CME Group
A CME/Chicago Board of Trade Company

Kathleen M. Cronin
Managing Director
General Counsel and Corporate Secretary

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VIA ELECTRONIC MAIL

Steven Schoenfeld
Director, Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: The Board of Trade of the City of Chicago, Inc. ("CBOT") Market Regulation Advisory Notice RA0907-1

Dear Mr. Schoenfeld:

CBOT hereby responds to the Commission's letter dated October 30, 2009 with respect to CBOT's Market Regulation Advisory Notice RA0907-1 (the "Advisory Notice"). For the reasons discussed below, the Advisory Notice does not constitute a "false certification" within the meaning of Commission Regulation 40.6(b). Moreover, neither the Advisory Notice nor CBOT Rule 538 violates Core Principle 18. ELX Futures, L.P.'s ("ELX") request for a stay of the Advisory Notice should be denied and the Commission's inquiry should be terminated.

I. Background

In accordance with Core Principle 9 and Commission Regulations 1.38 and 1.39, CBOT's rules prohibit non-competitive trades except in limited circumstances. (*See* CBOT Rule 539.) The only prearranged trades permitted on CBOT are block trades made pursuant to CBOT Rule 526 and Exchange for Related Positions ("EFRPs") pursuant to CBOT Rule 538. As authorized by the Commodity Exchange Act ("CEA"), CBOT Rules 526 and 538 were self-certified, without subsequent objection from the Commission.

CBOT Rule 538 specifically permits three types of Exchange for Related Positions ("EFRPs") transactions: (i) Exchange for Physical ("EFP"); (ii) Exchange for Risk ("EFR"); and (iii) Exchange of Options for Options ("EOO"). In relevant part, CBOT Rule 538 provides:

> **538. EXCHANGE FOR RELATED POSITIONS**
> The following transactions shall be permitted by arrangement between parties in accordance with the requirements of this rule:
>
> Exchange for Physical ("EFP") – A privately negotiated and simultaneous exchange of an Exchange futures position for a corresponding cash position.

Exchange for Risk ("EFR") – A privately negotiated and simultaneous exchange of an Exchange futures position for a corresponding OTC swap or other OTC instrument.
Exchange of Options for Options ("EOO") – A privately negotiated and simultaneous exchange of an Exchange option position for a corresponding OTC option position or other OTC instrument with similar characteristics.

For purposes of this rule, an EFP, EFR or EOO shall be referred to as an Exchange for Related Position ("EFRP").

538.A. Nature of an EFRP
An EFRP consists of two discrete but related simultaneous transactions. One party to the EFRP must be the buyer of (or the holder of the long market exposure associated with) the related position and the seller of the corresponding Exchange contract. The other party to the EFRP must be the seller of (or the holder of the short market exposure associated with) the related position and the buyer of the corresponding Exchange contract. However, a member firm may facilitate, as principal, the related position on behalf of a customer, provided that the member firm can demonstrate that the related position was passed through to the customer who received the Exchange contract position as part of the EFRP.

538.B. Related Positions
The related position (cash, OTC swap, OTC option, or other OTC derivative) must involve the commodity underlying the Exchange contract, or must be a derivative, by-product, or related product of such commodity that has a reasonable degree of price correlation to the commodity underlying the Exchange contract.

538.C. Quantity
The quantity covered by the related position must be approximately equivalent to the quantity covered by the Exchange contracts.

538.D. Prices and Price Increments
An EFRP transaction may be entered into in accordance with the applicable price increments or option premium increments set forth in the rules governing the pertinent Exchange contracts, at such prices as are mutually agreed upon by the two parties to the transaction.

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538.H. Documentation
Parties to any EFRP transaction must maintain all documents relevant to the Exchange contract and the cash, OTC swap, OTC option, or other OTC derivatives, including all documents customarily generated in accordance with relevant market practices and any documents reflecting payment and transfer of title. Any such documents must be provided to the Exchange upon request, and it shall be the responsibility of the carrying clearing member firm to provide such requested documentation on a timely basis.

In its Request for Approval of Amendment to ELX Futures, L.P. Rule IV-5(a)(iv) and (v) to add an Exchange of Futures for Futures, or "EFF"," Rule to the Rule Governing Exchange for Futures for Related Positions dated July 6, 2009 (the "Rule Filing"), ELX asked the Commission for, among other things, prior approval of Rule IV-5(a)(iv) to ELX's rules. ELX's Rule IV-5(a)(iv) (the "EFF Rule") amends ELX's existing rule respecting Exchange of Futures for Related Position to explicitly permit a futures contract to serve as the related position in such transactions. The ELX EFF Rule does not explicitly establish the means to liquidate the futures positions held at another clearing house or to establish new positions at another clearing house. Based on ELX's press statements and the explanation supporting its

rule filing, it is clear that the purpose of the EFF Rule is to enable persons who hold open, equal and opposite futures positions at another clearing house to require that clearing house and the relevant exchange that lists the contract to permit the liquidation of those positions and the corresponding open interest at that clearing house by means of some form of notice of fictitious paired transactions rather than a legitimate transaction. In relevant part, ELX's EFF Rule provides:

