange Act. That's why there's no ban in the Commodity Exchange Act.

Instead, the Commodity Exchange Act says, if you're going to execute and consummate trades on a contract market, you must be a member of that contract market. Well, in this proprietary exchange, the entities that are going to be consummating and executing trades are not members of the contract market. They're employees of the controller of the exchange, the Cantor Exchange.

So as a result of the proprietary nature of the Exchange, a series of legal deficiencies are presented, including the problems with the fitness requirements, the monopoly of floor brokerage, and the price fixing of brokerage commissions.

COMMISSIONER TULL: Thank you.

CHAIRPERSON BORN: Commissioner Holum?

COMMISSIONER HOLUM: Thank you. Mr. O'Neill, would you say, are there similarities between the relationship with the New York Exchange and Cantor Fitzgerald Securities? Is there a similar relation between that relationship and Globex and Reuters, say?

MR. O'NEILL: Well, I'm not sure of exactly the Globex relationship, but in the relationship between Cantor and New York Board of Trade, Cantor will be providing the electronic trading platform as I assume the Globex provides the electronic trading platform for the CME and the Matif and whatever other exchanges who are allowed on Globex. So in some ways, the relationship is similar, that Cantor will provide the electronic marketplace, and for their providing that electronic marketplace, they'll charge a fee. Will the terminal operators charge a fee? No. The fee will be charged by Cantor for providing an electronic marketplace.

COMMISSIONER HOLUM: Thank you.

CHAIRPERSON BORN: Thank you. Commissioner Spears?

COMMISSIONER SPEARS: I guess this question will be probably addressed to Mr. Young. Mr. Young, I don't think you mentioned it today, but I know through the various comment letters and comments that have been made in the past, that one concern of Chicago Board of Trade has had is that this application by Cantor and the New York Board of Trade

could fragment the market. Would you like to expand upon that as far as you are concerned, the potential fragmentation of the U.S. Treasury market? Is that still a concern of the Chicago Board of Trade and how would you respond to that?

MR. YOUNG: I think I'd say simply, Commissioner Spears, that that is a concern of the Chicago Board of Trade. It has become an increasing concern, as we've heard from Dr. Mendelson, the results of the research that he's doing on the issue. I think when people talk about making the Board of Trade's markets less efficient, more volatile, making hedging on those markets costlier and increasing the cost of the debt, the cost of financing the national debt, we all should be concerned. So it is a continuing concern that becomes an ever-greater concern when we look at some of these issues.

COMMISSIONER SPEARS: Thank you.

CHAIRPERSON BORN: I'm going to continue to skip Commissioner Newsome unless or until he gives me the high sign. Commissioner Tull?

COMMISSIONER TULL: I'm going to sign on with Mr. Newsome and rest.

CHAIRPERSON BORN: Commissioner Holum?

COMMISSIONER HOLUM: I have no questions at this time.

CHAIRPERSON BORN: Commissioner Spears?

COMMISSIONER SPEARS: I guess I'll follow my colleagues and defer, as well.

CHAIRPERSON BORN: On behalf of all of us, let me thank again the participants in today's meeting for your statements and for your willingness to respond to our questions.

With that, I will entertain a motion to adjourn.

COMMISSIONER TULL: I so move.

COMMISSIONER HOLUM: Second.

CHAIRPERSON BORN: All those in favor of the motion, signify by saying aye.

[Chorus of ayes.]

CHAIRPERSON BORN: All those opposed, say nay.

[No response.]

CHAIRPERSON BORN: The motion carries unanimously and the meeting is adjourned.

[Whereupon, at 4:06 p.m., the meeting was
adjourned.]

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