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July 15, 1998

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: Cantor Financial Futures Exchange, Inc. ("CFFE") Application for Designation as a Contract Market in U.S. Treasury Bond, Ten-Year Note, Five-Year Note, and Two-Year Note Futures Contracts (the "Application")

Dear Ms. Webb:

This letter will supplement our views on the Application expressed in our April 3rd correspondence¹ in light of the CFFE's May 21 Filing² and June 18 Filing.³

Amex strongly supports the goal of permitting innovative futures markets to compete freely and fairly with traditional pit trading markets. At the same time, however, we do not believe that it is necessary or appropriate to sacrifice the fundamental market and public protections of the Commodity Exchange Act ("CEA") to achieve this goal. To the contrary, we believe that market innovation and the CEA's protections may, and should, go hand in hand without compromising statutory or regulatory standards. In our view, the designation of a fundamentally flawed market such as the proposed CFFE (i) jeopardizes those who may trade in such market, (ii) unnecessarily

¹ The American Stock Exchange, Inc. ("Amex") submitted a letter to the Commission on April 3, 1998, regarding the Application for contract market designations by a new exchange organized by various affiliates of Cantor Fitzgerald L.P. (the "Cantor Group") and the New York Cotton Exchange (the "Cotton Exchange" or "NYCE"). Our comments were based upon the description of the Application published by the Commission in the Federal Register at 63 FR 5505 (February 3, 1998) (the "Release") as well as documents submitted by the CFFE's organizers in support of the Application and correspondence between Commission staff and the CFFE's organizers (the "Initial CFFE Filings").

² Letter dated May 21, 1998 from Michael R. Koblenz, Esq. to Alan Seifert, Deputy Director, Division of Trading and Markets, and David P. Van Wagner, Special Counsel, Division of Trading and Markets, Commodity Futures Trading Commission. The materials transmitted included "Responses to CFTC Questions dated May 6, 1998" (hereinafter referred to as "May 21 Q&A #") and revised "Cantor Financial Futures Exchange, Inc. By-Laws and Rules" Commission (the "May 21 Filings").

³ Letter dated June 18, 1998 from Michael R. Koblenz, Esq. to David P. Van Wagner, Esq., Special Counsel, Division of Trading and Markets, Commodity Futures Trading Commission. The materials transmitted included "Responses to CFTC Questions dated June 11, 1998" (hereinafter referred to as "June 18 Q&A #"), revised "Cantor Financial Futures Exchange, Inc. By-Laws and Rules," and "Form of Terminal Operator Agreement" (the "June 18 Filings").

compromises established regulatory standards to foster innovation, and (iii) may delay the approval of other innovative markets (to the detriment of the global competitive position of U.S. exchanges) should problems emerge that cause the Commission and/or Congress to examine untraditional futures markets.

At present the Application is deficient in several critical respects, among others:

- The proposed exchange's intricate structure creates a regulatory blind spot. That is, the proposed CFFE is a virtual shell, and ownership and control of all the mechanisms of the market are vested in an enterprise (i.e., the Cantor Group) that is not seeking contract market designation, and is a unitary group of persons outside the regulatory reach of the CEA, the proposed CFFE, and the Cotton Exchange. In addition, the Cantor Group family includes a company that is statutorily disqualified from even being an exchange board member.⁴
- The Cantor Group lacks even the introducing broker registration that is statutorily required for an enterprise in the business of "accepting orders" for futures contracts, even though Cantor Group employees, the terminal operators, will be the sole persons who accept such orders for input into the exchange's system.
- The persons with authority to hire, fire, and determine compensation of the terminal operators have no CEA mandated responsibility to supervise, and are not subject to possible liability for failure to supervise under the CEA, because the Cantor Group is not a Commission registrant.
- Because the terminal operators will operate in a private OTC securities trading environment when they handle the exchange's futures order flow, they should be closely regulated and monitored. The proposed CFFE and Cotton Exchange, however, lack adequate rules or regulatory resources to do these jobs.

We believe that electronic trading of Treasury and other futures contracts potentially offers market participants significant advantages in terms of low cost, fast and accurate executions.⁵ Electronic trading also may enhance market regulation. Our comments with respect to the Application, accordingly, should not be read as a general criticism of the electronic trading. Instead, our comments concern the particulars of this Application which, in reality, proposes computer assisted trading where human intermediation by employees of Cantor Fitzgerald is required to execute every order. In short, we continue to urge the Application not be approved as submitted.

Summary

The Initial CFFE Filings, the May 21 Filings, and the June 18 Filings (collectively, the "CFFE Filings") indicate that the Cantor Group proposes to own and control the CFFE's trading system, market data, and market access. The Cantor Group also proposes to select, employ, supervise, and compensate the brokers ("terminal operators") that will handle all orders for CFFE futures and related Treasury securities. The Cantor Group will appoint a majority of the CFFE board. *The*

⁴ "CFTC Accepts Settlement of Cantor Fitzgerald & Co. Charged with Aiding and Abetting Fraud and Registration Violations of Federal Commodity Law," CFTC News Release No. 3987-97 (January 28, 1997).

⁵ The Amex, through its Amex Commodities Corporation subsidiary, intends to develop an electronic market for futures on "on-the-run" and "when issued" Treasury securities.