> **IV-5 Exchange of Futures**
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> (a) The following transactions may be executed outside of the ELX System in all Futures in accordance with the requirements of this Rule.
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> **********
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> (iv) *Exchange of Futures for, or in connection with, futures transactions (Exchange for Futures Transactions" or "EFFs").*
> (v) For purposes of this Rule, all EFPs, EFSs, EFFs and EFRs shall be referred to as Exchanges of Futures for Related Positions.
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> (b) The Related Position (cash, swap, futures or OTC derivative) must involve the commodity underlying the Future, or must be a derivative by-product or related product of such commodity that has a reasonable degree of price correlation or other significant price relationship to the commodity underlying the Future.
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> (c) An Exchange of Futures for a Related Position consists of two discrete, but related simultaneous transactions. One party must be the buyer of (or have the long market exposure associated with) the Related Position and the seller of the corresponding Future, and the other party must be the seller of (or have the short market exposure associated with) the Related Position and the buyer of the corresponding Future. However, a Participant may facilitate, as principal, an Exchange of Futures for a related Position on behalf of a Customer, provided that the Participant can demonstrate that the Futures Position or Related Position as the case may be, was passed through to the Customer.
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> (d) The accounts involved on each side of an Exchange of Futures for a Related Position: (i) must have different Beneficial Ownership; and (ii) must be under separate control; or (iii) must involve separate legal entities.
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> (e) The quantity covered by the Related Position must be approximately equivalent to the quantity covered by the Futures.
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> (f) Exchanges of Futures for Related Positions may be entered into in accordance with the applicable trading increments for the Future involved, at such prices as are mutually agreed upon by the two parties to the transaction.

In its Rule Filing, ELX states that the purpose of its proposed rule "is to enable market participants to establish positions in futures contracts on ELX and liquidate such positions on another DCM that lists an *identical contract*, or to establish a position on such other DCM and liquidate it on ELX." (Rule Filing at 1, (emphasis added).) According to ELX, an EFF "consists of two related but discrete transactions which are executed non-competitively between the same exempt commercial participants." (Rule Filing at 2 n.1.) ELX further states in the Rule Filing that the specific purpose of its request for prior approval by the Commission is "to confirm that the EFF Rule can be used to create a trade that must be accepted under CBOT Rule 538 of the CBOT Rules. . . . and will not subject the CBOT participant to disciplinary action or threat thereof." (Rule Filing at 2.) Finally, in its Rule Filing, ELX specifically asks the Commission to "use the powers granted to it to order an amendment to CBOT Rule 538 in order to give

effect" to the ELX Rule Proposal. (Id.) The Commission neither granted ELX's request for prior approval nor amended CBOT Rule 538. ELX's proposed EFF rule, however, was "approved" by virtue of the fact that the Commission failed to take action within the statutory timeframe, which expired on October 5, 2009.

ELX's EFF Rule, that was submitted to the CFTC and permitted to become effective by the passage of time, neither requires nor permits the use of matching, prearranged block trades that negate market risk to liquidate positions in one clearing house and reestablish those same positions at another clearing house. Rather, it provides: "An Exchange of Futures for a Related Position consists of two discrete, but related simultaneous transactions. One party must be the buyer of (or have the long market exposure associated with) the Related Position and the seller of the corresponding Future, and the other party must be the seller of (or have the short market exposure associated with) the Related Position and the buyer of the corresponding Future." ELX's EFF Rule does not specify how the related futures position may be bought or sold and does not purport to control or alter the rules of the exchange at which the related futures position was established and where it is part and parcel of the open interest.

ELX's EFF Rule does not purport to provide the mechanism for the extinguishment of open interest at another clearing house. The rule can only control the creation or liquidation of open interest on its exchange and at its clearing house. The legitimate mechanism to transfer CBOT open interest to ELX is for the party who is short a CBOT contract to close that position by buying-in its short and reestablishing its short position by means of a lawful transaction at ELX. A party who is long the CBOT contract may close that position by selling its position and may reestablish that position by going long at ELX. Provided that the trades at CBOT occur in the open, competitive market, or as *legitimate* privately negotiated transactions executed consistent with CBOT rules, CBOT has no further interest in any subsequent transaction that does not take place through the use of its facilities.

In the absence of a ruling from the Commission stating that CBOT must adopt ELX's EFF Rule – an omission which effectively denied ELX's request for the Commission to amend CBOT Rule 538 – ELX embarked on an aggressive publicity campaign purporting to interpret CBOT Rule 538. For example, on October 14, 2009, ELX issued a press release stating that the Commission's approval of the EFF Rule gives "traders the ability to move positions between clearinghouses." On that same day, ELX issued a "Memo to Market" stating "[a]n ELX U.S. Treasury futures contract that is executed off-exchange as part of an EFF satisfies the 'other OTC derivative' requirement" of CBOT Rule 538. (*See* ELX Memo to Market, attached hereto as exhibit A.) ELX further states in the "Memo to Market" that there is "no open issue of a regulatory offense for which another exchange can use its rule enforcement powers should market participants" attempt to trade on another exchange pursuant to ELX's EFF rule. (Id.) ELX's claim that CBOT is obligated by ELX's EFF Rule to accept a non-competitive trade that is not permitted by CBOT rules is not supported by the terms of the CEA, by any rule or regulation of the CFTC, or by the terms of the ELX EFF rule. CBOT is unaware of any authority conferring such power on any DCM.

