Chicago Board of Trade

Thomas R. Donovan
President and
Chief Executive Officer

RECEIVED
C.F.T.C.
'99 NOV 18 AM 7 02
RECEIVED C.F.T.C.
RECORDS SECTION

RECEIVED
C.F.T.C.
'99 NOV 17 AM 8 02
OFFICE OF THE SECRETARIAT

99-37
(8)

November 16, 1999

COMMENT

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

Re: **Cantor Financial Futures Exchange's Proposal to Adopt Block Trading Procedures, 64 Federal Register 54620 (October 7, 1999) ("Cantor Release")**

Dear Ms. Webb:

On October 22, 1999, the Chicago Board of Trade ("CBOT®" or "Board of Trade") submitted a comment letter in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") request for comments on the block trading proposal submitted by the Cantor Financial Futures Exchange, Inc. ("CX") dated September 15, 1999 ("CX Submission"). The CX Submission proposes rule amendments to permit futures transactions of a minimum size to be executed privately, away from the market, coupled with delayed reporting of transaction prices (the "Proposed Rules"). In our letter we stated that we would like to examine the implications of the CX Submission on the CBOT's market surveillance activities and supplement our comments. We are pleased to have the opportunity to do so.

Today's existing U.S. Treasury futures complex was introduced to the marketplace by the CBOT which developed the contract specifications and nurtured these markets until they became extremely successful. We are still strongly opposed to allowing an illiquid market that has cloned our contract specifications to introduce block trading procedures that have the spill-over effect of degrading our markets for these products. This impinges on our decision making power and ability to protect our brand image. However, putting these general concerns aside, if the Commission were to change its views on permissible forms of non-competitive or block trading, the CX Proposal is an unacceptable precedent that goes too far. The Proposed Rules, most importantly their delayed reporting requirements, will encourage new types of market abuses and may well unfairly require us to divert resources from key CBOT strategic initiatives to expand our compliance activities to preserve the integrity of our markets against those abuses. Ironically, the CFTC would be forcing additional regulatory burdens on the CBOT at a time when the CFTC has announced its intent to provide regulatory relief to the exchanges.

Our specific comments follow.

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

A. **Ramifications for the CBOT's Surveillance and Enforcement**

We have been assessing the impact that the CX block trading proposal will have on our markets and market surveillance activities, if the proposal is adopted in its current form. CX's proposal, especially the delayed price reporting feature, has serious ramifications for us.

1. CX's block trading proposal will corrupt the quality of price reporting and market transparency in Treasury futures markets.

2. It will have a material adverse effect on the CBOT's Treasury futures markets by fostering opportunities for front-running in our markets that have heretofore been unavailable.

3. Finally, CX's block trading proposal, if approved in its current form, could force us to make significant expenditures to develop and implement an intermarket surveillance program for detection of the types of front-running abuses encouraged by CX's delayed reporting feature. This assumes, of course, that CX will capture reliable audit trail data on block trading activity that will be necessary for effective cross-market surveillance, which we highly doubt will be the case. In any event, the Board of Trade is currently dedicating all of its available resources to other important technology development initiatives that are necessary for us to compete in today's changing trading environment.

In short, CX's proposal puts us in an untenable "Catch 22" situation. The CBOT could be forced to act against our own business interests to conduct surveillance activities that will support CX's business strategy of diverting order flow from our markets. At the same time, business considerations would also demand that we expand our surveillance program to protect the integrity of our markets against the spill over consequences of CX's proposal.

We addressed the first two points previously in our October 22, 1999, comment letter, wherein we explained that we were evaluating the implications of CX's proposal to our surveillance activities. Based on our on-going analysis, we have identified the basic steps involved in establishing an effective intermarket surveillance program to protect the integrity of our markets against the types of potential cross-market abuses that CX's block trading procedures will create. We have drawn upon our recent experience establishing such a program with the New York Stock Exchange ("NYSE") in connection with the CBOT's Dow futures which we launched in 1997.

Step 1: Define Audit Trail Requirements

First, it will be necessary to define the audit trail data that we will need for effective cross-market surveillance. Based on the limited information currently available regarding CX's proposed block trading procedures, we believe that we will need the following audit trail data from CX: (1) the time that negotiations for a block trade commence; (2) the time the trade occurs; (3) the time the trade is reported by the parties to CX; and (4) the time CX publicly disseminates the block trade price. The audit trail data described in "1" and "2" are relevant if negotiations for a block trade can occur over any period of time. In that case, if a party to the block trade negotiations believes that the block trade is likely to occur, that party could potentially seek to front-run that block trade at some point during the negotiations through trades in the CBOT's markets. The audit trail data described in "3" and "4" is necessary to detect for potential front-running in our markets ahead of the public dissemination of the block trade price.[1]

It is unclear whether CX even plans to capture the above-described audit trail data or what steps, if any, it will take to ensure the accuracy of that data. Given CX's past track record, we are not confident that we will have access to the reliable data we need. But without reliable audit trail data from CX, it will be extremely difficult, if not impossible, for us to have an effective cross-market surveillance program with respect to CX's proposed block trading facility.