Cantor Group, accordingly, is not a simple service provider to the Exchange; it so completely controls market access, market information, order handling, systems, personnel, and corporate governance that, in reality, the Cantor Group is the exchange and is the owner/operator of a proprietary trading system. The nominal contract market that will be owned by the Cotton Exchange and its members (CFFE, Inc.) is a virtual shell that lacks the traditional attributes of a futures market. None of the business entities that comprise the Cantor Group, however, would be Commission registrants or subject to the CFFE's or Cotton Exchange's jurisdiction. This contrasts with the cash market for Treasury securities where Cantor Fitzgerald Securities is registered as a Government Securities Broker, is a member of the NASD, and its salesmen/terminal operators are registered as Government Securities Representatives. Since the Cantor Group and its senior management (i.e., the persons responsible for hiring and firing, directing employee conduct, and committing corporate resources) would not be Commission registrants, the Cantor Group and its management would have no obligation to supervise, or liability for failing to supervise, the terminal operators under Commission Regulation 166.3.⁶ The absence of a duty to supervise, in our view, would eliminate one of the Commission's most important tools for ensuring the protection of the public interest.

It is clear that a regulatory blind spot dominates the CFFE and that the market has been structured to create this blind spot and operate in the heart of it. The three key elements necessary to the regulation of a public futures market: *registrants, rules, and resources* are critically lacking from the proposed market. The CFFE Filings demonstrate that the Cantor Group intends to own and operate a trading pit or a series of trading pits in their offices over which the Commission and the nominal self-regulators will have limited or no jurisdiction.⁷ The terminal operators are proposed to act in the same manner as traditional cash market government securities brokers and will trade the cash and futures simultaneously. While the ultimate matching of orders for CFFE futures will be done through a computer, it should be clearly understood that **this is computer assisted trading rather than electronic trading**. Human intermediaries (employees of the Cantor Group) will handle all orders for CFFE futures with the consequent possibilities for trade practice violations to which all human based trading systems are susceptible. For example, since terminal operators will announce CFFE members' orders to the other brokers/terminal operators in the Cantor Group's trading pit, it is possible (and consistent with cash market practices) for terminal operators to "shop" an order for CFFE futures outside of the trading system in order to develop contra side interest. The customer that placed the order may not care if his order is shopped (indeed, the customer may prefer that the order not be immediately displayed to avoid signaling his intentions), but the shopping process may violate the Commission's regulations against prearrangement.

⁶ 17 CFR Section Part 166.3 provides:

Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business of as a Commission registrant.

⁷ See proposed CFFE Rules 8 ("Cantor System") and 31 ("Terminal Operator") with respect to the Cantor Group's ownership and control of the mechanisms of the market.

In our view, the Commission cannot exclusively rely on the customers of the Cantor Group to police terminal operator misconduct since the customers may not be the injured party, rather other market participants may be injured by non-competitive and other trading practice violations. The likelihood of improper trading practices occurring among the terminal operators is substantially increased by the complete absence of the natural competitive pressures that exist in a traditional trading pit or ring where (i) unaffiliated brokers and "locals" operate in plain view of one another and the locals have strong incentives to identify anti-competitive practices by their peers and (ii) an independent floor committee supervises trading. In contrast, the only brokers on the CFFE are employees of the Cantor Group who share a common economic interest with their employer.

In our view, it is critically important for the entities comprising the Cantor Group to be both registered with the Commission and subject to appropriate self-regulatory jurisdiction to ensure adequate oversight of this unique market. In this regard, we believe that the Cantor Group through its employees will be performing the functions of an Introducing Broker⁸ ("IB") and should be registered as such. In fact, the functions to be performed by the Cantor Group and its employees fall so precisely within the statutory definition of an IB that we believe the Commission should explain its reasons why such registration is unnecessary if it makes this determination.

We believe that the CFFE should have a clearly drafted set of rules describing in detail what the Cantor Group, its affiliates and terminal operators may and may not do given their central position as the exclusive access providers to the market, their significant and perhaps dominant position as brokers for Treasury securities, and the different trading standards applicable to futures and the physical Treasury securities.⁹ The proposed by-laws and rules of the CFFE, however, are almost completely devoid of such rules. For example, proposed CFFE Rule 311 (which embodies the "Trading Standards" of Part 155 of the Commission's regulations) is drafted to cover only "clearing members" and "screen based traders" and does not cover terminal operators. In addition, proposed CFFE Rule 712(b) ("Trading Prohibition") provides:

An employee of CFFE, Cantor, Cantor Fitzgerald Securities or its affiliates... shall not trade, directly or indirectly, any contract traded on, or cleared by CFFE or the Commodity Clearing Corporation... where the employee has access to material non-public information concerning such commodity interest." (Italics supplied.)

This ambiguously worded rule raises a variety of questions regarding the possible trading activity of the Cantor Group, its affiliates, and their personnel in the proposed CFFE that should be answered by the Commission prior to the approval of the application. For example, is the prohibition only limited to Cantor employees with access to material non-public information? Is the prohibition limited to *employees* so that principals of the firm, agents, and the various Cantor entities may trade CFFE futures for their accounts? Does proposed Rule 712(b) prohibit trading of CFFE futures by accounts managed by the various Cantor entities or their personnel? How effective is the prohibition of proposed Rule 712(b) if the various Cantor entities are not subject to the jurisdiction of the Cotton Exchange or CFFE?

⁸ CEA Section 1a(14).

