Chicago Board of Trade

98-26
(10)

Thomas R. Donovan
President and
Chief Executive Officer

COMMENT

July 17, 1998

The Honorable Brooksley Born
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20581

Dear Chairperson Born:

Thanks for taking the time to meet with us yesterday. As we told you then, we submitted the attached comment letter yesterday which we believe is a more comprehensive discussion of the many legal and policy issues created to date by the Cantor application.

We look forward to further dialog on these issues.

Sincerely,

Thomas R. Donovan

LaSalle at Jackson
Chicago, Illinois 60604-2994
312 435-3602
FAX 312 341-3392

Chicago Board of Trade

Thomas R. Donovan
President and
Chief Executive Officer

July 16, 1998

COMMENT

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

Re: **Application of Cantor Financial Futures Exchange, Inc. as a Contract Market in U.S. Treasury Bond, Ten-Year Note, Five-Year Note and Two-Year Note Futures Contracts, June 25, 1998**

Dear Ms. Webb:

The Chicago Board of Trade appreciates the opportunity to submit this comment letter on the above-referenced application of the Cantor Financial Futures Exchange, Inc. ("Cantor Exchange")[1] for designation as a contract market for various U.S. Treasury futures. The Cantor Exchange is a new board of trade sponsored by the New York Cotton Exchange ("NYCE") and the Cantor Group.[2] This letter supplements our earlier letters dated April 3, 1998, April 27, 1998 and June 30, 1998.

The Cantor Exchange application contravenes basic tenets of the Commodity Exchange Act and Commission rules, and should be disapproved. We discuss many of the legal flaws with the application in our April 27 and June 30 letters. We have tried to provide a comprehensive list of our legal objections in Exhibit A to this letter, but due to the short deadline, the Exhibit is a partial list[3]. Many of the legal flaws we identify are obvious. They flow directly from the unprecedented ways in which the Cantor Exchange proposes to deviate from the sound management practices of traditional contract markets through exclusionary trading practices, monopolistic brokerage activities, fixed commission rates, control over exchange operations and trading for the financial benefit of a single market participant, execution of customer orders by non-members, and avoidance of Congressionally mandated fitness requirements for exchange governing boards. Yet, the Commission staff's apparent "rush to judgment" based on a sharply abbreviated comment period and inadequate information suggests that a recommendation to expedite approval of the Cantor Exchange application, without addressing these legal problems, is to follow.

The Board of Trade is not asking the Commission to block competition. Competition is a reality. The Board of Trade has successfully faced competitive challenges in the past; we face them daily and will continue to face them again in the future. However, we oppose unfair competition gained

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1 The sponsors use the acronym "CFFE" as the short-hand name for its proposed exchange. To avoid confusion over the exchange's relationship to CFFE, LLC, which is wholly-owned by Cantor Fitzgerald, LP and not a part of the exchange's ownership structure even though it controls the new exchange through appointing 8 of 13 members of the Cantor Exchange board, we use the term "Cantor Exchange" in lieu of CFFE.

2 The term "Cantor Group" is used in this letter to refer generically to Cantor Fitzgerald, L.P. and related companies under its common control.

3 We request leave to modify Exhibit A necessary or appropriate to cover other legal objections.

LaSalle at Jackson
Chicago, Illinois 60604-2994
312 435-3602
FAX 312 341-3392

by discriminatory regulatory treatment. We ask that the Cantor Exchange be held to the same legal standards that other exchanges must meet to be designated as a contract market.

As presently constituted, the Cantor Exchange represents unfair competition. The Cantor Exchange and its sponsors have deliberately copied the Board of Trade's successful contract designs of our Treasury Bond, Ten-Year Note, Five-Year Note and Two-Year Note Futures Contracts. They freely admit that "The similarity of the [Cantor Exchange's] initial contracts to existing Treasury futures contracts will enable market participants to apply their trading strategies seamlessly to the CFFE [i.e., the Cantor Exchange] contracts." (CFFE Marketing Materials, p. 1.) The Cantor Exchange and its sponsors are seeking a competitive edge over the Board of Trade by circumventing regulatory requirements in their drive to siphon order flow from our Treasury complex. They are asking the Commission to approve their copycat contracts under a non-competitive block trading structure heretofore never allowed by the Commission for exchange markets and are seeking other regulatory advantages as well.

The Cantor Exchange should be required to comply with all the legal requirements, just like other exchanges are, or else face disapproval of its application. It is indefensible to allow the Cantor Exchange to offer replicas of the Board of Trade's Treasury futures contracts under less stringently applied regulatory standards, when the Commission prohibits the Board of Trade from offering the same contracts pursuant to the more limited relief afforded by the Commission's Part 36 Rules. (CFTC Rule 36.2(a)(4) limits the availability of the Part 36 exemptive relief to contracts that are "reasonably distinguished" from existing, non-exempt contracts traded by that contract market or by any other contract market.)

However, our objections go beyond unfair competition. The Board of Trade is concerned that the Cantor Exchange will harm the proven hedging and price discovery functions of our Treasury futures markets through market fragmentation. If approved in its current form, the Cantor Exchange will be allowed to free-ride on our successful contract designs and unjustly divert order flow from our markets with the lure of block trading. This will seriously undermine our ability to provide the reliable price discovery and efficient hedging that businesses around the world have come to expect and that Congress has found to be in the national public interest. As the Chicago Mercantile Exchange recently stated in an April 28 comment letter to the Commission, when a market seeks to offer non-competitive trading practices on the principal exchange's market, "the test must be whether the principal market is adversely affected. Otherwise, Internet exchanges can easily be established for the sole purpose of passing rules to permit upstairs trading that will drain liquidity from the true competitive marketplace."

Is the Commission preparing an assessment of whether harmful market fragmentation is likely to occur before deciding whether to approve the type of block trading facility the applicant proposes? Does the Commission plan to complete the study it initiated with its Concept Release on Regulation of Noncompetitive Transactions, which provides a framework for examining this very issue, before acting upon the Cantor Exchange's application? If not, this will represent a sharp departure from the Commission's current practice of deferring action on novel or complex exchange

proposals while it conducts a broader policy review through the concept release process,[4] thereby prejudging issues raised in the Non-Competitive Trading Concept Release.

Finally, we are concerned that the Cantor Exchange, with its numerous legal deficiencies, could harm the reputation of the futures industry. If the Cantor Exchange experiences major customer protection or market integrity problems, the entire U.S. futures industry, including the Cantor Exchange and the Chicago Board of Trade, will be tainted by the inevitable public backlash that will follow. The public will not know that the Cantor Exchange is operating under less stringent rules and offers less customer protection than other exchanges. To the contrary, if the Commission approves the Cantor Exchange application in its current form, the Cantor Exchange's federal license to operate as a designated contract market will simply foster the illusion that all exchange customers are vulnerable to the abuses that will characterize the Cantor Exchange, when they are not.

I. THE CANTOR EXCHANGE APPLICATION IS LEGALLY FLAWED AND SHOULD BE DENIED

Chairperson Brooksley Born stated, upon her appointment, that

> "we have a statutory obligation to enforce the law. We have the most admired regulatory system in the world in part because of our willingness to enforce our laws vigorously. I plan to continue the Commission's strong commitment to its enforcement program." (Remarks of CFTC Chairperson Brooksley Born at the Chicago Kent/IIT Commodities Law Institute, Chicago, Illinois on October 24, 1996.)

We agree that the Commission has an obligation to enforce the law. This is why it must disapprove the Cantor Exchange application.

Although our legal analysis is incomplete due to the material deficiencies of the record and other inadequacies of the public comment process in this case,[5] numerous legal flaws are apparent. In our June 30 letter, we focus on five of the most egregious areas where the Cantor Exchange and its sponsors, the NYCE and Cantor Group, propose willfully to violate federal law: qualifications for exchange board members, non-competitive trading, improper trade execution monopoly, floor brokerage price fixing and execution of futures transactions by exchange members. Any one of these legal deficiencies alone is grounds for disapproval and renders designation of the Cantor Exchange "contrary to the public interest." CEA Section 5(7). We cover a greater range of legal deficiencies in our April 27 letter.

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4 As noted in our June 30 letter, the Commission has deferred consideration of the New York Mercantile Exchange's and Board of Trade's separate proposals regarding, respectively, exchange of futures for swaps and exchange of agricultural futures for OTC agricultural options, pending the Commission's examination of the various issues it has identified in this Concept Release.

5 In our June 30 letter we cite several objections to the Commission's public comment process for the application, which we elaborate upon in Part V of this letter.

Exhibit A provides a partial listing of the legal objections we have identified. The listed objections, which total over 35, demonstrate that the Cantor Exchange compromises basic legal principles cutting across the Commission's entire regulatory regime. In addition to the five areas identified above, the application violates requirements in the areas of floor broker registration, exchange compliance and disciplinary programs, audit trails, EFPs, broker associations and fair and impartial arbitration forums. Approval of such a legally flawed application would call into question the Commission's commitment to enforce the laws under its administration. Approval of such a legally flawed application would constitute arbitrary and capricious agency action.

The Commodity Exchange Act establishes a model of exchange self-regulation subject to Commission oversight. This model of self-regulation is built upon two fundamental principles: (1) futures contracts must be "executed or consummated by or through ***a member*** of" a Commission designated contract market, or exchange (CEA Section 4(a)(2)); and (2) designated contract markets are responsible for overseeing the conduct of their members through effective compliance and disciplinary programs (CEA Sections 5a(a)(8) and 8c).

The Cantor Exchange, NYCE and Cantor Group threaten to undermine the CEA's proven model of responsible exchange self-regulation subject to Commission oversight through their deliberate obfuscation on the central issue of whether Terminal Operators -- ***who are the only individuals allowed to execute transactions on the Cantor Exchange***[6] -- are members of the Cantor Exchange, subject to the Cantor Exchange's self-regulatory jurisdiction as such. If the Terminal Operators are not members,[7] as is evident, then the Cantor Exchange violates Section 4(a)(2) of the Act and cannot be approved except pursuant to Commission exemptive action, which the Cantor Exchange and its sponsors are not seeking. To allow otherwise would create a gaping hole in the CEA's established regulatory regime. If Terminal Operators are members of the Cantor Exchange, then numerous other legal problems follow, as highlighted in Exhibit A.

We read the application's confusing and ambiguous statements regarding the status of Terminal Operators to mean that the Terminal Operators are not intended to be treated as members of the Cantor Exchange. But there is some confusion, perhaps deliberately fostered, on this point. On the one hand, the Cantor Exchange suggests that Terminal Operators are members by providing for limited (and inadequate) NYCE monitoring of Terminal Operator trading activities and by stating that Terminal Operators will become registered as floor brokers, which is allowed under CFTC and NFA rules only if they are exchange members. On the other hand, Terminal Operators are excluded from the provisions in the Cantor Exchange By-Laws and Rules setting out the scope of the Cantor Exchange's jurisdiction (see Exhibit A, Legal Objection 2); Terminal Operators are

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6 The right to execute trades is a commonly recognized attribute of exchange membership. The Commission itself defines a member of a contract market to include "individuals . . . given members' trading privileges" on a contract market. CFTC Rule 1.3(q).

