THE STATE UNIVERSITY OF NEW JERSEY
RUTGERS
Rutgers Business School - Newark and New Brunswick
Department of Finance and Economics
Janice H. Levin Building
94 Rockafeller Road • Piscataway, New Jersey 08854-8054
732-445-3907 • Fax: 732-445-2333

December 15, 2003

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: US Futures Exchange LLC DCM application

Dear Ms. Webb:

I am an academic and have been teaching courses on market microstructure for over 20 years. I have over 25 published articles, most of which examine issues in market microstructure. I have testified before Congress and am frequently quoted in the press. I therefore feel well-qualified to comment on the proposed entry of Eurex into the United States.

While I am not opposed to the entry of new exchanges, I am deeply concerned about the method Eurex appears to be planning to obtain market share from the CBOT. Previous attempts to garner market share away from the CBOT by the Cantor exchange and BrokerTec failed. Liquidity has a great deal of inertia, and the fact that futures contracts are not fungible across exchanges increases this inertia. I will address the issue of inertia later in the context of competition and consolidation. But first I want to provide a history lesson from one of Eurex's predecessors, Deutsche Terminboerse (DTB).

Until August 1989, German laws were such that losses from futures contracts were considered gambling debts and were therefore uncollectible. DTB became the first futures exchange in Germany and was started shortly after the repeal of this law. Because Germany had no futures exchange until the fall of 1989, trading in the German Bund contract was started on the London International Financial Futures Exchange (LIFFE) in September 1988. By the time DTB launch trading in the Bund contract in October 1990, trading in it on LIFFE was well established. According to press reports from early 1991, DTB considered their market share to be below expectations. To increase trading in the Bund contract, DTB took a number of steps.

In April, 1991 they required banks to quote minimum depths on contracts. This increase in quoted liquidity had little impact on DTB's market share of the Bund contract. In August 1991, they took another step to attract order flow away from LIFFE and eliminated all trading fees. Again, there was very little impact on DTB's market share of the Bund contract.

That changed after November 1, 1991. According to press reports at the time, DTB held a meeting of its 14 designated market makers and threatened them with removal of their designated bank (Germany has no distinction between commercial and investment banks as the US does) status if they did not meet a minimum quota of trade volume.[1] One article quotes a top German banker as stating, "We realized that all the quoting in the world wasn't going to get us far. The solution was that banks commit themselves to trade a minimum amount of contracts per day."[2] With a few days of the November meeting, DTB's market share of the Bund contract jumped dramatically. This trend continued and DTB gained the lion's share of the market in the Bund contract.

Threats of the type DTB reportedly made to its members would not work in the US. It could even be argued that DTB was justified in taking these measures as a matter of national interest. Then the question arises, just how does Eurex plan on succeeding in grabbing market share from existing futures markets – where others have failed? I have seen slides of a presentation that Eurex has made to potential US members. What I read in them greatly disturbs me. According to the slides, Eurex plans on sharing its revenue with the top volume member firms for the first two years of trading in the US. During the first year, Eurex will rebate 50% of its revenue to the top 10 agency activity firms and the top 10 principal activity firms. This amount will reduce to 25% of revenue in the second year and presumably be eliminated in the third year.

The top ten firms in each category could then see rebates that exceed the exchange fees they pay. Therefore, the Eurex plan is *very* different than the volume discount in exchange fee plans that US exchanges have. It also is not really payment for order flow, because the revenue sharing the top firms get is not based on *their* volume (as payment for order flow usually is), but instead based on *everyone's* volume. The more volume that is diverted to Eurex, the more the top firms get rebated to them. This

---

[1] DTB Volume Surge Leaves Members Optimistic about Competing with LIFFE." *Securities Week*, December 9, 1991, page 6.

[2] See "German Exchange Members Plan Greater Effort to Increase Trading of Bund Futures Contract." *Wall Street Journal Europe*, November 8, 1991, page 16.

encourages firms to get others to divert their order flow to Eurex. In this sense, Eurex's plan to gain market share in the US reminds me of a classic Ponzi scheme.

Ignoring the fairness of Eurex's plan for now, I will next examine several scenarios that may unfold if Eurex is allowed to enter the US market with a workable plan to capture market share.