⁹ A broker in the cash market for Treasury securities may match customer orders without exposing them to the entire market through open outcry. This same conduct, however, is impermissible in futures trading.

Proposed Rule 712(a) ("Disclosure of Information") prohibits terminal operators from disclosing to various persons, "material non-public information regarding *transactions* in Contracts."¹⁰ Does this prohibit terminal operators from selectively disclosing to CFFE members, other terminal operators, and their cash market customers *orders* that have not yet been entered into the system, market probes, indications of interest? We are particularly concerned with selective terminal operator disclosure of these types of information because such disclosures may be part of impermissible trade pre-arrangement or other non-competitive trading. Rule 712(a) goes on to provide that, "this provision does not prohibit disclosures made in the course of an employee's duties." Does this exception swallow up the rule? We understand that various representations have been made to the Commission regarding the permissible and impermissible activities of the various Cantor entities, their personnel, and terminal operators,¹¹ but we question the enforceability of these representations since they were made by the applicant rather than the Cantor entities and are not incorporated into the CFFE's by-laws and rules.

We believe that the Cotton Exchange's resource commitment and regulatory plan are inadequate, particularly in view of the unique structure of the CFFE and the recent finding that the Cotton Exchange's market surveillance area was inadequate.¹² As we understand it, the Cotton Exchange has advised the Commission that it does not need to commit additional resources to surveilling the proposed CFFE apart from the resources that the Commission's staff recently concluded were inadequate for the NYCE's existing markets. The Cotton Exchange further advised the Commission that if additional resources were necessary, it would commit 10% of CFFE gross revenues to the project. In our view, the Cotton Exchange has it backwards, telling the Commission that it is unwilling to commit additional resources to the CFFE until it sees if the market will be a success. A self-regulator, however, has an obligation from the start of trading to adequately police a market under its jurisdiction. In addition, we are troubled by the Cotton Exchange's assertion that less surveillance of terminal operators is required than is required with respect to a traditional trading pit.¹³ Again, the Cotton Exchange in our view has it backwards.

¹⁰ Italics supplied. We assume the word "transaction" in proposed CFFE Rule 712(a) has its customary meaning and refers to an executed trade.

¹¹ E.g., June 18 Q&A #9.

¹² "Rule Enforcement Review of the Market Surveillance Program at the New York Cotton Exchange," Commodity Trading Futures Commission, Division of Trading and Markets (February 24, 1998). The Division concluded that:

...the MSD's [Market Surveillance Department's] staffing levels are insufficient to monitor effectively the number of markets traded on the Exchange, and to conduct other routine surveillance activities, including the review of EFPs to determine the bona fides of those transactions...In fact, for virtually the entire target period of this review, only two people were directly involved in performing daily market surveillance activities: the Director of Market Surveillance and one analyst...[T]he Division believes that additional staff are necessary to carry out effectively the broad range of responsibilities attendant to an adequate market surveillance program.

¹³ May 21 Q&A Schedule VII, at 2:

It should be noted that 'floor surveillance' for CFFE differs from 'traditional' coverage of pit trading. With respect to CFFE, NYCE feels that periodic coverage will suffice (as opposed to every opening, every close, and intermittent periods during the day) because NYCE will have

Given the possibility of terminal operator misconduct between the time of order receipt and entry into the Cantor System and the complete absence of natural competitive pressures in the CFFE trading pit, we believe that there should be more, rather than less, physical observation of the terminal operators by the self-regulator than would occur in a traditional pit. We believe that relying primarily on customer complaints to police the market is an inadequate regulatory strategy since the customer that places an order may not be the injured party as when, for example, a trade is prearranged and market participants other than the parties to the trade are disadvantaged by being "cut-out" of the trade. We also believe that the Cotton Exchange (rather than the Cantor) should maintain the tape recordings of terminal operator telephone conversations to ensure their availability and prevent tampering. To our knowledge, U.S. futures exchanges currently maintain tape recordings of telephone calls to their floors. The proposed CFFE model, accordingly, would be contrary to current SRO practice.

In our view, there are numerous significant unanswered questions regarding the proposed CFFE.¹⁴ We believe that (i) the lack of answers to these questions renders the application materially incomplete, and (ii) the unanswered questions should be responded to completely prior to the disposition of the Application. We, therefore, recommend that the Commission reinstate the stay on the one-year review period provided in Section 6 of the Act. We also believe that the 15 day public comment period provided by the Commission is inadequate in light of the magnitude of the changes in the Application and the brief summary of the proposal in the July 1 Federal Register Notice that did not adequately identify the issues raised by the Application.¹⁵ We further believe that the information currently available regarding the proposed CFFE warrants a denial of the Application.

Absence of Government and Self-Regulatory Jurisdiction Over the Cantor Group

During the initial comment period, we noted the business entities of the Cantor Group would neither be registered with the Commission nor be members of the CFFE or Cotton Exchange. There has been no substantive change to this regulatory "blind spot," however, other than to suggest the registration of terminal operators as floor brokers. In our view, however, it is inadequate, illogical and inconsistent with the public interest policies underlying the CEA to require the registration of employees who, in reality, are merely operatives, and to exclude from registration and regulatory oversight the real powers behind the market (i.e., the business entities and senior management thereof). This lack of registration, moreover, would mean that the Cantor Group and its senior management would have no duty to supervise pursuant to Section 166.3 of the Commission's regulations. We submit that it is contrary to the public interest requirement of Section 5 of the CEA to exempt persons from a duty to supervise that hire and fire, determine the allocation of resources, set and enforce standards of employee conduct, and direct employee activities.

access to TO tapes.