7 Although the Board of Trade allows non-members to input orders into our Project A System, that is not valid precedent for waiving membership status for the Terminal Operators. In the Project A context, terminal operators must be employed by members of the Exchange, which eliminates any gap in our regulatory oversight. Moreover, the Board of Trade has clear jurisdiction directly over the individual terminal operators as employees of members. In sharp contrast, the Terminal Operators on the Cantor Exchange will be employed by Cantor Fitzgerald Securities, ***which is not going to become a member of the Cantor Exchange***. (It is Cantor Fitzgerald & Co. that will become a Clearing Member of the Cantor Exchange.)

subject to private rules (presumably set by the Cantor Group) which have not been submitted to the Commission for approval; and the Cantor Exchange and its sponsors offer no clear explanation regarding who, if anyone, may discipline Terminal Operators or under what procedures. In our view, these factors destroy any illusion that Terminal Operators are subject to meaningful regulatory oversight as quasi-members.

It is difficult to know if our interpretation is correct without any Commission staff description of its understanding of the membership status of the Terminal Operators. We could offer our legal analysis and comments based on such an interpretation on this critical point, if we had it. But since we do not, we have conducted our legal analysis in the alternative, covering both scenarios, and so note in Exhibit A.

II. THE COMMISSION SHOULD NOT RUSH THE APPROVAL PROCESS FOR A FIRST TIME APPLICANT FOR CONTRACT MARKET DESIGNATION

The approval process for contract market designation is a basic component of CFTC regulation. As the Commission recently stated when it adopted its "fast track" rules:

> "The requirement that boards of trade meet specified conditions in order to be designated as contract markets has been a fundamental tool of federal regulation of commodity futures exchanges for the past seventy-five years." 62 Fed. Reg., 10434 (March 7, 1997).

The designation process is most important for a first time applicant, such as the Cantor Exchange, which does not have established operations or any futures trading history. A de novo application such as this requires the Commission's careful consideration of all aspects of the new exchange's proposed operations to ensure that the exchange will comply with the qualification standards of Sections 5 and 5a of the Act.

Given this, we question why the Commission staff appears to be rushing its consideration of the Cantor Exchange application, especially when the application has so many legal problems and raises so many legal and policy issues. Indeed, many of the issues raised are the express subject of a pending concept release by the Commission. The Commission's unreasonable fifteen day deadline for the current comment period and its failure to offer any legal analysis, including any identification of relevant legal and policy issues for public comment in its Federal Register notices on the Cantor Exchange application,[8] provide compelling indications of this apparent rush to judgment. It also places the Commission in the untenable position of pre-judging issues on which it has solicited, but not yet received, public comment.

As further proof, the Commission staff has yet to apply the same close scrutiny to the technical capabilities of the Cantor Exchange's electronic bulletin board, the Cantor System, that it has

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8 In addition to the other examples we have cited relating to U.S. exchange proposals which the CFTC has tabled pending completion of a concept release process, the Commission recently advised the DTB that it will no longer consider the DTB's requests under a February 29, 1996 no action letter to place additional trading terminals within the U.S. because the Commission plans to undertake a broader policy review of how it should regulate expansion of foreign exchanges' electronic trading systems into the U.S.

applied to other exchanges' electronic systems. This disparity is illustrated by Exhibit B, which compares the Commission's review of the Board of Trade's Project A System versus the Cantor System. For example, the Commission staff has not required the Cantor Exchange to obtain an independent, in-depth verification of the technical capacity, security and reliability of the Cantor System, as it required of the Board of Trade for our Project A System. Commission approval of the Board of Trade's revised Project A Rules was delayed approximately four months while an outside consultant closely evaluated the Project A System, at a cost to the Board of Trade of over $100,000.[9]

Another indication is provided by the Commission staff's apparent willingness to waive traditional caution towards exchange non-competitive trading proposals. For example, those U.S. futures exchanges that permit crossing do so pursuant to Commission approved rules that require exposing orders to other market participants before they may be crossed, which ensures a correlation to the prevailing market. In this case, however, the Commission has not raised any serious objections to the Cantor Exchange's proposal to implement crossing procedures pursuant to which orders will be matched at a randomly selected price,[10] notwithstanding the Cantor Exchange's own admission that the assigned match price "may be inferior to the prices that could otherwise be obtained." (See the proposed Customer Information and Risk Disclosure Statement included in the June 18 submission as Schedule IV, at page IV-4.) Indeed, the Commission has been far more conservative in providing relief to existing exchanges from competitive trading requirements ***pursuant to its exemptive authority*** than has yet been displayed in the consideration of the Cantor Exchange's proposed closed and monopolistic Exclusive Time and Clearing Time procedures and off-market order crossing procedures. For example, when the Commission adopted its Part 36 exemptive rules for exchanges, it stated that it would re-evaluate an exchange's special, non-competitive execution procedures twelve months after they become effective [60 Fed. Reg. 51334 (Oct. 2, 1995)] and demanded adherence to strict audit trail standards (CFTC Rule 36.3(b)). In sharp contrast, the Commission staff have yet to even acknowledge that the Cantor Exchange's proposed trading procedures are non-competitive or that the Cantor Exchange's proposed audit trail is deficient.

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9 Relying on the Cantor Group's assurances that the Cantor System has been used by the Cantor Group in connection with its trading of cash Treasury securities is inappropriate. That base system must be enhanced to add new functionality for trading of futures contracts and to add new functionality for the Cantor Exchange's proposed market crossing procedures, which the Cantor Group does not offer as part of its cash brokerage activities. (See May 21 Q&A at question 83.) Moreover, the Cantor Exchange's press reports and membership materials indicate that the Cantor Exchange plans to move to interactive electronic trading, including placement of trading terminals directly with Authorized Traders outside building where the Terminal Operators will trade, shortly after the Commission approves the pending application. The Commission cited the Board of Trade's plans to expand access to Project A outside the Board of Trade building as one of the reasons for requiring us to obtain the outside consultant review at great expense and delay.

10 The match price will be selected randomly from trade prices that occur in the Cantor Exchange's parallel market during the three minute window following the relevant crossing time set by the Cantor Exchange. See proposed Cantor Exchange Rule 314-B. Treasury futures prices can move rapidly during a three minute interval. For example, on June 17, 1998, during the three minute interval from 8:21 a.m. to 8:23 a.m., the Board of Trade's June 98 Treasury Bond futures contract experienced 14 price changes within a 7 tick range ($218 per contract, or $2,180 for a 10-lot order). Similar price changes occurred within ranges of 4 to 7 ticks during other three minute intervals that day.

III. IF THE CANTOR EXCHANGE CANNOT COMPLY WITH THE LAW, IT MUST SEEK TO CHANGE IT

Commission approval of the Cantor Exchange application will move federal regulation of futures markets in a fundamentally new direction without proper analysis by the Commission staff. The Commission should not, and legally cannot, implement major policy changes through a contract designation proceeding. If the Commission wishes to alter the policies and legal requirements of its rules to accommodate the unique and unprecedented features of the Cantor Exchange, it may only do so in accordance with federally mandated rule making procedures or pursuant to its exemptive authority under Section 4(c) of the Act. If the Commission wishes to waive certain statutory provisions to accommodate the Cantor Exchange, it may only do so pursuant to its exemptive authority under Section 4(c). Whether the Commission proceeds through rulemaking or exemptive action, federal law is clear that the Commission must provide notice and an opportunity for public comment.

The Commission itself recognizes that:

> "the best mechanism for handling novel or complex issues, significant gaps in regulatory coverage, relief from regulatory requirements or initiatives for regulatory reform generally is the notice and comment rulemaking process or, where appropriate, exemptive action by the Commission itself after notice and public comment." CFTC Proposed Rule on Requests for Exemptive, No-Action and Interpretive Letters, 63 Fed. Reg. 3285, at 3285 (January 22, 1998).

Without question, the Cantor Exchange proposal raises the very type of "novel" or "complex" issues that signal significant gaps in regulatory coverage that necessitate regulatory action. For example, a number of the Commission's rules relating to trading activity are predicated upon "member" status. If Terminal Operators are treated as non-members, as the Cantor Exchange intends, they may circumvent requirements that should apply on the basis of a technicality.

The Cantor Exchange application raises other issues that may indicate regulatory gaps. This should not come as a surprise given that the Cantor Exchange would be the first "proprietary exchange" controlled by a single private firm. It is highly unlikely that Congress in promulgating the CEA or the Commission in promulgating its regulations contemplated a contract market that would be controlled by one firm. As House Agricultural Committee Chairman Robert F. Smith and Risk Management Subcommittee Chairman Thomas W. Ewing noted in their May 25 letter to Chairperson Born:

> "[P]roprietary exchanges, by definition, raise special fitness issues. If a firm controls an exchange's board, should that firm only be required to meet existing fitness standards for sitting on exchange boards or even a more exacting standard, since that single firm rather than a majority of members would decide policy for a proprietary exchange? Should the firm controlling the exchange or its affiliates be barred from trading on the exchange or in related cash markets, to the same extent as current exchange officials and personnel? What special market integrity problems do proprietary exchanges create?

The Cantor Exchange proposal does not fit the current regulatory framework established by the CEA and the Commission's regulations. If the Commission for any reason decides to continue to entertain the Cantor Exchange application, it should table the application until it has taken the time and steps necessary to develop and formalize a regulatory approach that applies equally to all exchanges and takes into consideration the public interest as required by CEA Section 4(c).[11] Those steps should include opportunity for substantive public comment and discussion to best assist the Commission in establishing an appropriate generic regulatory approach. The Commission will not be in a position to make an informed determination regarding the requisite level of regulation for the Cantor Exchange until it has had the opportunity to review and consider the relevant rulemaking comments from the public.

Furthermore, if the Commission simply adopts a case-by-case approach to the review of alternative exchange models such as the Cantor Exchange, and if the Commission applies regulatory treatment to such reviews on an ad hoc basis, it runs the risk of creating regulatory anomalies that could severely damage the futures industry. Instead, the Commission should consider a more comprehensive and structured approach, as it has in other instances.

IV. THE CANTOR EXCHANGE APPLICATION IS MATERIALLY INCOMPLETE

The Cantor Exchange, NYCE and Cantor Group have provided ample evidence that their proposal violates many CEA and Commission requirements and, therefore, should be disapproved. If the Commission believes, however, that more legal analysis is required, then it should demand greater responsiveness from the Cantor Exchange and its sponsors since the record they have provided is still missing critical information on which to base a complete legal analysis. As we noted in our June 30, 1998 comment letter, the Cantor Exchange's May 21 and June 18 submissions compound the material deficiencies of the record by providing ambiguous and non-responsive answers that ignore the questions as asked by the Commission staff.

The May 21 and June 18 application materials are replete with superficial, vague and ambiguous answers that appear to be deliberate attempts to obscure critical aspects of the Cantor Exchange proposal from careful scrutiny. This is especially true with respect to the status and oversight of the Terminal Operators. The ambiguous and confusing statements in the May 21 Q&A on such an important matter as who, if anyone, has authority to discipline Terminal Operators -- a confusion that still persists -- confirms the Cantor Exchange's planned obfuscation. (Compare the responses to question 16, which suggests that NYCE can discipline Terminal Operators, with the response to question 51, which indicates that only the Cantor Exchange may discipline them.) Of course, the January 8 submission initiated the confusion when the Cantor Exchange misrepresented the Terminal Operators as "clerical." That characterization is belied by the descriptions in the May 21 Q&A confirming that Terminal Operators will act in the same manner they do today as registered government securities representatives, having the same extensive interaction with customers and with one another in soliciting, receiving, handling and executing orders for Cantor Exchange

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11 In Part V of our April 27 letter, we discuss certain basic conditions dictated by public interest considerations that we believe should be incorporated into any alternative or revised exemptive framework for exchanges. These include, among others, limiting availability of the exemption to contracts that do not replicate non-exempt contracts and anti-fraud and anti-manipulation rules. Please refer to that earlier discussion.

futures contracts. (See, e.g., May 21 Q&A, responses to questions 47.a. through i.) The Commission staff so noted in its May 6 letter.

