



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527
www.cftc.gov

Division of
Market Oversight

January 22, 2010

Kathleen M. Cronin, Esq.
General Counsel and Corporate Secretary
CME Group, Inc.
20 South Wacker Drive
Chicago, Illinois 60606

Re: CBOT Rules and Interpretations Prohibiting the Exchange of Futures for Futures

Dear Ms. Cronin:

This letter concerns the Chicago Board of Trade's ("CBOT") self-certified market Regulation Advisory Notice RA0907-1, issued on October 19, 2009.¹ In that notice, CBOT stated that its rules do not permit the execution of Exchange of Futures for Futures transactions ("EFFs"), either in form or substance. In support of that position, CBOT suggested that such transactions are prohibited under the Commodity Exchange Act (the "Act" or "CEA").² Staff disagrees.

The Commodity Futures Trading Commission has already approved the execution of EFFs on other exchanges. Such approval carries with it a finding that approved rules implementing those EFF transactions are consistent with the requirements of the CEA. CBOT, therefore, is inaccurate to the extent that it construes the CEA to mandate a prohibition on the use of EFFs or EFF-like transactions.³ In these circumstances, Staff requests that CBOT further justify its Market Advisory Notice RA0907-1.

¹ CBOT Market Regulation Advisory Notice RA0907-1 (October 19, 2009) – Rule 538; Subject – Prohibition of Exchange of Futures for Futures (EFF) Transactions.

² Letter from Kathleen Cronin, General Counsel of CME Group, to Steven Schoenfeld, Director of CFTC's Division of Market Oversight, dated November 16, 2009. CBOT's Submission responded to inquiries from Division of Market Oversight Staff concerning CBOT Advisory Notice RA0907-1. See letter from David Van Wagner, CFTC Division of Market Oversight, to Kathleen Cronin, dated October 28, 2009.

³ *Id.* Accordingly, Staff's request for information consistent with its conclusion pursuant to Regulations 38.5(b) and 38.5(c) will be transmitted to CME Group on this date.

Background

The CBOT's October 19, 2009 Regulation Advisory Notice states that: (a) CBOT Rule 538 does not permit the execution of EFF trades; and (b) a matched pair of block trades executed for the purpose of transferring a futures position from one exchange to another is a "contingent and transitory" trade prohibited under CBOT rules. On October 29, 2009, CBOT separately self-certified its amendments to Rule 534 (Wash Trades Prohibited) and a related advisory clarifying certain aspects of the prohibition on wash trading (together with market Advisory Notice RA0907-1 ("Advisory")).⁴ Finally, by submission dated November 16, 2009 ("Submission"),⁵ CBOT stated that it viewed EFFs as wash trades and that its rules and interpretation prohibiting such transactions are consistent with the CEA.⁶

Commission Staff has reviewed the above-referenced CBOT rules, the Advisory, and the Submission, and has concluded that CBOT has mischaracterized the requirements of the CEA with respect to (i) the prohibition of EFF trades and matched block trades that are executed to enable inter-exchange transfers of futures positions as *per se* wash or fictitious trades in violation of the CEA; and (ii) the prohibition of such matched block trades as impermissible contingent and transitory trades. Moreover, as explained below, Staff believes that CBOT's interpretation of its rules respecting EFFs and matched block trades cannot be justified by the Commission's regulatory precedents.

A. Inter-Market Combination Trades are not *Per Se* Unlawful

Neither CBOT Rules 534 and 538 nor their related Advisories expressly characterize EFFs as wash trades. CBOT's Submission states that matching pairs of off-setting block transactions, Exchange of Futures for Physicals ("EFP"), Exchange of Futures for Risk, or Exchange of Options for Options are prohibited under CBOT's rule against wash and fictitious trading. CBOT's Submission concerning its Rule 538 goes further, stating that the fact that "the two legs contemplated by ELX EFF Rule would be related to the identical contract traded on different contract markets is of no consequence."⁷ CBOT's interpretation of its rules finding that EFFs are wash or fictitious trades conflicts with the Commission's previous finding that DCM rules allowing for inter-market combination trades as a means of transferring positions between two exchanges are not inconsistent with the CEA or the Commission's regulations and its

⁴ CBOT Market Regulation Advisory Notice 091305 (November 13, 2007) – Rule 534; Subject – Wash Trades Prohibited.

⁵ Letter from Kathleen Cronin, General Counsel of CME Group, Inc., to Steven Schoenfeld, Director of CFTC's Division of Market Oversight, dated November 16, 2009.