In response to ELX's erroneous statements regarding CBOT Rule 538, including the issuance of its *own* interpretation of CBOT's rule, CBOT was forced to issue Advisory Notice RA0907-1 on October 16, 2009 (the "Advisory Notice"), which clarified the scope of CBOT Rule 538. Although the plain language of CBOT Rule 538 makes clear that an EFF transaction is not a permissible EFRP transaction

on CBOT (*i.e.,* unlike the language added to ELX's previous EFRP rule, CBOT's Rule 538 nowhere mentions the term "EFF"), CBOT informed market participants in the Advisory Notice that, contrary to the information that had been circulated by ELX respecting CBOT Rule 538, EFF transactions were prohibited by the rule and that the rule, by its terms, permitted *only* EFPs, EFRs and EOOs. (Advisory Notice at 1.) The Advisory Notice also noted that CBOT's rules have "*never* permitted a futures contract to be used as the related position component of an EFR transaction" (Id., emphasis added.)

On October 20, 2009, pursuant to Commission Regulation 40.6, ELX requested that the Commission stay CBOT's Advisory Notice ("Request for Stay"). ELX asserts that its Request for Stay is based on: (1) factual errors contained in CBOT's Advisory Notice, which render it a "false certification" within the meaning of Regulation 40.6(b); and (2) an alleged violation of Core Principle 18. Although we respond to ELX's allegations in more detail below in response to the specific questions posed by the Commission, we briefly note that there are many ways in which a market participant could effectively move its positions in CBOT Treasuries to ELX Treasuries while complying with CBOT's rules, and that ELX's complaint regarding the Advisory Notice and CBOT Rule 538 is based on a willful misreading of the Advisory Notice and the certification, and on a misconstruction of the antitrust definitions and concepts embodied in Core Principle 18.

II. Legal and Economic Principles Justify Distinguishing Between EFFs and EFPs, EFRs and EOOs

If a designated contract market chooses to permit non-competitive trades, it has the right and obligation to shape its rules permitting such trades in the best interests of preserving transparency and liquidity on its markets. Commission Regulation 1.38 generally requires that all purchases and sales of a futures contract or an options contract on a futures should be executed by open and competitive methods. However, transactions may be executed in a "non-competitive" manner if executed pursuant to exchange rules specifically providing for the non-competitive execution of such transactions, provided such rules were approved by the Commission.[1] Nonetheless, futures exchanges must balance such rules with Core Principle 9 (Execution of Transactions) applicable to futures exchanges, which mandates that "[t]he board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions."

Last fall, the Commission issued a request for comment on revised guidance for Core Principle 9 and on certain proposed amendments for Regulation 1.38. In that Federal Register release, the Commission opined that the "implicit assumption" in Regulation 1.38 was that "trading should take place

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[1] Commission Regulation 1.38 provides, in relevant part:

(a) *Competitive execution required; exceptions.* All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity or commodity option: *Provided, however,* That this requirement shall not apply to transactions which are executed non-competitively in accordance with written rules of the contract market which have been submitted to and approved by the Commission, specifically providing for the non-competitive execution of such transactions.

on the centralized market unless there is a compelling reason to allow certain transactions to take place off the centralized market."[2] The Commission further noted that exchange rules and policies allowing such transactions:

> "should ensure that the impact on the centralized market is kept to a minimum. For example, certain types of off-centralized market transactions, such as block trades and exchanges of futures for related positions, can create new positions or reduce prior positions. If these transactions become the exclusive or predominant method of establishing or offsetting positions in a particular market, it might jeopardize the centralized market's role in price discovery and would not comply with Core Principle 9, which provides that trading be competitive, open and efficient." (id.)

In addition, the application guidance for Core Principle 9 provides that a "competitive, open and efficient market and mechanism for executing transactions includes a board of trade's methodology for entering orders and executing transactions" and that "a designated contract market that determines to allow block trading should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market."

The Treasury complex at both CBOT and ELX are liquid markets and there is no legitimate reason to permit a non-competitive transaction without any economic substance that will cause sudden, inexplicable changes in open interest. Any trader with a position at CBOT in a Treasury contract can quickly and easily exit that position and reestablish it at ELX by simultaneously buying and selling at the respective exchanges on their electronic systems. Indeed, our records indicate that CBOT has, at all relevant times respecting such transactions, had narrow spreads and substantial size bid and offered at the inside market. It is our understanding that ELX offers similarly narrow spreads and reported record volume in October 2009. If the size of the position to be moved is "too big" for the competitive market, a customer may enter into a block trade to liquidate its CBOT position and enter into a *separate and independent* block trade to establish an ELX position. In fact, ELX's block trading thresholds during regular trading hours are at least 80% smaller than the CBOT's block trading thresholds. While block trades may detract from the benefits derived from bringing all transactions to the competitive arena, they are tolerated, subject to clear limits and strict measures to assure a significant measure of transparency and fairness to other market participants pursuant to the rules established by CBOT and the Commission. CBOT does not believe it is in the interest of the market or of its customers to offer holders of open interest the opportunity to eliminate their positions and impact the open interest without any legitimate trade.