Another excellent illustration of the Cantor Exchange's non-responsiveness is its failure in the May 21 Q&A to offer any credible explanation to the Commission staff's questions regarding how a central feature of the Exclusive Time procedures, ***withholding better bids or offers from the two parties involved in the exclusionary work-up process***, is "not . . . inconsistent with Commission Regulation 1.38(a)'s requirements that all futures contracts be executed in an open and competitive manner." (Question 69.d.) After acknowledging that "bidding through an offer" or "offering through a bid" could occur without replacing the posted bid or offer, the Cantor Exchange then offers the contradictory statement that during the Execution Time (which includes Exclusive Time) "participants trade at ***the best available price***, which will be available to all participants on a fair and equal basis," as its explanation for how the Exclusive Time trade-matching algorithm "does not contradict the standards set forth in CFTC Regulation 1.38." (See May 21 Q&A, response to question 69.d., emphasis added.) When asked again ***how a trade matching algorithm that rejects bids or offers that better the market*** is consistent with the Commission's open and competitive trading standards, the Cantor Exchange simply refers back to this non-responsive answer, ignoring a core tenet of futures regulation. (See question 79 and corresponding answer.)

Other vivid examples of assertions masquerading as responsive explanations include:

1. When asked for the report ***or findings*** of the investigation that the Cantor Group commissioned to determine if any Cantor traders gained an unfair advantage by accessing terminal screens used by a Cantor interdealer broker affiliate, the Cantor Exchange responded with a copy of a letter from the outside investigators (Mr. Richard Breeden and Mr. Brandon Becker) containing general conclusory statements, with no explanation as to why the actual findings were being withheld. (See May 21 Q&A question 26 and corresponding answer and Schedule III.) In response to the Commission's June 11 follow-up request for a copy of the independent review underlying this letter, the Cantor Exchange revealed for the first time that "No written communication between Mr. Breeden and his legal advisors has been shared with Cantor Fitzgerald. Mr. Breeden provided Cantor Fitzgerald with an oral briefing of the results, but Cantor Fitzgerald never saw or received any written report or findings." (See June 18 Q&A question 7 and corresponding answer.) The Cantor Exchange offers no explanation of the actual findings in its June 18 submission.[12]

2. When asked how the trade matching algorithm for the market crossing sessions is consistent with the open and competitive trading requirements of CFTC Regulation 1.38, the Cantor Exchange responded with a description of the new procedures for setting the market crossing price, but offered no explanation of how the crossing procedures satisfy Regulation 1.38 other than to assert that the Cantor Exchange's participants "will all be treated exactly the same under such procedures." (See May 21 Q&A, question 82.a. and corresponding answer.)

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12 Further, if the Breeden-Becker letter is not based upon a complete written report of facts and findings, it would hardly qualify as the kind of third party expert opinion that should be given any weight by the Commission.

3. When the Commission recommended that the Cantor Exchange withdraw rules pertaining to the Clearing Time based on indications that the exchange did not have immediate plans to offer Clearing Time, the Cantor Exchange declined so that it would "have the necessary 'infrastructure' in place if it decides to introduce Clearing Time at a later stage." (See June 18 Q&A, question 3 and corresponding answer.) Yet, the Cantor Exchange has offered no justification for how such non-competitive practices are compatible with CFTC Regulation 1.38.

4. When asked what measures the Cantor Exchange or NYCE would take to prevent abuse of the look-back feature which is intended to allow a Terminal Operator to undo certain trades made in error, the Cantor Exchange responded with the generic statement that "NYCE compliance staff will monitor the use of the "error" and "undo" keys by CFFE TOs," without any explanation of how such monitoring will be conducted. (See May 21 Q&A, question 87.f. and corresponding answer.)

5. When asked to submit the amounts of the "Execution Fees" and "Transaction Fees" referenced in Cantor Exchange By-Law Section 32, the Cantor Exchange responded that "The fee amounts for the four Contracts that will initially be traded on CFFE [i.e., the Cantor Exchange] remain to be determined." (See May 21 Q&A, question 8 and corresponding answer.) It is important to know the amounts of these fees, along with clarification on what portion of the Transactions Fees will be paid to the Cantor Group and, in turn, to the Terminal Operators, to understand the financial incentives that may influence the conduct of those given a monopoly on trade execution on the Cantor Exchange. Moreover, the Transaction Fees represent the Cantor Exchange's attempt to fix floor brokerage commissions in violation of the federal anti-trust laws.

6. When asked to provide a "complete description of the measures CFFE [i.e., the Cantor Exchange], NYCE and Cantor have taken to ensure that their technical systems and the technical systems of each entity on which they rely for any part of their operations are Year 2000 compliant," the Cantor Exchange responded by providing two schedules that contain scant information relevant to its operations. (See May 21 Q&A, question 89 and corresponding answer.) Schedule V to the May 21 Q&A, which explains the NYCE's measure contains only the following statement directly pertaining to the Cantor Exchange: "since the inception of the partnership of NYCE and Cantor Fitzgerald to form the Cantor Financial Futures Exchange ("CFFE"), all development has taken into consideration Y2K." (Schedule V, p. V-2.) Similarly, the only statement pertaining to the Cantor Exchange contained in Schedule VI to the May 21 Q&A, which covers the Cantor Group's measures, is that "Y2K compliance has been built into the current release of the Cantor System." (Schedule VI, p. VI-1.) Commission staff has made on-site visits to the Board of Trade and other existing exchanges to review year 2000 readiness. It is not apparent from the publicly available materials whether the Commission is performing similar on-site reviews of the Cantor Exchange's technical systems.[13]

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13 Similarly, the Cantor System should be subject to independent verification like the Project A System.

7. When asked how ***certain Cantor Exchange rules*** pertaining to self-regulatory functions that NYCE will perform for the Cantor Exchange (such as rules on the composition of NYCE disciplinary committees when hearing Cantor Exchange cases) could ***govern the NYCE***, the Cantor Exchange responded by reiterating that NYCE has agreed to perform the Cantor Exchange's self-regulatory functions and by offering clarifications to the ***Cantor Exchange rules***. (See May 21, questions 1.a. and 2.a. corresponding answers.)

8. When asked to explain its statement that Terminal Operators are unlikely to engage in solicitation of orders, after confirming that "TOs will be permitted to solicit orders from. . . Authorized Traders," the Cantor Exchange ignored the thrust of the question by responding that "Soliciting business generally, as opposed to solicitation of specific trades, is simply a part of CFFE's [i.e., the Cantor Exchange's] general marketing efforts to become a successful and liquid marketplace." (See June 18 Q&A, question 15 and corresponding answer.)

9. When asked what portion of the Terminal Operators' bonuses would be based on the volume of trades they execute on CFFE, the Cantor Exchange again ducked the question by responding that "The discretionary bonus paid to a particular TO will be based upon the overall performance of CFFE [i.e., the Cantor Exchange] as well as the performance of such TO, taking into account (i) customer satisfaction, (ii) compliance with CFFE rules and other requirements applicable to TOs and (iii) discharge of all responsibilities in connection with his or her role as a TO." (See June 18 Q&A, question 21.b. and corresponding answer.) This response does not address whether bonuses would be based on the Cantor Group's customer business, but it is a conclusion that is hard to escape. Clarification on how the Terminal Operators are compensated is important to any meaningful analysis of whether dual trading concepts should apply to the Terminal Operators, as we believe they should.

10. When asked what measures the Cantor Exchange or NYCE would adopt "to ensure that error accounts are not abused by the designated Cantor affiliate by taking in favorable CFFE trades that were not, in fact, executed in error," the Cantor Exchange responded with a general description of the surveillance data that would be available, followed by the assertion that "NYCE will conduct spot checks of error trades," with the "frequency and intensity of such checks" to "depend on the results obtained." (See May 21 Q&A question 23 and corresponding answer.) Given the potential for abuse of error accounts, the Commission should insist upon a more complete description of the NYCE's compliance program for monitoring the error account.[14]

This list is not exhaustive; other examples exist. Moreover, critical information is missing in other areas not covered by the Commission's May 6 or June 11 questions. For example, the application

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14 The Cantor Group reportedly has used its house accounts on some occasions to trade against customers. See, Thomas Jaffe, "Between the Wall and the Wallpaper," Forbes, October 20, 1997. A copy of this article is attached as Exhibit D to our April 27, 1998 letter. Given the serious customer protection implications of these allegations, it would be inappropriate for the Commission to accept the Cantor Exchange's assertion that no wrong doing occurred without further inquiry.

materials provide scant information on how the Cantor Exchange will be integrated into the Commodities Clearing Corporation's clearing operations.

The Commission should remit the May 22 and June 18 submissions as materially incomplete and insist that the Cantor Exchange and its sponsors replace them with more complete and candid answers to the Commission staff's questions.

V. THE COMMISSION SHOULD REPUBLISH THE APPLICATION FOR FURTHER COMMENT IF IT IS SUPPLEMENTED

We wish to reiterate the objections we raised in our June 30 letter regarding the Commission's handling of the public comment process. In particular, we object to the current comment period as premature given the many deficiencies in the record which hinder a complete legal analysis. At fifteen days, it is also much too short. If the Commission decides to keep the application open rather than deny it based on the legal problems currently known to exist, then the Commission should suspend its review of the application as materially incomplete and provide for another comment period in the future, 60 to 90 days in length, after the Cantor Exchange, NYCE and Cantor Group provide a complete and unambiguous description of their proposal and the Commission staff completes its own legal analysis to identify relevant issues for public comment.

The NYCE and Cantor Group have made significant changes to their plans for the Cantor Exchange since the close of the original public comment process on April 27,1998, and are likely to continue doing so. These changes include, among others:

1. The Cantor Exchange now plans to have Terminal Operators register as floor brokers and has dropped the fiction that Terminal Operators will act only in a clerical capacity in soliciting, handling and executing orders for Cantor Exchange Treasury futures contracts. The Cantor Exchange does not explain, however, how Terminal Operators can qualify for floor broker registration without being "members" of the exchange, as required by CFTC and NFA rules.

2. The exchange will no longer be a joint employer of the Terminal Operators. In the May 21, 1998 submission, the Cantor Exchange stated that Terminal Operators will be jointly employed and compensated (including incentive bonuses) by Cantor Fitzgerald Securities, LLC and CFFE, LLC, which, despite the name association with the "CFFE" acronym that the exchange itself uses, is ***not*** part of the ownership structure of the exchange and is, in fact, a wholly-owned subsidiary of Cantor Fitzgerald, LP. In the June 18 submission, the Cantor Exchange now states that the Terminal Operators will be employed ***solely*** by Cantor Fitzgerald Securities, LLC or another Cantor Group company. (See response to June 18 Q&A question 21.a.)

3. In the May 21 submission, the Cantor Exchange stated that the rules governing the conduct of the Terminal Operators would be set out in a private employment agreement, and not in the Cantor Exchange By-Laws and Rules. This agreement, although material, was not included as part of the Cantor Exchange's May 21 submission, prompting the Commission to request a copy in its June 11 letter. (See June 11 letter, question 19.a.) The agreement that the Cantor Exchange included as part of its June 18 submission does not set out specific standards, but instead cross-references a "CFFE Policies and Procedures Manual"

(June 18 Q&A, Schedule III, at p. III- 2), which was not to be found as part of the June 18 submission.