See also May 21 Q&A Schedule VIII, at 1.

¹⁴ A list of some of these questions is included within the body of this letter.

¹⁵ 63 FR 35912 (July 1, 1998)

To our knowledge, it is unprecedented in the United States for the mechanisms of a public futures or securities market to be beyond the routine oversight of the applicable government agency and self-regulator. While the CFFE would be the first proprietary futures market in the U.S., there is a long history of similar systems with respect to securities, and the Securities and Exchange Commission ("SEC") has uniformly required the operators of such markets to be registered. For example, Instinct operates a proprietary securities market. Instinct is registered with the SEC as a securities broker, it is a member of the NASD, and it is subject to the regulatory regime applicable to brokers and dealers. Thus its personnel that do business with the public are registered as General Securities Representatives. Instinct also is subject to various SEC regulatory requirements pertaining to "broker-dealer trading systems"¹⁶ and "Electronic Communications Networks."¹⁷ The SEC also recently proposed a new, heightened, regulatory regime for "Alternative Trading Systems."¹⁸

We do not suggest that two government agencies need to approach regulation in the same way. In this case, however, we are unable to determine any difference in market structure or statutory basis that would justify exempting the persons owning and operating the mechanism of the CFFE from registration and oversight by government and self-regulators. Indeed, in the cash market for Treasury securities, Cantor Fitzgerald Securities is registered as a Government Securities Broker, it is a member of the NASD, and its salesmen/terminal operators are registered as Government Securities Representatives. This would suggest that the Cantor Group and its personnel at least should be subject to a similar regulatory regime with respect to CFFE futures and we are puzzled why the Commission has not heretofore insisted on such a registration model for the CFFE.

The Initial CFFE Filings stated that terminal operators would be mere clerks¹⁹ and that they would be joint employees of the CFFE (i.e., the exchange) and Cantor Fitzgerald Securities. The May 21 Filings, however, acknowledged that, "CFFE TOs will assume largely the same role and responsibilities as they presently have in the cash market for Treasury securities."²⁰ That is, they would bring buyers and sellers together and, in particular, accept orders for CFFE futures, initiate contact with CFFE members, express opinions regarding the direction of the market and strength of trends, advise CFFE members of buying and selling interest, call-out the terms of orders to other terminal operators, solicit orders, and act as NASD registered Government Securities Representatives with respect to Treasury securities.²¹ For these and other traditional brokerage services, terminal operators and their supervisors would be compensated by the Cantor Group (not

¹⁶ 17 CFR 240.17a-23

¹⁷ 17 CFR 240.11Ac1-1

¹⁸ Securities Exchange Act Release No. 34-39884, (April 17, 1998); 63 Fed. Reg. 23504 (April 29, 1998).

¹⁹ Item 10 "Draft Responses to CFTC Questions Concerning CFFE and NYBOC" that was included with the Initial CFFE Filings stated: "Terminal Operators are merely acting in a clerical capacity in accepting/placing orders with and into the Cantor System, and therefore should be exempt from registration."

²⁰ May 21 Q&A # 47.

²¹ May 21 Q&A ## 47, 48, and 53.

the exchange) based upon their ability to generate business for the market.²² The May 21 and June 18 Filings stated that terminal would be not be employed by the exchange in any capacity, but would be dual employees of Cantor Fitzgerald Securities and/or its affiliates.²³

Section 1a(14) of the CEA defines "Introducing Broker" to mean:

any person... engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom. (Italics supplied.)

The CFFE filings clearly state that the Cantor Group, through its terminal operator employees, will be, "engaged in soliciting or accepting orders for the purchase or sale of any commodity for futures delivery." The business entities in the Cantor Group, accordingly, should register with the Commission as IBs, and the terminal operators should register as associated persons of an IB. This would better reflect the fact that terminal operators are not independent floor brokers; rather, they are employees of an IB engaged in soliciting and accepting customer orders.²⁴ IB registration would establish the Commission's oversight jurisdiction over the Cantor Group (including establishing a duty to supervise by the entities and their senior management) and would be consistent with another federal agency's early regulation of proprietary trading systems.

Absence of Rules Regarding Terminal Operator Conduct

The acknowledgement that terminal operators would function in the same manner as cash market government securities brokers and would be registered with the Commission as floor brokers indicates that these persons should be subject to the Commission's "Trading Standards."²⁵ The CFFE, accordingly, should have rules requiring terminal operators to conform either to the standards enunciated in Sections 155.2 and 155.5 of the Commission's regulations (if they are registered as floor brokers), or Section 155.4 (if they are registered as associated persons of an IB). Proposed CFFE Rule 311 ("Trading Standards"), however, only applies to "clearing members" and "screen based traders" and does not establish any standards of conduct for terminal operators. In addition, as previously noted, proposed CFFE Rule 712(a) only prohibits terminal operators from disclosing, "material non-public information regarding *transactions* in Contracts," implying

²² May 21 Q&A ## 59 and 61. Terminal operators and their supervisors, "may be compensated by Cantor Fitzgerald Securities," and that their compensation, "will include a payment/discretionary bonus in respect of their services for CFFE, LLC." See also June 18 Q&A #21.