On its face the ELX rule does not permit a purely fictitious trade to eliminate open positions at another exchange. It requires a transaction. If the required transaction begins or ends with a legitimate competitive transaction at CBOT, CBOT does not have a direct regulatory interest. ELX, however, is promoting an entirely different means to accomplish the liquidation of open positions at CBOT and the reestablishment of those positions at ELX. ELX expects to authorize its members to enter into a matched pair of transactions, that involve no market risk and no change of position and to then send a note to

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[2] *See* Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9, 73 Fed. Reg. 54097, 54099 (Sept. 18, 2008).

CBOT and its clearing house announcing that 5,000, 10,000 or even 100,000 open bond positions have been liquidated.

EFRP transactions have traditionally been executed to preserve basis relationships and mitigate the execution risk associated with the initiation or liquidation of a futures or futures option position to hedge a physical or OTC position, and have fostered the use of transparent exchange markets as a price source for transactions in the physical and over the counter markets. In the case of certain transitory EFRPs, the mechanism has facilitated clearing for the OTC market, thereby allowing for the mitigation of counterparty and systemic risk and enhanced transparency. Contrary to ELX's assertion that an ELX futures contract represents an OTC instrument that qualifies under CBOT Rule 538 as the OTC component of a CBOT EFRP transaction, it is clearly not an OTC instrument but an identical futures contract.

If prearranged, matching pairs of offsetting EFP, EFR, EOO or block transactions were executed, without incurring market risk, CBOT's prohibitions on wash sales and fictitious trading would be violated. The fact that the prearranged and matching pair of transactions involves trades on CBOT and another exchange does not obviate the requirement that the CBOT trade be bona fide. In our view such trades constitute fictitious or wash trading, which, consistent with Commission precedent, are prohibited by CBOT Rules.[3] The Commission defines wash trading as "entering into, or purporting to enter into, transactions to give the appearance that purchases and sales have been made, without incurring market risk or changing the trader's market position." Such fictitious and wash trades are expressly prohibited by the CEA:

> **§ 4c. Prohibited transactions**
> (a) **In general**
> (1) **Prohibition**
> It shall be unlawful for any person to offer to enter into, enter into, or confirm the execution of a transaction described in paragraph (2) involving the purchase or sale of any commodity for future delivery (or any option on such a transaction or option on a commodity) if the transaction is used or may be used to—
> (A) hedge any transaction in interstate commerce in the commodity or the product or byproduct of the commodity;
> (B) determine the price basis of any such transaction in interstate commerce in the commodity; or
> (C) deliver any such commodity sold, shipped, or received in interstate commerce for the execution of the transaction.

[3] Rule 534. Wash Trades Prohibited

No person shall place or accept buy and sell orders in the same product and expiration month, and, for a put or call option, the same strike price, where the person knows or reasonably should know that the purpose of the orders is to avoid taking a bona fide market position exposed to market risk (transactions commonly known or referred to as wash sales). Buy and sell orders for different accounts with common beneficial ownership that are entered with the intent to negate market risk or price competition shall also be deemed to violate the prohibition on wash trades. Additionally, no person shall knowingly execute or accommodate the execution of such orders by direct or indirect means.

> (2) **Transaction**
> A transaction referred to in paragraph (1) is a transaction that—
> (A) (i) is, of the character of, or is commonly known to the trade as, a "wash sale" or "accommodation trade"; or
> (ii) is a fictitious sale; or
> (B) is used to cause any price to be reported, registered, or recorded that is not a true and bona fide price.

That the two legs contemplated by ELX's EFF Rule would be related to the identical contract traded on different contract markets is of no consequence. In fact, the Commission has expressly held on a number of occasions that a purchase and sale on two distinct systems does not avoid the wash sale prohibition when those trades have been prearranged. *See In the Matter of Byron G. Biggs,* CFTC Docket No. 04-22:

> "WASHINGTON, D.C. -- The U.S. Commodity Futures Trading Commission (CFTC) today announced the filing and simultaneous settlement of charges against Byron G. Biggs, a founder trader for BP Energy Company, for engaging in illegal wash trading on an electronic trading platform. Biggs has agreed to cooperate with the CFTC's Division of Enforcement.
> The CFTC order, issued on August 11, 2004, finds that on six occasions between April and June 2000, Biggs executed prearranged trades for electricity contracts at identical prices. On each occasion, according to the order, Biggs agreed to execute a buy or a sell order on the electronic trading platform and then immediately to reverse the transaction by bilaterally executing by telephone an equal and opposite buy or sell. The order finds that these trades resulted in a financial nullity." CFTC Release: 4967-04 (August 11, 2004)
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> See also *In the Matter of Joseph B. Knauth, Jr.,* CFTC Docket No. 04-15.
> "WASHINGTON, D.C. -- The U.S. Commodity Futures Trading Commission (CFTC) today announced the filing and simultaneous settlement of charges against Joseph B. Knauth, Jr., a former electricity trader, for engaging in illegal wash trading on an electronic trading platform.
> The CFTC order, issued on May 10, 2004, finds that on five occasions between April and June 2000, Knauth executed prearranged trades for electricity contracts at identical prices. On each occasion, according to the order, Knauth agreed to execute a buy and a sell order on the electronic trading platform and immediately to reverse the transaction by bilaterally executing over the telephone an equal and opposite buy and sell. The order finds that these trades resulted in a financial nullity." CFTC Release: 4925-04 (May 10, 2004)