<u>Step 2: Establish Information Sharing and Storage Arrangements</u>

After resolving the information requirements of the audit trail data we will need from CX, it will be necessary to establish logistic procedures for sharing this data, including the format of the information, how it is transmitted and then how it would be stored. How will CX capture the relevant audit trail data? How would the CBOT be able to access that information? What type of data feed would the CX use, how could the CBOT interface with the feed, and in what format will we receive the information?

After addressing these issues from a non-technical perspective, we would need to develop flow charts (business logic) and begin programming and testing with the appropriate feeds and field parameters. Additional edits and changes to the program most certainly would follow until we could effectively utilize the information for surveillance purposes.

Once an information sharing program with CX is developed and tested, we would need to address the issue of database storage and attendant costs. For surveillance purposes, data received on a daily basis must be stored on a database each day. The CBOT generally saves information pursuant to CFTC requirements for five years.

In the case of the Dow futures contract, it took approximately 5 months of technical staff resources to develop, test and implement an information sharing program with the NYSE. This process involved approximately 4 months of program development (using 1 in-house developer); 2 months

1 Our focus is on the adverse spill over consequences that CX's proposal poses to our markets. CX's block trading proposal also raises dual-trading concerns for CX's markets. The audit trail data we have identified would appear to be necessary for CX to have an effective compliance program to monitor for such abuses.

for data base administration activities (concurrent with development) and 1 month for testing.

We have every reason to believe the process will be more involved and time-consuming to establish an information sharing program with respect to CX's proposed block trading. First, the above figures apply only to technical staff activities, and do not include the participation of our surveillance staff who would need to participate in defining information and format requirements. Second, we are likely to need more types of audit trail information from CX for its program than we need from the NYSE for the Dow program. In the case of the Dow, our market surveillance program is designed to monitor stock basket transactions on the NYSE side executed via a computerized program trading, which simplified the audit trail requirements and the issues of how to receive that data.

Third, in the case of the Dow contract, we had an established, cooperative relationship with the NYSE through pre-existing agreements to share information both on a bilateral basis and through the framework of the Intermarket Surveillance Group to which both exchanges belong. The CBOT and NYSE developed our respective intermarket surveillance programs willingly as a cooperative initiative. Even then, there were many difficult issues to resolve between us. In this case, we are talking about exchanging information with a competitor regarding virtually identical products.

Step 3: Develop Inter-Market Surveillance Software Programs

Third, we will have to develop special computer programs for detecting potential intermarket front-running violations tailored to the unique types of abuses that CX's proposal will foster and to the type and form of the audit trail information we will receive from CX. We cannot simply use the programs we developed for the Dow contract. As mentioned above, CX's proposal creates opportunities to front-run not only the block trade itself, but also the dissemination of the block trade price due to the delayed reporting feature. This is an added layer of complexity we did not face with the Dow. It also means we need more timing information about CX block trades than we do about program trades that occur at the NYSE.

It is impossible to accurately estimate the cost of establishing an effective intermarket surveillance program based on CX's current proposal and the limited information CX has provided. In particular, we would need much more information about the type and accuracy of the audit trail data CX will capture for block trades and the format in which it will store and make that information available. Our Dow experience, however, confirms that the resource implications are significant.

Step 4: Dedicated Surveillance Staff

Fourth, it would be necessary for us to train and dedicate at least one compliance staff person to conduct on-going market surveillance using the data we receive from CX and the surveillance programs we develop. This would be an ongoing cost and diversion of resources from other more pressing CBOT projects.

Resource Implications for the CBOT

In short, the CBOT will face substantial costs to develop, test and implement an effective market surveillance program tailored to CX's block trading proposal, especially the delayed reporting feature. If the Commission approves CX's proposal in its current form, who is responsible for the CBOT's heightened surveillance obligations for potential problems we identified and objected to creating? Will the Commission require CX to reimburse the CBOT for its costs? What is our recourse if CX's audit trail proves to be unreliable? Alternatively, to reduce the cost while still ensuring market integrity, will the Commission require CX to adopt a rule to prohibit any party who executes a block trade from executing any proprietary or customer orders on that same day (or the following day for trades made in the last ten minutes of a trading day) in the CBOT's Treasury futures markets?

These are not idle questions. The CBOT today faces many demands on our limited financial resources. We have committed substantial staff and other resources to the CBOT/Eurex alliance both this year and for the coming year, especially in the information technology area. We have had to make difficult choices on how to allocate our resources to our various strategic initiatives. We should not be forced to divert resources from projects intended to enhance our future competitiveness to facilitate CX's efforts to take business away from our Treasury futures complex. CX's block trading proposal should be disapproved not only for the foregoing reasons, but also for the reasons set out below.