²³ May 21 Q&A # 18 states that, "CFFE TOs will be dual employees of CFFE, LLC and Cantor Fitzgerald Securities." Similarly, proposed CFFE Rule 31 states that, "the term 'terminal operator' means an employee of Cantor Fitzgerald Securities and Cantor." ("Cantor" is defined in proposed by-law Section I to mean CFFE, LLC.) June 18 Q&A #21a states, "TOs will be employed by CFS or its affiliates."

²⁴ We do not object to registering terminal operators as floor brokers. We simply believe that characterizing them as associated persons of an introducing broker is a more accurate description of their relationship to their employer.

²⁵ 17 CFR Part 155.

that disclosure of orders and market probes would be acceptable. Proposed Rule 712(a) goes on to provide that the restriction on disclosure, "does not prohibit disclosures made in the course of an employee's duties." The CFFE's rules, accordingly, apparently would allow terminal operators to make selective disclosure regarding pending orders and other market sensitive information to other terminal operators, CFFE members and their cash market customers. Similarly, while the May 21 Q&A states that terminal operators will be subject to the jurisdiction of CFFE for arbitration and (presumably) disciplinary purposes, the actual language of the CFFE by-laws and rules appears to exempt terminal operators from the CFFE's arbitration and disciplinary jurisdiction.²⁶ We believe that the CFFE's by-laws and rules need to be amended to correct these deficiencies and that additional representations in supplemental CFFE Filings are inadequate for this purpose.

Since terminal operators would handle all orders and call out the terms of such orders to the other terminal operators in the Cantor Group's trading pit, these persons will be able to prearrange trades, withhold orders from the market, disclose orders, "front run" customer orders, etc. For example, a terminal operator could observe that one of his customers is steadily buying CFFE futures through a trading session. This terminal operator then could enter into an agreement with a second customer whereby the terminal operator would purchase CFFE futures for the account of the second customer immediately in front of a new buy order for the first customer. In addition, since terminal operators will be able to see and hear each other and match buyers and sellers in the cash market, we believe that there will be a temptation or need to pair orders for CFFE futures.²⁷ In a traditional trading pit, competition for orders by locals creates a self-policing mechanism that tends to prevent the non-competitive order matching. In the CFFE model, however, all persons in the pit will have a common economic interest that will eliminate the natural policing of traditional pits and facilitate the non-competitive matching of orders. We believe that the selective disclosure of market information by terminal operators is unacceptably anticompetitive given that the CFFE trading rings will be staffed exclusively by Cantor employees and CFFE members would have no recourse to independent brokers.

²⁶ May 21 Q&A ## 16, 17 and 18. Proposed CFFE Rule 600 states that, "controversies regarding transactions made on CFFE involving persons under CFFE jurisdiction," shall be arbitrated before the Cotton Exchange. *The proposed CFFE by-laws, however, do not include terminal operators (and the members of the Cantor Group and their affiliates) within the list of persons subject to Cotton Exchange jurisdiction.* In this regard, the "Scope" provision of the CFFE by-laws states: "All persons who hold *Trading Privileges* on CFFE shall (i) comply with, and be subject to, all applicable By-Laws, Rules, procedures, policies, orders, directives and decisions of CFFE and the New York Cotton Exchange (the 'Cotton Exchange')...and (ii) be subject to the jurisdiction of CFFE and the Cotton Exchange for purposes of arbitration, disciplinary, compliance and surveillance procedures." (Italics supplied.) Terminal operators, however, do not hold CFFE "Trading Privileges" under the CFFE's proposed rules. (See proposed By-Law Section 36 and proposed Rule 32.) Paragraph five of the "Form of Terminal Operator Agreement" included with the June 18 Filings states that: "The individual Terminal Operator agrees to...submit to the jurisdiction of the Cotton Exchange *in accordance with CFFE By-Laws and Rules,*" however, since the CFFE By-Laws and Rules do not subject Terminal Operators to the exchange's jurisdiction, this provision is a meaningless nullity. We also question the efficacy and propriety of relying upon an agreement between Cantor Fitzgerald Securities and the terminal operators as the basis for regulatory jurisdiction over the terminal operators. For example, what would happen if Cantor Fitzgerald Securities did not obtain the agreement from a terminal operator or changed the terms of the agreement with respect to CFFE and Cotton Exchange jurisdiction?

²⁷ In our view, a combination order for the cash Treasury securities and CFFE futures almost inevitably would require some degree of non-competitive prearrangement by a terminal operator.

The proposed CFFE is not a pure electronic market. Human intermediation by terminal operators is required with respect to every order with consequent opportunities for trading practices violations. We, therefore, believe that it is essential for the CFFE to apply trading practice rules to the terminal operators and to ensure that these persons are subject to the Cotton Exchange's and CFFE's regulatory jurisdiction prior to the approval of the market.