4. Like the Terminal Operators, the Supervisors will no longer be jointly employed by the Cantor Exchange, even though they will have first line responsibility for monitoring the Terminal Operators' compliance with the private rules that govern their conduct and will have the authority to decide whether the Cantor Group will accept financial responsibility for Terminal Operator trading errors. According to the May 21 submission, the Supervisors will be jointly employed and compensated (including incentive bonuses) by two Cantor Group entities, Cantor Fitzgerald Securities, LLC and CFFE, LLC, the wholly-owned subsidiary of Cantor Fitzgerald, LP. It is unclear whether their employment status, too, has changed yet again, as it has with the Terminal Operators.

5. The Cantor Exchange has a newly created class of 1,000 Associate Memberships.

6. The methodology for setting the price at which orders will be crossed during Market Crossing Sessions has been completely changed; the crossing price will now be set by randomly selecting the price at which a trade outside the crossing session occurs during the three minute period following the relevant crossing time.

7. Commodities Clearing Corporation, and not a newly formed New York Board of Clearing, Inc., will clear Cantor Exchange trades. The Cantor Exchange's sponsors are also apparently considering creating a class "C" clearing membership limited to Cantor Exchange products. (See Letter dated April 3, 1998 from Mound, Cotton & Wollan to David VanWagner, Special Counsel, CFTC Division of Trading and Markets.) The May 22 and June 18 submissions did not provide any further information on this plan.

8. Class B Membership in the Cantor Exchange's holding company, CFFE Regulatory, LLC, will now be offered to full members of the Coffee, Sugar & Cocoa Exchange, as well as to full members of NYCE. (See June 18 Q&A response to question 10 and June 18 CFFE By-Law Section 35.)

Changes such as these impact any legal analysis of the Cantor Exchange. If the NYCE and Cantor Group make further material changes to their plans for the Cantor Exchange, the Commission should republish the application for further public comment. If the comment process is to have any value, interested parties should be allowed to comment on the sponsors' ***final (or near final) plans*** for the Cantor Exchange, not just on earlier versions of the proposal when many key features are in a state of flux.

The Commission also is obligated under Section 5a(a)(12) of the CEA to republish for public comment any future changes to the proposed Cantor Exchange By-Laws and Rules that the Commission determines to be of major economic significance. Section 5a(a)(12) requires the Commission to "give interested persons an opportunity to participate in the approval process" for such rules (including rule changes) by publishing notice of such rules in the Federal Register at least thirty days before their approval. The Cantor Exchange has already made a number of changes to its original set of proposed rules, and may make other rule changes as their business plans change or as the Commission identifies other questions through its on-going review of the application.

If the Commission reopens the application for public comment again, it should provide a more reasonable comment period than fifteen days. We recommend 60 to 90 days given the novel and complex issues that the application raises. At a minimum, the Commission should allow thirty days for public review and comment, consistent with Section 5a(a)(12) and the Commission's internal policy as stated in Appendix D to the Commission's Part 5 rules.[15]

Our own experience refutes any notion that fifteen days is adequate. We began our legal analysis of the Cantor Exchange application long before the Commission decided to reopen the comment process. Despite devoting substantial resources to this effort, our legal analysis is still on-going. We know first hand that it is extremely time consuming, and extremely resource intensive, to (i) obtain the publicly available materials; (ii) review those materials; (iii) piece together a coherent understanding of the proposal from the disparate, incomplete and inconsistent information contained in those materials; (iv) identify and analyze the myriad issues that the application poses; and (iv) draft a comment letter based on the legal analysis. It is unreasonable to expect anyone to complete that process in fifteen days, especially if they are considering commenting for the first time. In the end, we fear that the daunting task of reviewing the proposal within fifteen days without any assistance from the Commission in synthesizing the application materials to provide a comprehensive description of the proposal or in identifying the special issues that should be addressed has discouraged full public participation in the comment process and masked the significant legal and policy issues the application raises.

VI. CONCLUSION

The Commission should enforce the law as written and, as a result, disapprove the application, unless its sponsors agree to change their proposal to comply with federal law. The Commission should not engage in tortured interpretations of the many applicable legal requirements simply to accommodate the Cantor Exchange. Such legal contortions would constitute arbitrary and capricious action by the agency. Moreover, as the Commission itself has recognized, the "best mechanism for handling novel or complex issues. . . is the notice and comment rulemaking process or, where appropriate, exemptive action by the Commission itself after notice and public comment." 63 Fed. Reg. 3285.

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15 This provision states:

> "The Commission will seek public comment on applications for designation of futures and option contract markets by publishing a notice of availability of the terms and conditions of the proposed contract. Generally, the Commission will provide for a public comment period of thirty days on such applications for designation; provided, however, that the public comment period will be fifteen days for those applications submitted for review under the fast-track procedures of §5.1(b) under §140.96 of this part."

The Cantor Exchange rules do not qualify for fast-track treatment since the Cantor Exchange is a first time applicant for contract market designation. CFTC Rule 5.1(a)(4).

The Board of Trade would be happy to meet with the Commission to discuss the legal objections to the Cantor Exchange application set out in this letter and in our earlier comment letters.

Sincerely,

Thomas R. Donovan

cc: The Honorable Brooksley Born, Esq.
The Honorable John E. Tull, Jr.
The Honorable Barbara Pedersen Holum
The Honorable David D. Spears
I. Michael Greenberger, Esq., Director, Division of Trading and Markets
Steven Manaster, Director, Division of Economic Analysis

EXHIBIT A
SUMMARY OF LEGAL OBJECTIONS WITH THE CANTOR EXCHANGE[1] APPLICATION

A. NON-COMPLIANCE WITH QUALIFICATION STANDARDS FOR BOARD MEMBERS

1. CFFE, LLC, a wholly owned subsidiary of Cantor Fitzgerald, LP, will appoint 8 of 13 directors on the Cantor Exchange's board. This control is contrary to CEA Section 5a(a)(16) and CFTC Rule 1.63 and to CEA Section 5a(7)'s public interest requirement for contract market designation.

In January 1997, the CFTC fined Cantor Fitzgerald & Co. $500,000 and imposed various sanctions on the firm in settling CFTC allegations that the firm participating in a fraudulent money management scheme. CFTC Rule 1.63(b)(1) requires a contract market to adopt rules making "a person ineligible" to serve on the exchange's board of directors who "was found within the prior three years by a final decision of . . . the Commission to have committed a disciplinary offense." The CFTC's 1997 order against Cantor Fitzgerald & Co. involves a disciplinary offense that disqualifies the Cantor Group[2] from serving on the Cantor Exchange's board until January 2000. Unless the Commission intends to render the requirements of CFTC Rule 1.63 a complete sham, the rule should also disqualify the Cantor Group from appointing any directors to serve on the Cantor Exchange board, let alone a majority of the directors as proposed.

The Cantor Group's control of the Cantor Exchange board violates CFTC Rule 1.63 and the Commission's underlying policy that "SRO bodies which establish and enforce an SRO's rules be impartial and free from the potential for ***and even the appearance of impropriety***." 54 Fed. Reg. 37001 (Sept. 6, 1989) (emphasis added).

B. IMPROPER DELEGATION OF TRADE EXECUTION TO NON-MEMBERS

2. Section 4(a) of the CEA requires transactions to be "executed or consummated by or through a member of" a designated contract market. The Cantor Exchange violates this basic legal tenet, as well as CEA Section 5a(7)'s public interest requirement for contract market designation, because trades will be executed by or

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1 The sponsors use the acronym "CFFE" as the short-hand name for its proposed exchange. To avoid confusion over the exchange's relationship to CFFE, LLC, which is wholly-owned by Cantor Fitzgerald, LP and not a part of the exchange's ownership structure, we use the term "Cantor Exchange" in lieu of CFFE.

2 The term "Cantor Group" is used in this letter to refer generically to Cantor Fitzgerald, L.P. and related companies under its common control.

through Terminal Operators who are not members of the Cantor Exchange.[3]

The Cantor Exchange and its sponsors, the New York Cotton Exchange ("NYCE") and Cantor Group, have provided some confusing indications of whether Terminal Operators are members. On the one hand, they suggest that Terminal Operators are members by providing for limited (and inadequate) NYCE monitoring of Terminal Operator trading activities and by stating that Terminal Operators will become registered as floor brokers, which is allowed under CFTC and NFA rules only if the Terminal Operators are exchange members.

We conclude that the Terminal Operators are not members, however, because they are excluded from the provisions in the Cantor Exchange By-Laws and Rules[4] setting out the scope of the Cantor Exchange's jurisdiction. The preamble to the Cantor Exchange By-Laws states:

> "All persons who hold Trading Privileges on CFFE [i.e., the Cantor Exchange] shall . . . (ii) be subject to the jurisdiction of CFFE and the Cotton Exchange for purposes of arbitration, disciplinary, compliance and surveillance procedures."

Cantor Exchange By-Law 36, in turn, omits Terminal Operators from the list of persons who are eligible for "Trading Privileges" on the Cantor Exchange, thereby excluding them from the Cantor Exchange's jurisdiction. Instead, the Terminal Operators are employed by the Cantor Group and "provided by" the Cantor Exchange to perform certain services.[5]

None of the persons whom the Cantor Exchange attempts to pass off as "members" by conferring so called "Trading Privileges" on them -- namely, Screen Based Traders, Associate Members and Clearing Members -- can actually execute transactions in futures contracts on the Cantor Exchange. The Cantor Group and its Terminal Operators will have a monopoly on all trade executions. The "Trading Privileges" that the Screen Based Traders, Associate Members and Clearing

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3 Their Cantor Group employer, Cantor Fitzgerald Securities, LLC, is also not a member of the Cantor Exchange; it is Cantor Fitzgerald & Co. that will become a Clearing Member of the Cantor Exchange. Thus, the situation is not analogous to the Board of Trade, where non-members may input orders into our Project A System, because such operators must be employed by a member of the Board of Trade, which eliminates any gap in our regulatory oversight. The Board of Trade also has clear jurisdiction over the Terminal Operators as employees of members.

4 References to Cantor Exchange By-Laws and Rules are to the June 18 draft, unless otherwise noted.

5 See Cantor Exchange Rule 724, which begins "The CFFE [i.e., the Cantor Exchange] shall provide Terminal Operators to perform certain services for Clearing Members and Screen Based Traders with respect to the CFFE."

Members[6] enjoy is simply the right to place orders directly with a Terminal Operator. "Trading Privileges" constitute nothing more than the right commonly enjoyed by many non-members today to phone orders directly to a member or member firm's personnel on an exchange's trading floor. "Trading Privileges" is a misnomer designed to create the illusion that Clearing Members, Screen Based Traders and Associate Members, and not Terminal Operators, should be the focus of the Cantor Exchange's self-regulatory oversight.

If the Terminal Operators are not members, as we have concluded, then the Cantor Exchange violates Section 4(a)(2) of the Act and cannot be approved except pursuant to Commission exemptive action, which the Cantor Exchange and its sponsors are not seeking. To allow otherwise would create a gapping hole in the CEA's established regulatory regime. If Terminal Operators are members of the Cantor Exchange, then numerous other legal problems follow, as highlighted in this Exhibit.