The first scenario is that the CBOT and Merc do not respond, and Eurex is successful in capturing all of the market share in US Treasury derivative products. They are then free to charge whatever exchange fees they want. Fees could again rise to current levels or higher. Eurex may seek to recapture the rebates they paid out to buy the market by charging higher fees. The top member firms will have gained a temporary revenue gain in return for higher fees later on.

An alternative scenario is that the method Eurex proposes to gain market share is replicated by the CBOT and Merc. This may very well lead to a race to the bottom for exchange fees, where each market matches fee cuts by other markers. I am afraid that if this happens, market surveillance funding will become a casualty. Some say that the lack of increased budgets for market surveillance on NASDAQ allowed the well publicized implicit collusion between market makers to keep spreads wide, to flourish. I am afraid of similar problems for futures markets role as SROs. The CFTC needs to take precautions to safeguard the market surveillance function of markets.

The final scenario I consider plausible is that Eurex gains some market share and an equilibrium occurs in which markets charge differential fees. However, as in all of these scenarios, fees are only a small part of the total cost of trading. The price the contract is entered into can have far greater impact on an investor than exchange fees. A higher fee at a better price is better for investors than a lower fee at an inferior price. I will next illustrate the danger is allowing futures markets to become fragmented with orders being routed by some intermediaries based on exchange fees.

If Eurex is successful in garnering significant but not complete market share in US Treasury products, then the futures markets will face a situation similar to that faced by the options markets following the start of multiple listing of options. Prior to the start of multiple listing, options on an underlying firm's stock tended to be traded on only one exchange. Because of this there was no need to have intermarket linkages as stock markets did through the Intermarket Trading System (ITS). Trading rules required brokers to get the best price available on a market where an option order was sent. Since options were mostly only traded on one exchange, this rule was tantamount to getting investors the best *available* price. Multiple listing of options led to a very large number of cases where trades occurred at prices inferior to those available on another exchange (called trade throughs). This in turn led the SEC to attempt to create an intermarket linkage for options, similar to ITS for equities.

Since there are no rules (that I am aware of) in the futures markets that guarantee investors the best price available across markets, I am afraid that a great number of trade through cases will exist if Eurex captures some of the CBOT and Merc's market share. While fee reductions are good for intermediaries I am worried that investors' orders will be routed based on potential cost savings for intermediaries and not the best price available across all markets. A one tick price difference on a long bond contract is worth $31.25. A trade may be routed to an exchange to save the intermediary $0.50 in fees, but may cost the customer $31.25 or more in inferior pricing. While it could be argued that customers would not stand for inferior pricing, my experience has been that they don't know they are getting an inferior price. The fact that many investors did not realize there were better prices available is one of the main reasons that the SEC imposed the Order Handling Rules on NASDAQ in 1997.

I think it is therefore essential that if the CFTC decides to allow Eurex to enter the US market, that the commission first establish rules protecting investors' rights to obtain the best price and further to require the necessary linkages to guarantee the best price. Competition between exchanges may lower fees for traders. However, as illustrated above, the resulting fragmented market may also cause losses to investors which far exceed the reduction in fees. In this sense, the commission would be penny wise, but dollar foolish.

Competition should be between natural buyers and sellers of a good. Other countries have learned the benefits of consolidating order flow. The Italian regulatory body, CONSOB, as well as Euronext, and the Toronto Stock Exchange (among others) have all enacted rules requiring that all but the largest market orders interact directly with limit orders for equities. Consolidation allows natural buyers and sellers to interact in a true competitive environment. It is time that US regulators learn the value of consolidation. Fragmentation can lead to large costs for investors through inferior prices.

In summary, I urge the commission to consider the legality and fairness of Eurex's plan to capture market share in US Treasuries derivatives products. If the commission, in its wisdom, does allow Eurex to enter the US market, I strongly urge that rules and linkages be put in place first that will guarantee that investors get the best available price.

Sincerely;

Daniel G. Weaver, Ph.D.
Visiting Associate Professor of Finance
732.445.5644
Daniel_weaver@rbsmail.rutgers.edu