B. Request for Additional Information

We stated in our October 22 comment letter that the CX submission falls far short of the Rule 1.41 form and content requirements and is far too vague to draw any positive conclusions about the integrity of their procedures. CX's proposal raises many questions. We have attached a list of issues which supplement the preliminary list we included with our earlier comment letter. Many of these questions are important for us and the Commission to fully assess and understand the implications of CX's proposal to the CBOT's market surveillance activities. Other questions illustrate that CX has gone out of its way to disconnect its proposed block trading activity from the centralized markets, so that certain participants can make off-line side trades that will fragment those other markets.

C. The Larger Marketplace

In the first round of comments several exchanges, including the CME and the NYMEX, concurred that when multiple exchanges offer virtually identical products, only the exchange with the dominant market should be allowed to adopt noncompetitive trading practices. Exchanges that are primary markets have a stronger incentive to protect against fragmentation and to prevent non-competitive and manipulative behavior that would threaten their brand image. The CME and NYMEX correctly cited risks posed by CX's block trade execution procedures, including the risk that a delay of ten minutes before participants must report their block trades would render markets opaque and engender a new type of inter-market front-running.

In contrast, the CME and NYMEX, as primary markets have crafted their block trading rules to encourage transparency. The "all or none" block trading procedures they promote allow all participants to see block trades performed openly, with the prices immediately reported and disseminated to market users. We urge the Commission not to approve the CX proposal as its first "test case", because it will open the floodgates to lower transparency standards within the marketplace. These low standards will harm customers who want to execute transactions at the best price available, and who want to know what that price is on a real time basis. The Commission should not approve anything that goes beyond this open "all or none" approach.

D. Conclusion

As Chairman Rainer pointed out in a speech to futures industry participants on October 28, 1999:

> "The efficiency of the futures markets and their depth of liquidity for risk management activity rely upon their public nature."

We agree with the implication of Chairman Rainer's words that market transparency is a necessary condition for efficient futures markets. This philosophy is an underpinning of the open and competitive trading requirement of the Commodity Exchange Act ("CEA"). Putting aside the debate over whether financial futures markets are used for price discovery, market users in any event require and demand price integrity (i.e., accuracy) of their financial futures transactions, especially if used for hedging and risk management. The availability of this information lowers their costs by sparing market participants the burdens (i.e., the cost and the attendant uncertainty) associated with price and search verification. Decentralized markets do not provide this benefit.

The CFTC should weigh any minimal competitive impact that that the CX Submission might represent against its unquestionably corrosive effect upon customer protection and public economic welfare. The intentionally fragmentary and divisive nature of the CX's block trading proposal indicates that it serves little purpose other than to becloud the market transparency and price integrity that investors are accustomed to finding in the CBOT's U.S. Treasury Bond futures complex. The Commission should view this particular approach with profound skepticism.

We are happy to discuss our comments with the Commission.

Respectfully submitted,

Thomas R. Donovan

cc: Commissioner Thomas J. Erickson
Commissioner Barbara P. Holum
Commissioner James E. Newsome
Commissioner David D. Spears
John Lawton, Acting Director, Division of Trading & Markets
Alan Seifert, Division of Trading & Markets
David Van Wagner, Division of Trading & Markets

REQUEST FOR ADDITIONAL INFORMATION

1. How will CX monitor for and enforce its fair price requirement (if it will not break trades made at unfair prices)?

2. How does CX propose to prevent front-running abuses in other markets? During the ten minute reporting lapse, how will CX prevent its participants from entering the CBOT's market or the cash market to execute transactions based on unreported trade information?

3. How does CX justify a ten minute delay? How will CX verify the length of reporting time?

4. How long can parties negotiate a "block trade" before reporting it? Can this negotiation take place over the course of a trading day and then be executed during the last ten minutes of a trading day?

5. How long will CX have to report block trades, after the information has been reported to Cantor? The prompt reporting requirement seems extremely vague.

6. What recourse is available to other market participants who rely on pricing information from a CX block trade made at an unfair price?

7. What is the justification for allowing participants to wait until the next day to report trades executed during the last ten minutes of the trading day? At which opening would these trades have to be reported? The next opening in the operable jurisdiction, the next opening in New York?

8. What is the justification for defining small 50 lot transactions as block trades, when other facilities require much larger quantities?

9. What is the justification for allowing these trades to take place in private, bilateral negotiations without the knowledge of other market participants?

10. How can the CBOT perform its surveillance operations in its own market without accurate, up to date, last trade information?

11. How does CX define the time of execution for off-line trades? How does CX define the beginning of negotiations? When does the clock start running for reporting purposes? What time stamps will CX require (e.g., will it require the stamps when negotiations begin? Will it require them when a block trade occurs?)?

12. How will CX monitor for compliance with any audit trail standards it has?

13. What audit trail data will CX have regarding block trades that it can share with the CBOT? In what format? How reliable will it be?

14. Has CX evaluated whether its block trading procedures create potential for dual trading types of abuses in its own markets? What compliance programs will it have to detect and deter such abuses?

15. Does CX plan to reimburse the CBOT for any intermarket surveillance programs we may have to develop, test and implement with respect to its block trading facility and the CBOT's Treasury futures contracts?