Inadequate Cotton Exchange Self-Regulatory Program

We believe that the proposed "Integration of CFFE into NYCE's Compliance Program" contains a number of serious deficiencies.²⁸ A critical tool of the CFFE's market surveillance program will be the telephone tapes of terminal operator conversations with their customers and CFFE members.²⁹ These tapes will be produced by the Cantor Group and maintained by the Cantor Group for only 45 business days.³⁰ We believe, however, that the Cantor Group should not maintain these tapes since the Cantor Group and its affiliates may be a participant in the market as broker, principal,³¹ and perhaps in other capacities (e.g., a money manager and employee trading). One of the principal lessons of recent problems in the futures industry (e.g., Barings and Sumitomo) is that the persons that trade should not maintain trading records in order to prevent tampering and to ensure their availability. Moreover, we believe that U.S. futures exchanges currently tape record telephone conversations to their floors and the SROs, rather than their members, maintain the tapes of these conversations. The CFFE proposal regarding tape recordings of telephone conversations, accordingly, is inconsistent with current practice in the U.S.

In February 1998, The Commission's Division of Trading and Markets (the "Division") concluded that the Cotton Exchange had committed inadequate resources to its Market Surveillance Department. In its May 6 correspondence,³² the Commission asked whether the Cotton Exchange would add staff or commit additional funds to its compliance program to monitor trading on CFFE. In response, the NYCE stated that (i) additional staffing was unnecessary, (ii) if additional resources were necessary, 10% of the CFFE's "gross revenues" would be spent on enhancements to the compliance and surveillance programs, and (iii) the compliance and surveillance staff would

²⁸ Schedule VII to "Responses to CFTC Questions dated May 6, 1998."

²⁹ The importance of the telephone tapes of terminal operator conversations is described at May 21 Q&A ## 21, 23, 44, 58 and the section of Schedule VII captioned "'Floor Surveillance'" that states:

With respect to CFFE, NYCE feels that periodic coverage will suffice (as opposed to every opening, every close, and intermittent periods during the day) because NYCE will have access to the TO tapes. Such tapes represent an effective deterrent because a TO will not know when compliance staff will ask for, or be listening to, a tape.

³⁰ May 21 Q&A #44(a) states that Cantor Fitzgerald would retain terminal operator tapes for 20 business days. June 18 Q&A #36 states that "CFFE is prepared to retain such tapes for 45 days," and that copies of such tapes would be made available to NYCE on request. It is our understanding that CFFE is synonymous with Cantor Fitzgerald, and that Cantor Fitzgerald is the proposed custodian of the tapes. We also observe that a copy of a tape may be inadequate for prosecution purposes due to concerns with alterations and requirements that the original record be introduced as evidence.

³¹ As noted above, proposed CFFE Rule 712(b) would permit the various Cantor entities and their employees to trade CFFE futures.

³² Letter dated May 6, 1998 from David Van Wagner, Special Counsel, Commodity Futures Trading Commission to Michael R. Koblenz, Esq., Mound Cotton & Wollan.

increase by 150% as a result of the Cotton Exchange's merger with the Coffee, Sugar and Cocoa Exchange ("CSCE").³³

We believe that there should be enhancements to a regulatory program that the Commission's staff recently found to be inadequate for the Cotton Exchange's existing markets prior to the approval of the Applications to trade additional futures contracts. A 150% increase is staff from a base of two represents a total market surveillance staff of only five persons. Existing CSCE staff, moreover, is already committed to reviewing trading in their markets. The Commission, accordingly, should take no comfort from the fact that the merged NYCE and CSCE will have a total of five persons allocated to market surveillance. Indeed, it is unclear whether all or any of these persons are solely dedicated to market surveillance of other markets or whether they have duties other than market surveillance

We believe that, dedicating 10% of CFFE gross revenues to compliance and surveillance may constitute an insignificant commitment of resources depending upon the absolute level of revenues. We also would suggest that start-up markets with little trading activity (and little revenue) may require the same or greater resources to monitor than markets with more activity. If there is little trading volume or CFFE receives relatively little of the revenues attributable to CFFE activities (e.g., the Cantor Group receives most of the revenue), 10% of gross revenues may be insufficient to cover the fixed costs of the affirmative action program required by the Commission. In sum, we believe that it is contrary to the public interest to tie a commitment to regulation to revenue that may or may not materialize and may not correspond to the time when these resources are most needed.

Given the unique structure of the CFFE, the attendant absence of competition among independent locals and brokers for orders, and consequent lack of natural self-policing in the trading pit, we disagree with the Cotton Exchange's statements that the terminal operators will require less surveillance than a traditional trading pit. Furthermore, we are concerned by the Cotton Exchange's proposed reliance on random reviews of telephone operator tapes. In our experience, reviewing tape recordings of telephone conversations is a highly effective regulatory tool when the SRO has identified a specific event or series of events that it wishes to investigate. Reviewing tapes randomly, however, has not been a particularly effective oversight tool due to the time required to listen to taped conversations and the lack of a filter on the conversations that are reviewed. The lack of a filter would be a particularly significant problem with respect to the CFFE where many terminal operator conversations will concern cash market transactions and have nothing to do with CFFE futures. In our view, the Cotton Exchange should employ its regulatory resources by engaging persons knowledgeable in government securities trading and having these persons observe the terminal operator facility on a continuous basis. In the absence of an independent floor committee or natural competition among independent brokers and traders, direct observation by knowledgeable staff would be the appropriate regulatory tool.³⁴

³³ May 21 Q&A # 96.

³⁴ June 18 Q&A #34 states:

NYCE personnel plans to *initially* visit CFFE's trading room on a daily basis. Monitoring activities will include physical monitoring of the trading room and/or monitoring TO phone lines. (Italics supplied.)