Judicial and administrative authorities have been consistent and clear: Proof of intent is not required to prove a wash trade, nor will a purported business motive prevent a transaction from being deemed a wash trade where the intent to avoid or negate market risk is sufficiently evident from the transaction's structure.

In *In the Matter of Olam International Ltd:* CFTC Docket No. 04-13 (April 15, 2004), the customer explained that it had a legitimate commercial purpose for its transaction – specifically, its interest in offsetting positions that were held at different clearing firms. The customer in *Olam* also appears to have

had a legitimate alternative means to accomplish its goal, which it failed to pursue out only of ignorance. The Commission rejected these defenses and reiterated its view of the legal standard:

> Section 4c(a) of the Act makes it "unlawful for any person to offer to enter into, enter into, or confirm the execution of a transaction" that "is of the character of, or is commonly known to the trade as, a 'wash sale'. . . ." The central characteristic of a wash sale is the intent to avoid making a *bona fide* transaction or taking a *bona fide* market position. *In re Citadel Trading Co. of Chicago, Lid.,* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,082 at 32,190 (CFTC May 12, 1986).
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> The factors that indicate a wash result are (1) the purchase and sale (2) of the same delivery month of the same futures contract (3) at the same (or a similar) price. *In re Gilchrist,* [19901992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,993 at 37,653 (CFTC Jan. 25, 1991). Here, Olam bought and sold the same delivery month of the same futures contract at the same price in two delivery months on June 13, 2002 (i.e., 345 July 2002 cocoa futures contracts at 1475 per contract and 345 March 2003 cocoa futures contracts at 1465 per contract) and again in two delivery months on July 10, 2002 (*i.e.*, 450 September 2002 cocoa futures contracts at 1780 per contract and 450 December 2002 cocoa futures contracts at 1761 per contract).

Nonetheless, in addition to these factors, the liability of the customer initiating the wash sale depends upon evidence demonstrating that the customer intended to negate market risk or price competition. *In re Piasio,* [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH)1 28,276 at 50,685 (CFTC Sep. 29, 2000). Market risk or price competition is negated "when it is reduced to a level that has no practical impact on the transactions at issue." *In re Gimbel,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) 1 24,213 at 35,004 n.7 (CFTC Apr. 14, 1998), *aff'd as to liability,* 872 F.2d 196 (7th Cir. 1989). Similarly, the liability of a participant in the wash sale depends upon the demonstration that the participant knew, at the time he chose to participate in the transaction, that the transaction was designed to achieve a wash result in a manner that negated risk. *In re Bear Stearns & Co.,* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,994 at 37,665 (CFTC *Jan.* 25, 1991).

While the intent to avoid a *bona fide* market position can properly be inferred from prearrangement, it can also be inferred "from the intentional structuring of a transaction in a manner to achieve the same result as prearrangement." *In re Three Eight Corporation,* [19921994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶25,749 at 40,444 n.15 (CFTC Jun. 16, 1993) (citing *In re Collins* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH)¶22,982 at 31,90001 (CFTC Apr. 4, 1986), *rev'd on other grounds sub. nom. Stoller v. CFTC,* 834 F.2d 262 (2d Cir. 1987) *("Collins I")).* "In an individual transaction . . ., a trader may avoid a *bona fide* market transaction in many instances merely by structuring the buy and sell orders so that they are simultaneous, or practically so, and by signaling . . . , directly or indirectly, that a price match is the objective of the transaction." *Collins 1,1* 22,982 at 31,900-01.

CBOT rules permit a firm or customer to establish or liquidate a position by means of a legitimate trade. CBOT rules require, in accordance with the requirements of the CEA, that the trade be a bona

fide trade rather than a fictitious trade. CBOT's interpretation of its rules, consistent with CFTC precedent, makes clear that a prearranged, matched pair of trades executed for the purpose of moving a futures position from one clearing house to another involves both contingent and transitory trades that are fictitious rather than bona fide and consequently violate CBOT rules. The Advisory Notice did not change CBOT Rules.