3. The Cantor Exchange violates the implicit CEA requirement that an exchange must provide open membership access subject to reasonable eligibility standards. This requirement is reflected in CEA Section 5(5), which prohibits an exchange from excluding certain cooperative associations from exchange membership. It is also embodied in the Commission's Part 8 Rules, which set out procedures for Commission review of exchange membership denial actions.

The CFTC defines the term "Member of a contract market" to mean and include "individuals, associations, partnerships, corporations, and trusts owning or holding membership in, or admitted to membership representation on, a contract market or given members' ***trading privileges*** thereon." CFTC Rule 1.3(q) (emphasis added). Although Terminal Operators are not members of the Cantor Exchange, Terminal Operators clearly fall within this definition given their trade execution role.

The Terminal Operators are the only ones given what would be commonly recognized as "members' trading privileges" on the Cantor Exchange. They are the true analogy to traditional floor members, yet the Cantor Exchange does not treat them as "members." The Cantor Exchange violates the qualified open membership requirement by giving the Cantor Group and its Terminal Operators an exclusive monopoly on trade execution. The Cantor Group alone decides who it will assign as Terminal Operators, subject only to NYCE background checks, and Terminal Operators must be employees of Cantor Fitzgerald Securities.

C. PROBLEMS WITH REGISTRATION OF TERMINAL OPERATORS AS FLOOR BROKERS

The Terminal Operators will be performing trade execution functions that the CFTC has determined require floor broker registration. Yet, the Cantor Exchange's proposal to register the Terminal Operators as floor brokers without treating them as members of the Cantor Exchange is a half-step that attempts to create the illusion that Terminal Operators will be subject to appropriate oversight.

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6 The definitions of these terms in the Cantor Exchange's rules cover that same persons listed in Cantor Exchange By-Law 36.

4. Registration of the Terminal Operators as floor brokers would violate CFTC Rule 3.11. CFTC Rule 3.11(a)(2) prohibits registration of an applicant as a floor broker "unless the applicant has been granted trading privileges by a board of trade designated as a contract market by the Commission." In other words, an applicant must be a member of a designated contract market before he or she can become registered as a floor broker. The Cantor Exchange, however, does not include Terminal Operators within its concept of "membership" and, indeed, excludes Terminal Operators from its rule defining the categories of persons who do have "trading privileges." Thus, the Commission cannot permit registration of Terminal Operators unless and until the Cantor Exchange treats them as members.

5. The National Futures Association ("NFA") processes floor broker registrations for the Commission. The NFA's rules incorporate the Commission's Part 3 registration rules by reference. See NFA Rule 201. Thus, absent amendment, the NFA's rules also bar registration of the Terminal Operators as floor brokers unless and until the Cantor Exchange treats them as members.

6. CFTC Rule 1.62 requires each exchange to adopt and enforce rules prohibiting a person from purchasing or selling futures contracts for others "in or surrounding any pit, ring, post, or other place provided by such contract market for the meeting of persons similarly engaged" unless such person is registered as a floor broker. Although the Cantor Exchange has represented that Terminal Operators will register as floor brokers, it does not have any rules setting out this requirement. And, in any event, such rules could not be enforced unless the Cantor Exchange clearly treats the Terminal Operators as members. (See "4".)

7. The Cantor Exchange may also violate CFTC Rule 3.34.

Assuming the Terminal Operators are eligible to register as floor brokers, this rule requires that they attend ethics training sponsored by an SRO or by a Commission approved party. The Cantor Exchange indicates that Cantor Fitzgerald will be involved in providing the ethics trading, although the firm's precise role is not clearly defined. In the June 18 Q&A, the Cantor Exchange states that:

> "The seminars for TO would be part of a customized training program developed by Cantor Fitzgerald and NYCE, which will include a review of compliance and ethics issues. Such program will take into account the particular role and function of TOs and will, therefore, have to be different from NYCE's current broker training program."

Cantor Fitzgerald is not, however, approved to provide ethics training, nor does the firm meet the Commission's qualification standards. CFTC Rule 3.34(a)(3)(iii)(A) expressly disqualifies a person from presenting ethics training or preparing an ethics training video or electronic presentation if such person is barred from serving on an exchange board under CFTC Rule 1.63. As discussed above in "1," Cantor Fitzgerald is disqualified to serve on the Cantor Exchange's board (or any exchange's board) by its January 1997 settlement of fraud charges with the Commission. Thus, the firm cannot be approved to present ethics training or prepare certain ethics training materials.

More information is needed on Cantor Fitzgerald's planned role with ethics training to determine if there is a violation of CFTC Rule 3.34.

8. The Cantor Exchange offers floor broker registration of Terminal Operators as a major concession that somehow cures the problem that the Terminal Operators are exempted from clearly prescribed trade practice and other standards of conduct set out in the Cantor Exchange Rules. In June 4, 1998 correspondence to the Commission, the Cantor Exchange's counsel states that "the NFA and CFTC have jurisdiction over TOs as registered floor brokers." NFA does not have rules governing floor broker trading practices; that is an exchange self-regulatory responsibility. And in the case of the CFTC's jurisdiction, Terminal Operators may circumvent many CFTC rules that would, and should, apply but will not because the Terminal Operators are not members of the Cantor Exchange. For example, the audit trail requirements of CFTC Rule 1.35 apply to contract market members. As with other aspects of the proposal, the NYCE and Cantor Group are merely offering the illusion of meaningful regulatory oversight by offering to register the Terminal Operators as floor brokers.

D. MONOPOLY AND PRICE FIXING

9. The Cantor Exchange grants a monopoly on all floor brokerage commissions to the Cantor Group and its appointed Terminal Operators. Approval of this monopoly would contravene the Commission's obligations under CEA Section 15 and would be contrary to CEA Section 5a(7)'s public interest requirement for contract market designation. Section 15 requires the Commission to reject unduly anti-competitive exchange rules. The Commission recently denied the Board of Trade's proposed minimum capital requirements for issuers of shipping certificates under our new grain delivery terms, claiming that the capital requirements unduly restrict potential issuers to a handful of firms under Section 15. The Cantor Exchange is proposing the most egregious anticompetitive restriction imaginable -- restricting floor broker status to a single firm, Cantor Fitzgerald Securities.

This monopoly will mean that customers could not shop around for the best services from competing executing FCM's. Cantor Fitzgerald Securities and its Terminal Operators could favor certain "pet" customers of the Cantor Group over others. For example, Cantor Exchange Rule 300 authorizes the Cantor Group to decide "in its sole discretion" who among NYCE members may receive dedicated phone lines on the NYCE trading floor.[7] Terminal Operators may also favor one customer over another in giving out market data or market color. (The May 21 Q&A, at question 47, reflects that Terminal Operators have broad latitude in their communications with their designated accounts.)

If the Commission approves the Cantor Group's execution monopoly in violation of Section 15, the Commission will put itself in the untenable situation of having to

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7 The Cantor Exchange's assertion that traders with a dedicated phone line will not have an advantage over those who do not because those "without a dedicated phone line would dial in through a regular phone line" is simply not credible. (See May 21 Q&A at Q.30.) If dedicated phone lines don't provide any advantage, they would not be offered to selected customers.

monitor the Cantor Group's customer relationships to make sure it does not abuse its monopoly power. This monopoly also heightens the need for surveillance and disciplinary oversight of Terminal Operators since the Cantor Exchange structure eliminates the free market self-policing among floor brokers that exists at other exchanges.

10. The Cantor Exchange proposes to engage in illegal price fixing of floor brokerage commissions. Proposed Cantor Exchange By-Law Section 32 contemplates that the Cantor Exchange will charge separate Execution and Transaction Fees in amounts to be set out in the Cantor Exchange rules. Execution Fees are comparable to the transaction fees that other exchanges charge. Transaction Fees are, in effect, brokerage commissions, and are charged to the aggressor side only in accordance with cash market conventions (except on market crossing trades, when buyers and sellers split the Transaction Fee). (See May 21 submission, response to question 11.) The Cantor Group will receive all or some portion of the Transaction Fees (amount unknown/unspecified). (See May 21 submission, response to question 25.) This price fixing of Transaction Fees eliminates price competition among floor brokers (the Terminal Operators) and thus is incompatible with the federal anti-trust laws as reflected in the consent decree that the Board of Trade entered into in the 1970's regarding setting of floor brokerage by rule.[8] Commission approval of the Cantor Exchange's rules to fix brokerage commissions would contravene its obligations under CEA Section 15 to CEA and would be contrary to Section 5a(7)'s public interest requirement for contract market designation.

E. FAILURE TO ADOPT APPLICABLE STANDARDS AS EXCHANGE RULES

11. CEA Section 5a(a)(1) requires each contract market to "promptly furnish the Commission copies of all bylaws, rules, regulations, and resolutions made or issued by it or by the governing board thereof or any committee, and of all changes and proposed changes therein." CEA Section 5a(a)(12) and CFTC Rule 1.41 require CFTC pre-approval of most contract rules. ***The analysis regarding these requirements is presented in the alternative based upon the Terminal Operators' membership status.*** (See Legal Objection 2.)

If the Terminal Operators are members of the Cantor Exchange, as they should be, then the Cantor Exchange violates these requirements because it has not submitted the standards governing the Terminal Operators' conduct to the CFTC as rules for review and approval. Even if the Terminal Operators are not members, as we believe is intended, the Cantor Exchange violates these requirements because the NYCE's delegated surveillance responsibilities include monitoring of the Terminal Operators. (See descriptions of NYCE's compliance program and automated trade surveillance for the Cantor Exchange in Schedules VII and VIII to the May 21 submission.) Of course, the Terminal Operators status as non-members means that the Cantor Exchange violates CEA Section 4(a) and, thus, can only be approved pursuant to exemptive action by the Commission. The applicant and its sponsors are not seeking exemptive relief, nor does the Commission have an exemptive

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8 A copy of this consent decree is attached to our June 30, 1998 comment letter.

framework for exchanges that waives the member trading requirement of Section 4(a).

The Cantor Exchange has made numerous representations about standards governing the Terminal Operators. With one exception (proposed Cantor Exchange Rule 712), these standards are not set out in the Cantor Exchange By-Laws or Rules. According to the May 21 submission, these standards would apply to the Terminal Operators through their employment agreement with Cantor Fitzgerald Securities. The Cantor Exchange did not, however, provide a copy of this agreement until its June 18 submission, and then only because requested by the Commission. The draft agreement cross references a "CFFE Policies and Procedures Manual," ***which the Cantor Exchange did not include as part of the June 18 submission.***

The only Cantor Exchange rule that imposes any express restrictions on Terminal Operators (as Cantor Group employees) is Rule 712. Rule 712 sets out non-disclosure and trading prohibitions on employees of the Cantor Exchange, NYCE and Cantor Group, which would cover Terminal Operators. The Commission is requiring the Cantor Exchange to include Terminal Operators within the coverage of this rule to satisfy the restrictions of CFTC Rule 1.59, which apply to SRO employees who possess material non-public information. (See the Commission's June 11 letter, question 21.a.) Absent this Commission pressure, the Cantor Exchange goes out of its way in other Rules that reasonably should apply to Terminal Operators to avoid any mention of the Terminal Operators. For example, Cantor Exchange Rules 303, "Execution of Orders," and 303-A, ""Market Crossing," carefully omit reference to the Terminal Operators in describing trading procedures and priorities even though they can only be implemented with the agency of the Terminal Operators. Of course, this is consistent with the Cantor Exchange's attempt to shield the Terminal Operators from meaningful disciplinary liability by treating them as non-members.