Unanswered Questions

We believe that there are many unanswered questions regarding the CFFE that are compounded by the ambiguous answers to the Commission's questions and frequent changes in the Application. For example, we believe that the following questions regarding the regulation of the market should be fully and satisfactorily answered prior to any final consideration by the Commission of the Application or the CFFE's proposed by-laws and rules:

- Are there any limitations on the Cotton Exchange's ability to discharge its regulatory responsibilities in its contractual arrangements with the Cantor Group? We note that these agreements were not released or summarized by the Commission so that commentators were unable to review and discuss for possible limits on self-regulatory oversight contained in these materials.³⁵
- Why is the CFFE structured so that the business entities in the Cantor Group that provide the trading system, market information, and order handling functions are outside the Commission's, the CFFE's and the Cotton Exchange's oversight jurisdiction?
- May the Cantor Group change the CFFE trading system or other CFFE systems without notice and/or approval of the Cotton Exchange, CFFE, or Commission? What review, testing and/or approval mechanisms (if any) exist with respect to such changes?
- Do the contractual relations between the Cotton Exchange and the Cantor Group provide the Cotton Exchange with sufficient resources (e.g., financial wherewithal, access to trading systems and trading rings, jurisdiction over market participants) to discharge its self-regulatory functions?
- What tests have been performed on the Cantor System with respect to futures trading to ensure that it operates as described in the CFFE filings? Since the Cantor Group owns and maintains the CFFE's systems, what controls will be placed on the Cantor Group to ensure that the system is not modified in inappropriate ways? Who will check the integrity of the trading system?
- Will there be inspections and/or audits of the CFFE trading system to ensure that it does not provide certain market participants (e.g., Cantor Fitzgerald & Co.) with an unfair competitive

For the reasons stated above, we believe that the Cotton Exchange's commitment to observe activity in the CFFE trading room is unclear and inadequate and that random monitoring of terminal operator tapes is an ineffective substitute for direct physical observation. We also note the acknowledgement that the terminal operator facility is a "trading room." Since the terminal operators work in a trading environment, rather than a facility where automatons process orders into the Cantor System, this suggests that ongoing physical observation of the terminal operators should be a requirement of the surveillance plan.

³⁵ We believe that the commercial arrangements of private parties should be disclosed for public comment to the extent that these arrangements affect the regulation of a public market for futures contracts and thereby impact the public interest.

advantage or that it is not modified in inappropriate ways? How will these inspections be done and who will conduct them? How costly are such inspections and who will bear the expense? Does the Cotton Exchange have the expertise and resources to conduct such inspections?

- Who will determine member fees for CFFE services such as terminal access (e.g., access to information regarding trading and order entry and execution), transaction charges, telephone access to terminal operators? What will these fees be? How will these fees be determined? Will all members receive the same service or will there be discrimination among members? What is the justification for discrimination among members with respect to access to services or fees if such discrimination may exist? (See Q&A # 37 in the May 21 Filings.)
- What is the role of CFFE, LLC and Cantor Fitzgerald Securities in the proposed market? Why are the terminal operators employees of Cantor Fitzgerald Securities and/or its affiliates? The Initial CFFE Filings stated that the terminal operators would be employed by the Exchange and Cantor Fitzgerald Securities. Why was this change made? What types of business does CFFE, LLC engage in?
- Q&A # # 19 and 27 in the May 21 Filings and Q&A # 9 in the June 18 Filings state that Cantor Fitzgerald entities will not trade CFFE futures for their proprietary account except to correct errors. Will proposed CFFE Rule 712 be modified to embody this restriction? Will this proposed prohibition extend to the employees, officers and partners of the Cantor Fitzgerald Group? If not, what types of trading will these persons be permitted to engage in? Will these persons be permitted to manage accounts that trade CFFE futures? How will the prohibition on proprietary trading be enforced if it is not in the CFFE's rules, and the Cantor Fitzgerald entities are not members of the CFFE, Cotton Exchange or Commission registrants? What are the consequences (if any) of one of the Cantor entities or its personnel trading CFFE futures if they did not make the representation to the Commission regarding proprietary trading?
- How is the requirement under proposed rule 308(c) to challenge a trade within 30 minutes of receipt of a fax consistent with the Exchange's obligation under Section 5a(11) of the CEA to provide a fair and equitable procedure for the settlement of customer claims?
- Will terminal operators be prohibited from disclosing information regarding indications of interest, orders, transactions or other information regarding the CFFE futures to their cash market customers and CFFE members? If this type of disclosure is allowed, may futures information be disclosed on a selective basis at the discretion of the individual terminal operator? If such disclosures are prohibited, what CFFE rule would prohibit this conduct and how would it be enforced? For example, is it realistic to assume that terminal operators will have a "Chinese Wall" between the right and left lobes of their brains to prevent their knowledge of potential futures orders from influencing their conversations with their cash market customers or other CFFE members?
- In May 21 Filings Q&A # 67, the applicants provided several ambiguous responses to the Commission's questions regarding the terminal operators' proposed role with respect to EFP

transactions.³⁶ We believe that the applicants should clarify the terminal operators' role with respect to EFPs on the CFFE and in other markets.