III. The Advisory Notice and CBOT Rule 538 Comply With Core Principle 18

In neither its Rule Filing nor its Request for Stay does ELX explain how CBOT's Advisory Notice or CBOT Rule 538 violates Core Principle 18. Rather, ELX simply makes the conclusory assertion that "[t]he use or threat of disciplinary action by an SRO to prevent another exchange from competing is a chilling threat." (Rule Filing at 4.) ELX's assertion that CBOT is "prevent[ing]" ELX – or any other exchange – from competing is outlandish. Nothing in CBOT's Advisory precludes any person from trading Treasury contracts at ELX or clearing those trades at the OCC. As discussed above, no CBOT rule prevents CBOT customers from closing open positions and reestablishing them at ELX. We are aware of no principle of antitrust law that requires a successful business to structure its rules in the way that will best facilitate the transfer of its open book of business to a third party (OCC) in order to assist a competitor (ELX). It is unequivocal that a violation of Core Principle 18 requires an "unreasonable restraint of trade," not "refusal to assist a competitor."

Core Principle 18 states:

> "Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid:
> (A) adopting any rules or taking any action that result in any unreasonable restraints on trade; or
> (B) imposing any material anticompetitive burden on trading on the contract market.

The legislative history of Core Principle 18 makes clear that its terms are derived from antitrust law. *See* 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION §2.12[1] (2004) (discussing legislative history of CEA Section 15, the predecessor to Core Principle 18). Mere disadvantage to a competitor does not fall within the scope of "unreasonable restraint on trade" or "material anticompetitive burden" as those terms are defined by antitrust law. An exchange's refusal to adopt new rules or amend established rules in order to assist a competitor is not the kind of behavior contemplated by Core Principle 18.

It is not anticompetitive for an exchange or a clearing house to refuse to enter into offset arrangements (formal or de facto) with another exchange or clearing house. There are a plethora of cases enunciating this basic principle of antitrust law. For example, in *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP.,* 540 U.S. 398, 124 S.Ct. 872, 157 L.Ed.2d 823 (2004), the Supreme Court emphasized that traditional antitrust principles recognized only very limited exceptions (none of which is applicable here) to the general and well-accepted proposition that there is no duty for an enterprise to assist its rivals. 157 L.Ed.2d at 838. The Supreme Court and lower federal courts have repeatedly held that the purpose of antitrust laws is to protect competition, not competitors such as ELX. As the Supreme Court stated in *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 458 (1993): "The purpose of the [Sherman] Act is not to protect businesses from the working of the market, it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."

ELX fails to explain how CBOT's Advisory Notice or Rule 538 harms consumers by raising prices or reducing output. *See Ball Mem. Hosp., Inc. v. Mut. Ins., Inc.*, 784 F.2d 1325, 1334 (7th Cir. 1986) (antitrust injury "means injury from higher prices or lower output….") Nor has ELX even suggested how CBOT's Advisory Notice might cause an actual and substantial adverse effect on competition that outweighs its pro-competitive effects of fostering an open and competitive marketplace and prohibiting unlawful and misleading fictitious transactions. *See Chicago Board of Trade v. United States*, 246 U.S. 231, 238 (1918) (To determine whether conduct promotes or suppresses competition, "the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable.) The view that any impediment to a competitor is an unreasonable restraint of trade does not deserve to be given any credence by the Commission. *See NYMEX v. Intercontinental Exchange, Inc.*, 323 F.Supp.2d 559 (S.D.N.Y. 2004).

Moreover, in this instance, the question of whether or not CBOT's Advisory Notice or CBOT Rule 538 constitutes an unreasonable restraint of trade is not relevant. Core Principle 18 begins with the clause, "[u]nless necessary or appropriate to achieve the purposes of this chapter." This means that the antitrust considerations do not apply when the action is necessary or appropriate to achieve the purposes of the CEA. One of the explicit purposes of the CEA is to prevent fictitious trading and wash trading. If a rule or rule interpretation is "appropriate" to achieve that purpose, the antitrust concerns of Core Principle 18 do not come into play. Section 4c(a) clearly prohibits wash trades, accommodation trades and fictitious trades. It also forbids the reporting of prices that are not true and bona fide prices. As previously discussed, the EFF contemplated by ELX constitutes a fictitious trade. CBOT's Advisory Notice setting forth its interpretation of its existing rule prohibiting conduct forbidden by the CEA is thus fully consistent with CBOT's obligation to take affirmative steps to prevent violations of the CEA involving the reporting of fictitious transactions and prices. For this reason, the Advisory Notice (and CBOT Rule 538) is exempt from any limitation in subparagraphs A and B[4] of Core Principle 18.

It appears that ELX interprets Core Principle 18 as precluding CBOT, or any contract market for that matter, from taking any action that ELX judges to be contrary to its best interests. As the discussion above demonstrates, this is not what Core Principle 18 stands for, and neither the Advisory Notice nor CBOT Rule 538 violates this principle.

IV. CBOT's Self-Certification of the Advisory Notice Is Not a "False Certification" Within the Meaning of Regulation 40.6(b)

Regulation 40.6(b), in relevant part, provides that the Commission may stay "the effectiveness of a rule implemented pursuant to paragraph (a) of this section during the pendency of Commission proceedings for filing a false certification or to alter or amend the rule pursuant to section 8a(7) of the Act." (Reg. 40.6(b).) Although Regulation 40.6 does not define the term "false certification," CBOT can confidently attest that there is nothing "false" or otherwise incorrect in its Advisory Notice.