The numerous representations regarding the Terminal Operators should constitute rules and should be codified by the Cantor Exchange and treated by the Cantor Exchange and the Commission as such. The cited standards cover precisely the types of conduct normally addressed by exchange or Commission rules, such as trading practices and non-preferential treatment of customers. If the standards are not treated as rules, how will customers know their rights, that is, how will they know what requirements are supposed to protect them against potential abuses by the Terminal Operators? How can the Cantor Exchange enforce the standards against the Terminal Operators, as required by CEA Section 5a(8)? And how can the Commission conduct rule enforcement reviews without a clear understanding and delineation of the rules to be enforced?

12. Although not entirely clear, it appears that the Cantor Group is responsible for adopting the CFFE Policies and Procedures Manual. If so, this would be contrary to the requirement in CEA Section 5a(a)(1) that contract market rules are adopted by an exchange governing board or committee. And since the provisions in the Policy Manual are not being treated as exchange rules, how can the Commission ensure that the Cantor Group does not unilaterally change them?

13. The Cantor Exchange may also violate CEA Sections 5a(a)(a) and 5a(a)(12) and CFTC Rule 1.41 because it has not submitted any rules to the Commission regarding the conduct of the Terminal Operator Supervisors. The Supervisors, however, may act as Terminal Operators, are responsible for monitoring Terminal Operators' communications with customers, and are responsible for determining whether the Cantor Exchange should acknowledge liability for Terminal Operator trading errors (which then become the Cantor Group's responsibility to correct through the error account maintained by CF Account Managers LLC)

14. The Cantor Exchange has made numerous representations about standards governing the Cantor Group (e.g., proprietary trading restrictions, use/misuse of confidential information), most of which are not set out in the Cantor Exchange or NYCE rules. For example, in the May 21 submission, the Cantor Exchange represents that "Cantor Fitzgerald entities (other than the entity that will be in charge of the error account) will not be allowed to engage in proprietary trading of futures on Treasury securities on CFFE." (See May 21 Q&A at question 19.) As another example, the Cantor Exchange represents that "[t]he only function" of the Cantor Group company that will handle the error account "will be to correct transactions resulting from errors by TOs." The Cantor Exchange also represents that the persons acting on behalf of the Cantor Fitzgerald & Co., an FCM that will become a Clearing Member, and CF Account Managers, which will manage the Cantor Group error account for Terminal Operator trading errors, "will be located in separate rooms, without any eye- or ear-contact to TOs." (June 18 Q&A at question 9.)

The Cantor Exchange may violate CEA Sections 5a(a)(a) and 5a(a)(12) and CFTC Rule 1.41 because it has not formally submitted rules setting out these or other important restrictions to the Commission for review and approval. The Commission, however, has only asked the Cantor Exchange to provide "a comprehensive description of measures the Exchange would have in place" that "prescribe the conduct of Cantor Fitzgerald and its subsidiaries at the Exchange" (which it did not receive). (June 18 Q&A question 9.) At the very least, the restrictions should be codified as rules as they relate to the two Cantor Group companies that will be members of the Cantor Exchange: Cantor Fitzgerald & Co, which will become a Clearing Member, and CF Account Managers, which, presumably, must also become a Clearing Member.[9]

Given the Cantor Group's involvement in and control over this venture, customers are entitled to know the special restrictions and standards that apply to the Cantor Group and to have the comfort of knowing that the Cantor Group is bound by them as Cantor Exchange or NYCE rules and can be disciplined for violating them. This is especially true with respect to the error account, especially given the potential for abuse by covertly taking favorable customer trades into an error account that were

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9 The Cantor Exchange provides no clear statement on whether CF Account Mangers will become a Clearing Member. Since that company will manage the Cantor Group error account for Terminal Operator trading errors, we presume that it must become a Clearing Member to operate. If not, then we question whether Commerce Clearing Corporation needs to amend its rules to define and govern CF Account Mangers' special status. No such rule changes are included in the publicly available materials.

not executed in error.[10] The Cantor Exchange should not expect the Commission to take on first line responsibility for monitoring the Cantor Group's compliance with private standards of conduct.

If the Cantor Exchange is not responsible for enforcing the Cantor Group's compliance with clearly prescribed restrictions set out in its rules, a regulatory gap will exist. If the Commission permits this to occur, this is an example of the type of gap that the CFTC may then need to fix in its own rules through agency rulemaking.

F. NON-PUBLIC RULES

15. The Cantor Exchange violates the requirement that exchange rules should be available to the public by setting out the Terminal Operator standards in a private Policy Manual and may also violate this requirement by not codifying the special standards that purportedly apply to the Supervisors and Cantor Group. The policy that exchange rules should be published for the benefit of market participants is reflected in CEA Section 8c(a)(2)'s requirement that exchanges should "make public its findings and reasons for" exchange disciplinary actions. It is also implicit in CFTC Rule 1.51, which requires exchanges to have a compliance program that includes investigation of customer complaints, which presumes that customers have an understanding of the rules that apply.

G. INADEQUATE COMPLIANCE AND DISCIPLINARY PROGRAMS

Terminal Operators are not subject to responsible exchange self-regulation; they are subject to private self-regulation controlled by the Cantor Group, for whose benefit the new exchange will principally be operated. This is the Nick Leeson model of "self"-regulation which proved so disastrous for Barings Bank, PLC. The problem is compounded by the confusing status of the Terminal Operators as non-members who are nonetheless purportedly subject to surveillance by the NYCE compliance staff. The Cantor Exchange violates many provisions regarding contract market obligations to maintain effective compliance and disciplinary programs.

Several of the following Legal Objections are based on the premise that the Cantor Exchange has self-regulatory obligations to ensure that Terminal Operators comply with the standards governing their conduct. (See Legal Objection 11) If the Commission were to conclude that the Cantor Exchange has no such obligations on the grounds that the Terminal Operators are not members, that will create a gaping hole in the oversight of trade execution activities contemplated by the Act and Commission Rules.

16. CFTC Rule 1.51 requires each contract market to "use due diligence in maintaining a continuing affirmative action program to secure compliance with . . . all of the

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10 The Cantor Group reportedly has used its house accounts on some occasions to trade against customers. See, Thomas Jaffe, "Between the Wall and the Wallpaper," Forbes, October 20, 1997. A copy of this article is attached as Exhibit D to our April 27, 1998 letter.

contract market's bylaws, rules, regulations and resolutions which such contract market is required by the Act to enforce."

We question whether the NYCE's compliance programs for the Cantor Exchange are adequate to meet the requirements of CFTC Rule 1.51. Our concern is heightened by the Commission's recent February 24, 1998 "Rule Enforcement Review of the Market Surveillance Program at the New York Cotton Exchange," which cited major deficiencies in the NYCE's enforcement program. The Commission states on page 20 of the report that "the Market Surveillance Department ("MSD") at NYCE has insufficient staffing levels to monitor effectively the number of markets traded on the [NYCE], and to conduct other routine surveillance activities, including the review of selected EFPs."

The Cantor Exchange provides only the most cursory overview of the surveillance that NYCE will perform for the Cantor Exchange in Schedules VII ("Integration of CFFE into NYCE's Compliance Program") and VIII ("Description of Automated Trade Surveillance") to the May 21 Q&A. Schedule VII is a scant 3 pages, a page of which is simply a list of information included in certain audit trail data logs. Thus, it is difficult on the limited information available to fully assess whether NYCE will provide an effective compliance program for the Cantor Exchange. The Commission should conduct a follow-up review to confirm that the NCYE has corrected the cited deficiencies before determining whether the Cantor Exchange, through its delegation to NYCE, has adequate enforcement programs and staff.

17. More specifically, the Cantor Exchange's compliance program, administered by the NYCE, violates CFTC Rule 1.51 as it pertains to surveillance of potential Terminal Operator misconduct. An exchange's compliance program under Rule 1.51 must cover, among other things, surveillance of floor trading practices, investigation of customer complaints regarding handling of their orders and investigation of apparent rule violations.

Terminal Operators' are the "floor trading" population and should be the focus of NYCE's trade practice surveillance, but they are not. Instead, the Cantor Exchange Rules and descriptions of the compliance programs that NYCE will administer on its behalf focus on trade practice surveillance of Screen Based Traders and Clearing Members. While the types of trade practice violations cited in Cantor Exchange Rule 311 (which addresses CFTC Part 155 requirements) have some relevance for order intermediaries (e.g., trading ahead, pre-arranged trading), these types of rules are generally thought of as "floor practice" rules that apply principally to "floor" execution practices and not back office practices.

The NYCE's plans for conducting physical floor surveillance of Terminal Operators are also deficient. The NYCE does not plan to physically observe Terminal Operators daily at every open and close and at intermittent periods, as the Commission requires of other exchanges. Instead, NYCE compliance staff will conduct physical observations of Terminal Operators on an unspecified, periodic

basis.[11] (Schedule VII of the May 21 submission at page VII-1) The NYCE argues that more limited physical observation is warranted because "floor surveillance" for the Cantor Exchange may differ in certain respects from "'traditional' coverage of pit trading." (See Schedule VII of the May 21 submission at p. VII-2). We agree; but those differences warrant a ***higher degree*** of floor surveillance, not a lesser degree, because (among other things) of the potential for private negotiation of trades between Terminal Operators while their customers are on the line and the potential for Terminal Operators to favor one customer over another in entering orders on the bulletin board, which is the critical step for establishing a customer's order priority. The Commission should be concerned about the NYCE's lack of understanding of the Cantor Exchange markets it has agreed to police.

The NYCE is also placing undue reliance on the audio tapes of the telephone conversations between the Terminal Operators and customers as a surveillance tool. These tapes appear to be the NYCE's primary tool for independent monitoring of the Terminal Operators. Although audio tapes can provide important evidence, no exchange should place primary reliance on them as a surveillance tool for monitoring a critical part of the trade execution process, as NYCE proposes. Based on the Board of Trade's extensive experience, we know first hand that it is often difficult if not impossible to discern what is being said or by whom on audio tapes. Those problems are aggravated in this case by the fact that (i) Terminal Operators can take two calls at once,[12] and (ii) Terminal Operators, as the Commission staff itself has observed, shout out to one another, which will create background noise that the tapes may pick up. Before accepting audio tapes as a substitute for physical observation or an effective audit trail, the Commission should listen to tapes from the Cantor Group's existing brokerage operations to make its own independent determination of how useful the tapes will be as a surveillance tool and whether it makes sense for NYCE to place as much reliance on them as it has.

Even if the NYCE enhanced its planned surveillance activities with respect to Terminal Operators, we question whether the Cantor Exchange can ever have an adequate enforcement program so long as Terminal Operators are not members and are not subject to clearly prescribed rules and disciplinary procedures. (See Legal Objections 2, 11 and 15.)[13] (See Legal Objection 2.)

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11 In the June 18 submission, the Cantor Exchange indicated that, initially, "NYCE personnel plans to . . . visit [the Cantor Exchange's] trading room on a daily basis." (Question 34.a). Although unclear, the response indicates that the personnel would visit the trading room only once a day, and not multiple times throughout the day as the Commission requires of other exchanges.

12 "Each CFFE TO's phone turret is equipped with two head sets. This enables a TO to listen to one trader while talking to another." May 21 Q&A at question 41.