- Q&A # 28 in the May 21 Filings requests a description of CFFE procedures to prevent the flow of material non-public information between CFFE and Cantor and its affiliates. In response, the applicant only stated that the terminal operators will be physically separated from Cantor and its affiliates. Is this rudimentary procedure, without further controls, sufficient in view of the possibility of telephone and other means of electronic communication between terminal operators, the Cantor system and the various Cantor entities and their personnel? What, if any, audit will be performed on the information fire walls between the CFFE and Cantor and its affiliates? Who will perform these audits? How will the audits be performed? How meaningful is the described information firewall procedure in light of the fact that terminal operators are allowed to discuss both the cash and futures markets with CFFE members, including, presumably, Cantor and its affiliates? (See also Q&A # 47 and 53 in the May 21 Filings.)

Conclusions

The proposed CFFE is deficient with respect to the three key elements necessary to the oversight of a public futures market: registrants, rules, and resources. The proposed CFFE has a complicated structure with nominal ownership residing with the Cotton Exchange and its members. In reality, however, the CFFE is a proprietary trading system of the Cantor Group by virtue of Cantor's ownership or control of market access, market information, order handling, market systems, personnel, and corporate governance. The Cantor Group and its senior management, however, are neither Commission registrants nor members of the CFFE and will not be subject to the oversight jurisdiction of the Commission, the Cotton Exchange or the CFFE. We believe that the intended result of this unprecedented structure is to create a regulatory blind spot and to permit the Cantor Group and its management to operate within the heart of this blind spot.

Compounding the problems associated with the lack of jurisdiction over the real powers behind the market are (i) the near total absence of any enforceable provisions in the CFFE's proposed by-laws and rules regarding terminal operator standards of conduct and (ii) the Cotton Exchange's inadequate self-regulatory plan. Given the absence of competitive self-policing among the Cantor terminal operators that would exist in a traditional trading pit, the Cotton Exchange should be proposing enhanced oversight of the CFFE. Instead, the NYCE states that it will make do with the resources that the Commission's staff recently concluded were inadequate with respect to its existing markets. The near total lack of rules regarding terminal operator conduct will exacerbate the potential problem of terminal operator misconduct. The trading of both the physical Treasury securities and CFFE futures simultaneously under the different trading standards of the cash and

³⁶ For example, in response to the question, "What role would TOs play in EFP transactions?" the applicant provided the following ambiguous answer:

Cantor Fitzgerald Securities, through its brokers, already provides services including the brokerage of EFP transactions between participants in the cash market for Treasury Securities on the CBOT. It will continue to provide such services on CFFE. In contrast, CFFE TOs, in their capacity as such, will be limited to recording EFP transactions that are reported by a customer, for clearing through the CCC.

futures markets will create tremendous temptations or need for terminal operators to pair orders and engage in other non-competitive practices that may be entirely appropriate in the cash market, but are not permitted in futures trading.

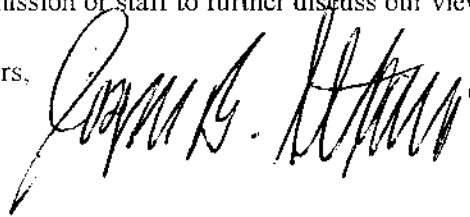
The Commission recently solicited public comment on a concept release regarding the regulation of non-competitive transactions executed on or subject to the rules of a contract market.³⁷ In our view, if Commission intends to change its rules and policies regarding non-competitive trading, the change should be effected through this rule making process (which would affect all exchanges equally and simultaneously) rather than by approving proposed CFFE rules that would have the effect of permitting cash market non-competitive practices (e.g., selective disclosure of orders, market probes, etc.) on one market only. We, accordingly, believe that approval of the Application should be withheld (unless substantially amended), until the Commission completes its review of the issues raised in the concept release and has adopted implementing rules.

We believe that the Application as currently formulated is materially incomplete and that it would be impossible for the Commission to make the required determinations about the proposed market without the missing information.³⁸ Moreover, once all missing information is provided, the Application should be renoticed in the Federal Register for additional public comment. We also believe that the information currently known to the Commission warrants the denial of the Application unless further amended.

* * * * *

We appreciate the opportunity to comment on the CFFE Application and would be pleased to meet with the Commission or staff to further discuss our views.

Very truly yours,



cc: Hon. Brooksley E. Born, Chairperson
Hon. Barbara Pedersen Holum, Commissioner
Hon. David D. Spears, Commissioner
Hon. John E. Tull, Jr., Commissioner
I. Michael Greenberger, Director, Division of Trading and Markets
Alan Seifert, Deputy Director, Division of Trading and Markets
Jeffrey Aronow, Director, Division of Enforcement
Steven Manaster, Director, Division of Economic Analysis

³⁷ 63 FR 3708 (January 26, 1996)

³⁸ Section 5(g) of the Act requires exchanges to demonstrate that trading in the proposed contract is not contrary to the public interest. In addition, the Commission has stated that, under Section 5a(12) of the Act, it will disapprove contract market rules which conflict or are inconsistent with any of the policies, purposes and public interest considerations embodied in the Act. The Commission also has stated that Section 15 contemplates that the Commission will disapprove, or attempt to modify, a contract market rule which would have serious anticompetitive effects that are not outweighed by the policies and purposes of the Act to be served by the rule. CFTC Interpretation, "Standard to be Applied by the CFTC in Disapproving Contract Market Rules," 45 FR 34873 (May 23, 1980), CCH Paragraph 6526.