[4] In fact, subparagraph (B) is not applicable here. It pertains to a rule of a board of trade that imposes anticompetitive burdens on the participants trading on the contract market that adopts the rule. Note that it does not refer to trading on "another contract market." The actual clause pertains to restrictions "on trading on *the* contract market." (emphasis added.) This clause was intended to prevent an exchange from discriminating among its own members in respect of trading on its markets.

As previously noted, ELX's claim that CBOT committed a violation of Commission Regulation 40.6(b) is itself based on false information. ELX states that "CME contends that it does not accept 'contingent or transitory EFRPs,'" (Request for Stay at 2,) yet the Advisory Notice clearly was issued on behalf of the DCM CBOT, and explicitly states that "*CBOT rule*s do not and have never permitted a futures contract to be used as the related position component of an EFR[P] transaction" and that "a prearranged, matched pair of block trades that are executed for the purpose of moving a futures position from one clearing house to another are *both contingent and transitory trade*s, and under *CBOT rule*s, may not be employed to create or liquidate a futures position." (Advisory Notice at 1 (emphasis added).) Although at one time CBOT did allow transitory EFRP trades in its metals complex (which, as the Commission knows, was sold over a year and a half ago), CBOT's current rules prohibit both contingent and transitory trades. Contrary to ELX's contention that CBOT permits transitory EFRPs in its agricultural products (Request for Stay at 2,) the referenced transactions are not transitory in nature. Indeed, in the transactions referenced in ELX's Request for Stay, there is no obligation by either party to do the second EFRP; instead, a non-transferable right to effectuate the second EFRP at some future date is granted by one party to the other. ELX does not, because it cannot, explain how a non-transferable right to effectuate the second EFRP at some future date renders the transaction transitory.

Without mischaracterizing the content of the Advisory Notice, ELX cannot claim that any aspect of the Advisory Notice contains false information. Indeed, nowhere in its Request for Stay does ELX attempt to challenge the veracity of the *actual* statements made in the Advisory Notice by CBOT. Moreover, CBOT – the DCM at issue here – has authority to interpret its rules and make a determination as to the types of trades permitted on its exchange so long as its rules are consistent with the CEA. Just as ELX's Rule IV did not expressly permit EFFs prior to its recent amendment, CBOT's rules do not – and have never – expressly permitted EFFs. As previously noted, the Advisory Notice was issued only in response to the inaccurate information disseminated by ELX respecting CBOT Rule 538's application to EFFs. Indeed, it is entirely inappropriate for ELX to be issuing public regulatory guidance with respect to CBOT rules. That ELX disagrees with CBOT's reading of *its own* rules does not render that interpretation "false." ELX does not – because it cannot – provide any evidence demonstrating that CBOT has acted inconsistent with the interpretation of CBOT Rule 538 set forth in the Advisory Notice.

Finally, ELX argues that an EFF is "factually not a transitory trade." (Request for Stay at 3.) In support of this argument, ELX states that "A transitory trade involves the rapid or prearranged purchase and sale of **the same** contracts between the parties. Here the parties are exchanging different contracts … and thus the EFF trade as proposed by ELX and approved by the Commission is not transitory or contingent." (Request for Stay at 3 (emphasis in original).) This statement flatly contradicts the representations ELX made in its Rule Filing. Indeed, in its Rule Filing, ELX states that these same contracts are "identical." (Rule Filing at 1.) ELX cannot now change its position before the Commission out of convenience. In fact, to accept the position articulated in ELX's Request for Stay would be to make a finding that ELX's own Rule Filing was based on false information.

For all these reasons, the Advisory Notice does not constitute a "false certification" within the meaning of Regulation 40.6(b).

V. Respond to the Assertion in the ELX Letter That CME Group Designated Contract Markets Have "in a number of markets, and for many years, accepted transitory trades."

As the Commission is aware, CME Group Inc. ("CME Group") was formed in 2007 following the merger of CME Holdings and CBOT Holdings. At the creation of CME Group, CBOT and the CME became wholly owned subsidiaries of CME Group. When CME acquired NYMEX in 2008, NYMEX also became a wholly owned subsidiary of CME Group.[5] CME Group is not a designated contract market pursuant to the CEA, nor has it been delegated any SRO responsibilities with respect to its subsidiary contract markets. Designated contract market status is maintained individually by each of CME, CBOT, NYMEX and COMEX. Thus, each designated contract market is responsible for its *own* rules and operation.[6] CBOT, for example, limits block trading and pre-execution communications in the electronic trading environment to a greater degree than CME, NYMEX or COMEX. None of these markets is answerable for or in any way responsible for the actions taken by another market. Thus, for purposes of the instant inquiry, we submit the only relevant contract market is CBOT.

Notwithstanding the foregoing, NYMEX, COMEX and CME permit transitory trades in limited circumstances, which are expressly provided for by the respective contract market's rules. Specifically, transitory EFRPs are permitted *only* in NYMEX energy and metals products, COMEX metals products and CME foreign exchange products. None of these markets, however, permit fictitious or wash trades. As discussed above, based on the information submitted by ELX, CBOT does not believe that actual economic risk is incurred in each part of the EFF contemplated by ELX's Rule Filing.