13 The Terminal Operators' status as non-members raises the concern that the Cantor Exchange may seek to justify its lack of effective compliance and disciplinary programs for Terminal Operators on the grounds that it is not required to implement such programs with respect to non-members. If the Commission allows this to occur, it would be sanctioning a major gap in regulatory oversight of persons who execute customer orders.

18. Exchanges are required to maintain an effective enforcement program for taking prompt disciplinary action for the violations they uncover through their surveillance activities. See CFTC Rule 1.51(a)(7), and CFTC 8.05(a). The Cantor Exchange violates this requirement because it does not have any formal enforcement procedures for taking disciplinary action against Terminal Operators for potential violations of the standards (albeit private) that apply to their trading conduct and communications with customers. The NYCE's purported surveillance of Terminal Operators is meaningless if it is not complemented by rigorous enforcement through established disciplinary procedures. As with many other issues, however, the Cantor Exchange has provided incomplete and ambiguous statements on oversight and discipline of Terminal Operators, which prevent a definitive legal analysis on this issue.

Indeed, the Cantor Exchange's statements on who, if anyone, has authority to discipline the Terminal Operators, or under what authority and procedures, appear to be deliberate attempts to obscure careful scrutiny of these important topics. For example, the Cantor Exchange implies that Terminal Operators are subject to the NYCE's disciplinary procedures when it states with respect to the NYCE's arbitration forum that "CFFE [i.e., the Cantor Exchange] will have jurisdiction over CFFE TOs (as will the CFTC directly)." (May 21 Q&A at question 16). Yet, in the same submission, the Cantor Exchange describes a more limited role for the NYCE which does not include the authority to discipline the Terminal Operators, when it describes NYCE compliance staff as having only the limited role and authority to "suggest" to the Cantor Exchange that a Terminal Operator does not meet applicable standards. (May 21 Q&A at question 51.) In that same response, the Cantor Exchange emphasizes that it is its responsibility, "in its capacity as the self-regulatory organization," "to remove TOs that do not meet it continuing standards," but indicates that its authority to do so derives from the Terminal Operators' *employment* relationship with the Cantor Group. Yet, in June 4, 1998 correspondence to the Commission, the Cantor Exchange represents that Terminal Operators "may have their right to operate on CFFE [i.e., the Cantor Exchange] suspended or terminated by NYCE."

The Cantor Exchange describes only one limited circumstance in which the Terminal Operators are clearly intended to be subject to NYCE's formal disciplinary procedures, and this is for potential violations of Cantor Exchange Rule 712, which the Commission has required the exchange to apply to Terminal Operators. (See Legal Objection 11.) The Cantor Exchange states "Any violation of CFFE Rule 712 would subject the employee in question to disciplinary action by CFFE [i.e., the Cantor Exchange] through NYCE, in addition to any internal action taken by CFFE, LLC." (Rule 712 sets out non-disclosure and trading prohibitions on Terminal Operators and other exchange insiders and is intended to comply with CFTC Rule 1.59.) Even in the case of potential Rule 712 violations, however, it is not clear how NYCE has binding authority over Terminal Operators to discipline them.

In the end, it is not the Cantor Exchange's confusing representations that should govern, but the Cantor Exchange's rules. The Terminal Operators are not members (see Legal Objection 2), and there is nothing in the proposed Cantor Exchange By-Laws and Rules, or in the NYCE Rules, that subject Terminal Operators to any formal disciplinary procedures for violating the private standards set out in the

Policy Manual. There is a provision in the draft Terminal Operator employment agreement (Schedule II of the June 18 submission) whereby a Terminal Operator agrees to "submit to the jurisdiction of the Cantor Exchange in accordance with the CFFE By-Laws and Rules," but since the Cantor Exchange By-Laws and Rules do not include any disciplinary procedures and do not obligate the Terminal Operators to submit to the NYCE's disciplinary procedures, this provision is meaningless.

The Commission should insist upon a complete and unambiguous explanation of whether the Cantor Exchange plans to implement the type of disciplinary program required by CFTC rules with respect to the Terminal Operators, including a description of the disciplinary procedures that will apply to potential Terminal Operator misconduct; the types of sanctions that can be imposed (are they limited to suspension or termination or do they include fines?); which exchange, the NYCE or Cantor Exchange, will administer the disciplinary program; what committees will have authority to hear cases; and which exchange's board would hear appeals of disciplinary action taken against Terminal Operators. The Cantor Exchange has the obligation of demonstrating that it has an effective disciplinary program for Terminal Operators. To date, it has not met its burden.

19. The Cantor Exchange may also violate the requirements to maintain effective compliance and enforcement programs with respect to the Cantor Group. There are no formal procedures for the Cantor Exchange or NYCE to discipline firms in the Cantor Group for violating the special provisions (wherever set out) that the Cantor Exchange has represented will apply to them. Neither Cantor nor NYCE has express jurisdiction over any Cantor entity for violating the restrictions specific to those entities, except perhaps in the case of Cantor Fitzgerald Securities and CF Account Managers based on there status as Clearing Members. (See Legal Objection 14.)

20. CFTC Rule 8.05(a) requires each exchange to "establish an adequate enforcement staff which shall be authorized by the exchange to initiate and conduct investigations, to prepare reports incident to such investigations and to prosecute possible rule violations within the disciplinary jurisdiction of the exchange." We question whether the Cantor Exchange has adequate enforcement staff to take on these added responsibilities with respect to the Cantor Exchange, especially in light of the Commission's recent findings in its recent February 24, 1998 Rule Enforcement Review of NYCE that NYCE has insufficient surveillance staff for its existing markets.

In the May 21 Q&A, the Cantor Exchange implies that the NYCE's merger with the CSCE will have a positive effect on the NYCE's compliance program. The Cantor Exchange states that "after completing the merger with CSCE, the combined compliance and surveillance staff of the Board of Trade of the City of New York will increase by 150% over current NYCE staffing levels." (See question 96) But the Cantor Exchange does not explain whether this merger results in an increase in compliance staff dedicated to the NYCE or in added staff resources to perform surveillance for the Cantor Exchange.

21. It is not clear whether NYCE will maintain separate dedicated staff to conduct surveillance for the Cantor Exchange, as implicitly required by the statement in CFTC Rule 8.05(a) that an exchange's enforcement staff "shall consist of

employees of the exchange ***and/or persons hired on a contract basis***." The Commission also requires the Board of Trade to maintain such separate dedicated staff with respect to our subsidiary, the MidAmerica Commodity Exchange.

22. The Cantor Exchange will also violate CFTC Rule 8.05(a)'s requirement that an exchange's enforcement staff "may not include . . . persons whose interests conflict with enforcement duties" by delegating front line responsibility for overseeing Terminal Operators to Supervisors who, like the Terminal Operators, are employed and paid, including incentive pay, by the Cantor Group.

23. One consequence of the lack of defined rules for taking disciplinary action against Terminal Operators is that the Cantor Exchange does not have an express mechanism for "making public its findings and the reasons for the exchange action in any such proceeding, including the action taken or the penally imposed," as required by CEA Section 8c(a)(2). This is also contrary to CFTC Rule 9.13

24. The deficiencies described in Legal Objections 16 through 23 are contrary to CEA Section 5a(7)'s public interest requirement for contract market designation.

H. AUDIT TRAIL/RECORD KEEPING

25. The Cantor Exchange violates the audit trail requirements of CEA Section 5a(b) and the public interest requirement for contract market designation of CEA Section 5a(7) because it does not capture and incorporate into its audit trail data base the time when orders are received by a Terminal Operator over the phone.

The Cantor Exchange has indicated that it plans to rely solely on the audit trail data from the Cantor System for its audit trail data base used in its automated surveillance programs. See the response in the May 21 Q&A at question 107, which focuses on how each "key stroke is captured" to justify an exemption from CFTC Reg. 1.35(a-1). See also NYCE's descriptions in Schedule VII to the May 21 Q&A of the Data Entry Transaction Log and Transaction Log, which appear to be the major audit trail data bases for conducting trade practice surveillance. These descriptions indicate that the Cantor Exchange's audit trail data bases will be limited to key stroke data pulled from the Cantor System.

Taping of Terminal Operator telephone conversations on time indexed lines does not cure the problem since that Cantor Exchange does not plan to pull the time an order is received from the tapes to incorporate into its comprehensive audit trail data base. It is also not clear whether time indexing on the various tapes will be synchronized, which if not would undermine the accuracy and value of that data. As a further problem, it would appear to be difficult and time consuming to actually pull timing data from the tapes to determine when an order is actually placed. For example, an order could be placed well into a phone call after discussions about market color or cash orders, or a customer may place multiple orders over the course of a call.

The fact that Clearing Members and Screen Based Traders are required to prepare a time record when they send orders to a Terminal Operator (except in the case of proprietary orders) is also irrelevant and for the same reason: that data also is not incorporated into the Cantor Exchange's audit trail data base. (See May 21 Q&A at

question 100.) Moreover, there does not appear to be any requirement that Clearing Members and Screen Based Traders must synchronize their time clocks against a master clock.

The absence of critical audit trail data on when an order is receive by the Terminal Operators (i.e., when an order is received on the trading floor) seriously compromises NYCE's ability to run automated programs to detect whether Terminal Operators are showing preferential treatment to certain customers or are pre-arranging trades before posting customer bids or offers on the Cantor System.

26. CFTC Rule 1.35 imposes a number of audit trail record keeping requirements on members of contract markets, including, among others, the obligation to prepare time stamped and dated written records of telephone orders upon receipt on the trading floor. CFTC Rule 1.35(j) requires each contract market to have rules in effect to implement the audit trail requirements imposed on contract market members. ***The analysis regarding these requirements is presented in the alternative based upon the Terminal Operators' membership status.*** (See Legal Objection 2.)

The provisions of Rule 1.35 that impose obligations on members of contract markets would apply to the Terminal Operators if they are members of the Cantor Exchange, as they should be. In that case, the Cantor Exchange would also be required to adopt audit trail rules for Terminal Operators, which it has not. Even if the Terminal Operators are not members, as we believe is intended, the Commission should impose the audit trail requirements of its Rule 1.35 with respect to Terminal Operators to ensure a complete and accurate audit trail as required by CEA Section 5a(7), including order receipt times by the Terminal Operators. The Commission's Rule 1.35 is an example of regulatory requirements that the Cantor Exchange is seeking to circumvent on a technicality.

Of course, the Terminal Operators status as non-members means that the Cantor Exchange violates CEA Section 4(a) and, thus, can only be approved pursuant to exemptive action by the Commission. The applicant and its sponsors are not seeking exemptive relief, nor does the Commission have an exemptive framework for exchanges that waives the member trading requirement of Section 4(a) or strict adherence to audit trail standards.

27. The Cantor Exchange will violate CFTC Rule 1.31(a)(1). That rule requires that "All books and records required to be kept by the Act or by these regulations shall be kept for a period of five years from the date thereof and shall be readily accessible during the first 2 years of the 5-year period." Since the audio tapes are treated as a supplement to the Cantor Exchange's incomplete audit trail and are identified as a primary surveillance tool for monitoring Terminal Operator activity, the tapes should be retained for 5 years as required by this CFTC rule. However, the Cantor Exchange has indicated that the tapes will be retained for only 45 days. (June 18 Q&A at question 36.) The Commission staff, inexplicably, asked that the tapes be held for only 180 days. (There is some confusion as to whether the Cantor Exchange or the Cantor Group will hold the tapes. The May 21 Q&A, at question 44.a., says it is the Cantor Group, but the June 18 Q&A suggests that the Cantor Exchange will maintain the tapes.)