⁶ An EFF has been described as two discrete but integrally-related, inter-market transactions that are privately negotiated between the same commercial participants pursuant to the rules of a designated contract market ("DCM") whereby one party establishes a futures position on one DCM and simultaneously offsets its futures position on another DCM, and where the other party takes the other side of these transactions. For purposes of this letter, the terms "combination trade" or "inter-market combination trade" refer to either an EFF or a matched block trade that is executed to enable inter-exchange transfers of futures positions.

⁷ CBOT's Submission at p. 8.

approval of those rules. Accordingly, Commission regulatory precedent does not support CBOT's assertions that these trades are unlawful wash or fictitious transactions.

In 2002, the Commission approved NYMEX's Basis Trade Facility, which enabled traders to liquidate Brent Crude Oil futures contracts at the International Petroleum Exchange, then immediately establish the same quantity of Brent Crude Oil futures contracts on NYMEX, using a block trade.⁸ More recently, on October 5, 2009, the Commission approved ELX's EFF rule.⁹ ELX's rule permits traders to establish positions in futures contracts on ELX while concurrently liquidating futures positions on another DCM that lists contracts with the same terms and conditions, or conversely, to establish positions on another DCM that would replace positions liquidated on ELX. The Commission's determination to approve any DCM rule is predicated on its analysis that the rule would not violate the Act or its regulations.

Exchanges of futures for a commodity or a derivatives position¹⁰ are considered *bona fide* if they include the following essential elements, among others: separate but integrally-related transactions involving the same or a related commodity, with price correlation and quantitative equivalence of the futures and cash (or derivatives) legs, actual transfer of ownership of the commodity or derivatives position, and both legs transacted between the same two parties.¹¹ In 2008, the Commission discussed some of these characteristics in a proposed Commission rulemaking to amend Regulation 1.38 and the acceptable practices for Core Principle 9 concerning off-centralized market transactions.¹² In the case of both NYMEX's Basis Facility and ELX's EFF rules, the Commission concluded that the subject inter-market combination trade rules did not violate the Act and regulations. The criteria for these trades are consistent with the criteria listed above for *bona fide* EFPs, EFSs and other such trades.

Staff is mindful that traders intent on engaging in violative behavior could seek to abuse any method of trading to accomplish their unlawful purposes. In this regard, Staff notes that it is every self-regulatory organization's responsibility to monitor its market to ensure that traders do not engage in transactions in violation of CEA Section 4(c) or any other CEA or regulatory provision.

⁸ May 2, 2002 letter from Jean A. Webb, Secretary of the Commission, to J. Robert Collins, Jr., then NYMEX president, with notification of the Commission's approval of NYMEX Rule 6.21D.

⁹ October 5, 2009 letter from David Stavick, Secretary of the Commission, to Neal Wolkoff, Executive Officer, ELX Futures L.P., with notification of the Commission's approval of ELX Rule IV-5(a)(iv) and (v).

¹⁰ While this letter focuses on EFFs and matched block trades, it should be noted that the term inter-market combination trade can refer as well to an EFP, EFS and similar transactions. See, e.g., the Commission's proposed rulemaking *Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9*, 73 F.R. 54097 at 54101 (Sept. 18, 2008) (proposing changes to Regulation 1.38 and Guidance on Core Principle 9) (hereafter referred to as "CFTC's 2008 Guidance").

¹¹ See *Regulation of Noncompetitive Transactions Executed On or Subject to the Rules of a Contract Market*, 63 FR 3708 at 3711 (January 26, 1998) (hereafter referred to as "CFTC's 1998 Noncompetitive Concept Release"); CFTC's 2008 Guidance, 73 F.R. 54097 at 54101.

¹² CFTC's 2008 Guidance, 73 F.R. 54097 at 54101.

B. Matched Block Trades are not *Per Se* Unlawful

CBOT asserts that a matched pair of block trades is unlawful because both trades are contingent and transitory trades. Staff disagrees. As explained more fully below, while Staff has viewed contingent EFP trades as raising regulatory concerns, Staff also has found that transitory trades do not raise the same regulatory issues.