Moreover, as noted in our response to the Commission's first question, the Commission recently has become more critical of transitory EFRPs. Specifically, in its release of last fall on revised guidance for Core Principle 9, the Commission proposed to make two substantive amendments to its acceptable practices regarding EFRPs, including one that clarifies that transitory EFRPs are permissible *only* when each part of the transaction – the EFRP itself and the related cash transaction – is a stand-alone, bona fide transaction. Inasmuch as certain of the CME Group DCMs permit transitory EFRPs, we have been working very closely with the Commission to address its concerns in this context.

Although a centerpiece to ELX's Rule Filing was the fact that, in 2002, NYMEX sought and obtained approval from the Commission for a rule entitled "EXCHANGE OF FUTURES FOR, OR IN CONNECTION WITH, FUTURES TRANSACTION" (the "NYMEX Rule"), this is mentioned nowhere in its Request for Stay. To rely on the title of the NYMEX Rule to advance its claim that the Commission should approve its EFF Rule and force CBOT to accept non-competitive and/or fictitious trades from ELX is to elevate form over substance.

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[5] Prior to the CME Group's acquisition of NYMEX, COMEX was a subsidiary of NYMEX. COMEX remains a subsidiary of NYMEX today.

[6] Each of the DCMs owned by CME Group has its own rules respecting the rule approval process. Indeed, the CBOT rule approval process is different in key respects from the rules of CME Group's other DCMs. (*Compare* CBOT Rule 230J *with* CME Rule 230J and NYMEX Rule 230J.)

No trade was ever effectuated pursuant to the NYMEX Rule and the rule was subsequently withdrawn at the Commission's request. Moreover, there are genuine, material differences between the NYMEX Rule and ELX's EFF Rule.[7] The NYMEX Rule was, in substance, a restricted block trading rule that included information reporting requirements that were analogous those contained in EFRP rules. Specifically, the NYMEX Rule provided that the minimum transaction size for effectuating trades pursuant to the rule was 50 contracts, which, at the time, exceeded in size more than 90% of the transactions that had been executed in the months before NYMEX sought approval for the rule in the contract at issue. (*See* NYMEX RULE, attached hereto as exhibit B.) Moreover, only "eligible contract participants," as defined in the CEA, could take advantage of the new procedure set forth in the NYMEX Rule. (Id.) Neither requirement is present in ELX's EFF Rule.

Significantly, the NYMEX Rule did not seek to bind other contract markets. In fact, the NYMEX Rule explicitly provided that a market participant seeking to take advantage of the rule needed to liquidate its position on the other contract market involved pursuant to the rules of *that* contract market. Specifically, the NYMEX Rule provided: "As a condition precedent to the NYMEX Transaction, the parties to the NYMEX Transaction *must have engaged in a transaction on the other regulated futures exchange pursuant to the procedures of such other exchange that resulted in liquidating an existing position at such other exchange*." (*See* NYMEX Rule, subsection (2), (emphasis added).) ELX, whose CEO should be intimately familiar with the NYMEX Rule, obviously withheld these key details from its Rule Filing and Request for Stay, and failed to include similar provisions in ELX's EFF Rule.

VI. EFFs Are Not Permitted on COMEX

Neither COMEX nor any of the other three CME Group exchanges permits EFFs. Although the question posed by the Commission does not explain the basis for the assertion that EFFs are permitted on COMEX, we assume for purposes of this response that the Commission had in mind the London Metals Exchange ("LME") copper contract that COMEX permitted to be used as part of an EFP. The LME contracts are appropriately considered forward rather than futures contracts and therefore have been permitted as the physical leg of an EFP; COMEX did not, and does not, consider such a transaction to be an EFF.[8]

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[7] *See* New York Mercantile Exchange, Inc., CFTC Rule Approval Notice (May 3, 2002), *available at* http://www.cftc.gov/files/foia/comment02/foicf0203b002.pdf.

[8] *See, for example:*
The Professional Risk Managers' Guide to Financial Markets, Alexander and Sheedy, 2007, p.169: "Most forwards are not traded on exchanges, but there are anomalies. For example, on the LME, forwards are traded."

Futures and Options, Spence, 1997, p.20: "The LME is not a futures market in the traditional sense – it is more a forward market."

VII. Conclusion

For the foregoing reasons, CBOT's Rule 538 and its Advisory Notice are entirely accurate. Neither constitutes a "false certification" under the meaning of Regulation 40.6(b). Moreover, for the reasons set forth above, CBOT Rule 538 and the Advisory Notice comply with Core Principle 18. Accordingly, ELX's Request for Stay should be denied and this inquiry should be ended. If you have any comments or questions, please feel free to contact me at (312) 930-3488 or Kathleen.Cronon@cmegroup.com, or Brian Regan, Managing Director, Regulatory Counsel at (212) 299-2207 or Brian.Regan@cmegroup.com.

Sincerely,

Kathleen Cronin
General Counsel and Corporate Secretary
CME Group Inc.