I. NON-COMPETITIVE TRADING

28. The Act and Commission Rule 1.38 require open and competitive trading. The Cantor Exchange will violate those precepts on a regular basis by allowing two or more traders to negotiate block trades pursuant to the Exclusive Time and Clearing Time procedures. Cantor Exchange Rule 303(b)(1) confirms that during Exclusive Time those who trade opposite the party with the exclusive rights lose the benefit to trade against any other "bid or offer superior to such trader's bid or offer [that would] otherwise be available." According to the May 21 Q&A, the Exclusive Time will initially be six seconds, which in a moving market can be a long time to deny market users the opportunity to trade against a superior bid or offer. The price could potentially be locked even longer through a succession of Exclusive Time periods. Cantor Exchange Rule 315 indicates that the Exclusive Time, alone or as a series of trades at a given price could last as long as 5 minutes. Our April 27 and June 30 letters provide more discussion on how the Cantor Exchange would regularly violate CFTC Rule 1.38 and would not comply with the requirements applicable to boards of trade under the Act. See CEA Section 5(6).

29. The Cantor Exchange will also regularly violate open and competitive trading requirements with its market crossing sessions and procedures. The crossing sessions are the only opportunity for customers wishing to trade a smaller size than the Cantor Exchange's minimum 10 contract size requirement to participate in the Cantor Exchange's markets. The price at which orders will be crossed during a Market Crossing Session is set by the Cantor System randomly selecting the price at which a trade outside the crossing session occurs during the three minute period following the relevant crossing time. By the Cantor Exchange's own admission, the assigned match price "may be inferior to the prices that could otherwise be obtained." (See the proposed Customer Information and Risk Disclosure Statement included in the June 18 submission as Schedule IV, at page IV-4.)

30. CFTC Rule 155.2 requires each contract market to "adopt and submit to the Commission for approval . . . a set of rules which shall, at a minimum, with respect to each member of the contract market acting as a floor broker," prohibit such member from engaging in various trading practices, such as pre-arranged trading. ***The analysis regarding these requirements is presented in the alternative based upon the Terminal Operators' membership status.*** (See Legal Objection 2.)

If the Terminal Operators are members of the Cantor Exchange, as they should be, then the Cantor Exchange violates these requirements because it has not submitted any rules to the Commission setting the required trade practice standards with respect to Terminal Operators. Even if the Terminal Operators are not members, as we believe is intended, the Cantor Exchange should be required to adopt trade practice rules for the Terminal Operators since the Cantor Exchange plans to register the Terminal Operators as floor brokers (but see Legal Objections 4 and 5), and CFTC Rule 155.2 on its face is intended to apply to floor brokers. The Commission's Rule 155.2 is another example of regulatory requirements that the Cantor Exchange is seeking to circumvent on a technicality.

Of course, the Terminal Operators status as non-members means that the Cantor Exchange violates CEA Section 4(a) and, thus, can only be approved pursuant to

exemptive action by the Commission. The applicant and its sponsors are not seeking exemptive relief, nor does the Commission have an exemptive framework for exchanges that waives the member trading requirement of Section 4(a).

J. DUAL TRADING

31. The Cantor Exchange may violate CFTC Rule 155.5 regarding dual trading. Although it is represented that the Terminal Operators will not trade futures contracts for their own account or for any proprietary accounts of the Cantor Group, it appears that Terminal Operators may receive bonuses based on the Cantor Group's customer business. If that is correct, they may have an indirect financial interest in their customers' accounts and dual trading concepts may be applicable. More information is needed on how Terminal Operators are compensated to analyze this issue.

K. BROKER ASSOCIATIONS

32. The Commission's Part 156 Rules require exchanges to register broker associations, publicly disclose the names of each person who is a member or has a beneficial interest in the broker association, and to "monitor the trading activity of broker associations and their members for potential abuse." (CFTC Rule 156.3.) ***The analysis regarding these requirements is presented in the alternative based upon the Terminal Operators' membership status.*** (See Legal Objection 2.)

CFTC Rule 156.1 defines a "broker association" to:

> "include two or more contract market members with floor trading privileges, of whom at lest one is acting as a floor broker, who: (1) Engage in floor brokerage activity on behalf of the same employer, (2) have an employer and employee relationship which relates to floor brokerage activity, (3) share profits and losses associated with their brokerage or trading activity, or (4) regularly share a deck of orders."

The Terminal Operators are the floor brokers on the Cantor Exchange. All of the Terminal Operators are employed by Cantor Fitzgerald Securities. Thus, Cantor Fitzgerald Securities and the Terminal Operators, together, constitute a broker association within the meaning of CFTC Rule 165.1, but for the fact that the Terminal Operators are not "members" of the Cantor Exchange.

If the Cantor Exchange treated the Terminal Operators as members, as it should, then the Cantor Exchange violates CFTC Rule 156.1 because the exchange does not register Cantor Fitzgerald Securities and the Terminal Operators as a broker association, make their names publicly available or have a special enforcement program for broker associations.

Of course, the Terminal Operators' status as non-members means that the Cantor Exchange violates CEA Section 4(a) and, thus, can only be approved pursuant to exemptive action by the Commission. The applicant and its sponsors are not seeking exemptive relief, nor does the Commission have an exemptive framework

for exchanges that waives the member trading requirement of Section 4(a) or that addresses the policy implications of waiving such a requirement on the Commission's regulation of broker association.

33. The Cantor Exchange also violates the Commission's Part 156 Rules by not having any registration or enforcement programs for broker associations that may be formed among Clearing Members and Screen Based Traders. In this regard, we agree with the Commission staff's original conclusion that the Cantor Exchange needs to implement rules for broker associations as required by Part 156. (See the Commission's May 6 questions, question 39.) Moreover, if the applicant insists on fostering the fiction that "Trading Privileges" vest in the Clearing Members and Screen Based Traders, and not in the Terminal Operators, then it should abide by the consequences of that action.

L. EFP TRANSACTIONS

34. The Cantor Exchange's proposed EFP Rule, Rule 305, does not set out all of the appropriate elements of a bona fide EFP in that it does not prohibit sham, "ABA" type transactions that are a mechanism for block trading of Treasury futures away from the market. This is contrary to CEA Section 5a(7)'s public interest requirement for contract market designation and to the Commission's long-standing interpretation that an EFP must be a bona fide commercial transaction and not a sham for engaging in illegal trading conduct.

35. We question whether the NYCE has an adequate surveillance program for monitoring EFP transactions involving Cantor Exchange futures contracts to comply with the requirements of CFTC Rules 1.51 and 8.05. The Commission specifically cited deficiencies with respect to EFP surveillance in its February 1998 rule enforcement review of the NYCE.

M. ARBITRATION

36 The Cantor Exchange does not provide a "fair and impartial forum" for claims against the exchange, the Cantor Group or Terminal Operators, as required by CFTC Rule 180.02.

The NYCE will provide its arbitration forum for the Cantor Exchange. The NYCE, however, has a financial self-interest in the outcome of any arbitration claims filed against the Cantor Exchange (which the Cantor Exchange rules allow), because the NYCE and NYCE members indirectly own the Cantor Exchange. Further, it is NYCE members who, presumably, would sit on arbitration panels. NYCE also has a self-interest not to issue awards against Terminal Operators, to avoid antagonizing the Cantor Group, on which NYCE and its members rely so heavily for the success of the Cantor Exchange venture.

There are other legal objections relating to adequacy of restrictions against potential misuse of confidential trading information; conflicts of interest giving rise to customer protection concerns; the potential for abuses through handling of Terminal Operator trading errors, including through the Cantor Group error account; registration; and inadequate disclosure, which we would have covered given more time.

EXHIBIT B
SUMMARY OF CFTC'S DISPARATE REVIEW OF THE CBOT'S PROJECT A SYSTEM VERSUS THE CANTOR SYSTEM

Project A

First Incarnation - For low volume contracts (e.g., barge freight rate) not listed on GLOBEX; terminals located only within CBOT building.

1. CBOT submits rules for the Project A trading system to the CFTC for approval on 12/13/91; ***ten months*** elapse before amended rules are approved by CFTC on 10/19/92.

2. CBOT had to answer over 115 written questions regarding the trading system, as well as many oral questions. Questions covered a wide range of topics, including the Project A matching algorithm and equilibrium opening price; clearing and settlement; order entry and execution; terminal access; records; surveillance; liability; disclosure; products; trading hours; transparency; financial integrity; system security, reliability and capacity; physical environment; system capacity; system software; data integrity; access controls; systems testing; documentation; training; internal controls and contingency plans.

3. 29 of the CFTC's questions, raised in a letter dated 7/24/92, related directly to trading system security, capacity and reliability.

4. At least two formal meetings between CBOT and CFTC staff to discuss issues raised by CFTC (on 2/25/92 and 7/30/92).

Second Incarnation - CBOT migration to Project A from GLOBEX; expanded product offering and terminal placement outside CBOT building.

5. CBOT submits rule amendments to CFTC for expanded/revised Project A trading on 5/24/94; almost ***five months*** elapse before revisions are approved by CFTC on 10/5/94.

6. CFTC required the CBOT to retain an outside consultant to conduct an in-depth verification review of the Project A trading

Cantor System

1. From the publicly available materials, CFTC has asked far fewer questions regarding system functionality and operations, no questions regarding system security, and ***only 2 questions*** relating to capacity and reliability of the Cantor System, as follows.

   (i) In a 5/6/98 letter, the CFTC asked:

   > "Please provide the Division [of Trading and Markets] with any reports that evaluate the Cantor trading system that would be used for CFFE trading, including any beta testing or mock trading sessions. If any of these reports noted deficiencies in the trading system, please explain what, if any, measures Cantor has taken to address these deficiencies." (Question 88)

   The Cantor Exchange provided a short three sentence response asserting that the "Cantor system has successfully operated for more than two years" for Treasury securities.

   (ii) In a 6/11/98 letter, the CFTC asked:

   > "Please describe in detail any system failures experienced by Cantor Fitzgerald Securities since cash trading on the Cantor System began. Please provide details regarding the causes of, and recoveries from these failures, as well as information on the duration and frequency of these failures." (Question 24.a.)

   The Cantor Exchange provided a tally of failures that have occurred by generic type, with only cursory details and the assertion that "the Cantor System functioned flawlessly during October of 1997 despite extremely heavy volume and volatility."

These two questions and the abbreviated responses they yielded stand in sharp contrast to the CFTC's 29 questions

system to assess the functional and technical capabilities of the Project A application. It took the CBOT's consultant, Deloitte & Touche, approximately ***fourth months*** to complete the in-depth study required, ***at a cost of over $100,000.***

7. Numerous informal contacts between CBOT and CFTC staff explaining the Project A system and responding to CFTC staff questions.

8. CFTC has a standing request for the CBOT to conduct another independent system review of Project A if certain volume parameters are exceeded.

regarding Project A security, capacity and reliability. (See "3").

2. No indication in the publicly available materials that the CFTC is requiring the Cantor Exchange to conduct the same in-depth, independent review of the Cantor System required of the CBOT. (See "6") To our knowledge, the CFTC has not requested any further information beyond the Cantor Exchange's responses to described above.

3. No indication in the publicly available materials that the CFTC has made any kind of standing request for the Cantor Exchange to conduct an independent review of the Cantor System if certain volume parameters are exceeded, as it has with the CBOT (see "8").