In guidance, the Commission has used the terms “transitory” or “contingent” in connection with its evaluation of whether an exchange of futures for a related position (“EFRP”) is a *bona fide* trade.¹³ EFRPs are two-legged transactions allowed by a DCM to be executed off its centralized marketplace. In effecting EFRPs, one party (1) buys a cash commodity or instrument, an over-the-counter (“OTC”) swap based on the underlying commodity or instrument, or some other form of derivative based on the underlying commodity or instrument; and (2) simultaneously establishes a short futures position (which may close out a long position) based upon that same commodity or instrument; while the opposite party (1) sells the cash commodity or instrument, an OTC swap or other derivative instrument; and (2) simultaneously establishes a long futures position. The most common types of EFRP trades are EFP and EFS trades.¹⁴

In guidance¹⁵ regarding EFRPs, the Commission has recognized that certain EFRP trades raise regulatory concerns. When an EFRP trade (in addition to the usual two-legged trade that pairs a futures trade with another cash or derivatives leg) is arranged with—and made contingent upon—the execution of a third leg/trade that effectively nullifies the non-futures (cash, OTC or other derivative) leg, both parties establish or change their futures positions without any change to their cash, OTC or other derivative position prior to the EFRP trade.¹⁶ In the combined three-legged trade (contingent EFRP), this third leg lacks actual economic risk and cannot stand on its own as a commercially appropriate transaction. In other words, the third leg of a contingent EFRP trade has no commercial purpose other than to give the parties the ability to carry out an off-the-centralized market, non-competitive futures transaction with no real change in the

¹³ CFTC’s 1998 Noncompetitive Concept Release, 63 F.R. 3708 at 3713; CFTC’s 2008 Guidance, 73 F.R. 54097 at 54101. As previously noted, an exchange of futures for a commodity or for a derivatives position often is referred to as an exchange-for physical (“EFP”), but the term also includes exchanges for swaps (“EFS”) and similar transactions. CFTC’s 2008 Guidance, 73 F.R. 54097 at 54101. Although EFRP is a similar term, and includes trades that are included in exchange of futures for a commodity or for a derivatives position, Staff notes that the term EFRP was coined by CBOT and is not part of the CFTC lexicon. The Noncompetitive Concept Release similarly noted that the use of EFPs has evolved to include practices not contemplated at the time CEA section 4c(a) originally was enacted, many of which arise out of trading practices in various cash markets which accomplish a variety of commercial purposes. CFTC’s 1998 Noncompetitive Concept Release, 63 F.R. 3708 at 3710.

¹⁴ An EFP consists of two discrete but integrally-related transactions that are privately negotiated between two participants pursuant to the rules of a DCM whereby one party buys a physical commodity and simultaneously sells a futures contract (or closes out a long position) while the other party sells the physical commodity and simultaneously buys a futures contract. An EFS resembles an EFP but the futures contract is exchanged for a cash-settled swap position in the same or a related commodity.

¹⁵ CFTC’s 1998 Noncompetitive Concept Release, 63 F.R. 3708; and CFTC’s 2008 Guidance, 73 F.R. 54097.

¹⁶ CFTC’s 1998 Noncompetitive Concept Release, 63 F.R. 3708 at 3713.

parties' original cash, OTC or other derivatives position.¹⁷ Therefore, the Commission stated that contingent EFRPs are not permissible under the CEA.¹⁸

In order to address the regulatory concerns raised by contingent EFRP trades, the Commission distinguished between EFRP trades where the EFRP trade was made contingent upon the execution of the additional third leg (that, as described above, nullifies the second EFRP leg) and those EFRP trades that resulted, through happenstance, in the close-out of the separate non-futures position (a transitory EFRP). In the latter case, although one leg of the EFRP was transitory, both legs of the transaction were *bona fide*: the parties incurred actual economic risk, and the transaction itself was otherwise legitimate. In its proposed rulemaking,¹⁹ the Commission expressed the opinion that transitory EFRPs are permissible under the CEA.


Commission staff has not identified any overriding regulatory concerns unique to matched block trades that are executed to enable inter-exchange transfers of futures positions, nor has CBOT identified any such concerns. An individual matched pair of block transactions, like any trade, may be used by traders for an unlawful purpose; however, Staff does not believe that matched pairs of block trades executed for the purpose of moving futures positions from one exchange to another raise any unique regulatory concerns.

In view of the foregoing, Staff finds unpersuasive CBOT's arguments that inter-market combination trades (including matched block trades) are unlawful.

Sincerely,



Richard A. Shilts
Acting Director
Division of Market Oversight



Ananda Radhakrishnan
Director
Division of Clearing
and Intermediary Oversight

¹⁷ *Id.*

¹⁸ *Id.* See also Regulation 1.38(a).

¹⁹ CFTC's 2008 Guidance, 73 F.R. 54097 at 54101.