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August 10, 2001

Mark D. Fichtel President and CEO

Commodity Futures Trading Commission
Office of the Secretariat
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

COMMENT

Re: **Restriction of Dual Trading
in Security Futures
Products by Floor Brokers**

Gentlemen:

The Board of Trade of the City of New York, Inc. ("NYBOT") hereby submits comments on the Commodity Futures Trading Commission's ("CFTC") proposed Regulation 41.27 restricting dual trading in security futures products, as published on July 11, 2001 (the "Proposed Rule").*

The Proposed Rule is intended to implement the dual trading restrictions contained in Section 4j of the Commodity Exchange Act, as amended by the Commodity Futures Modernization Act of 2000 (the "Act"). As discussed hereafter, NYBOT believes that the Proposed Rule is significantly more restrictive than section 4j of the Act and should not become effective unless altered to address the concerns expressed herein.

Section 4j requires the CFTC to issue regulations to prohibit the privilege of dual trading in security futures products and to provide exceptions to such prohibition. The Proposed Rule would define dual trading in a manner that is more restrictive than the statute, and to that extent is simply unjustified. Section 4j(b) of the Act defines the term "dual trading" as the execution of a customer order by a floor broker during the same session as the broker executes a trade for any of three account types - - his own account, an account over which he has trading discretion, or an account controlled by a broker with whom he is associated. These three categories are identical to the categories in Section 4j's dual trading prohibition as in effect prior to the Commodity Futures Modernization Act of 2000 (the "CFMA"). In other words, Congress saw no reason to make the dual

*66 F.R. 36218-36223

trading restriction any more restrictive in this respect when applied to security futures. In contrast to the legislative expression, the Proposed Rule adds two more account categories - - the house account of the broker's clearing member and the account of any member present on the floor of the exchange or an account controlled by such a member - - without any explanation or precedent. The CFTC does not point to any negative experience suggesting that the addition of these account categories is necessary to ensure orderly trading in security futures products. Indeed, even CFTC Regulation 155.5, which prohibited dual trading in contract markets with certain volume thresholds prior to adoption of the CFMA, did not bar a broker from executing these types of orders in the same session that customer orders were executed. We believe the statute appropriately recognizes that where a broker has a business relationship with another member that renders them "associated" for purposes of the Act, it may be inappropriate to allow orders for both customers and the associated broker to be executed in the same session. However, there is no basis to conclude that orders for members with whom the executing broker has no association should be treated in the same way. By adding such members to the list of "non-customers" contained in paragraph (a)(4) the Proposed Rule would remove a whole sub-class of customers from the customer sector. To do so is without precedent in other markets.

In keeping with this overly comprehensive approach, the CFTC also seeks comment on whether the "non-customer" category should be even further expanded to include orders for any clearing member and any member who is not present on the trading floor. If adopted with this further modification, the Proposed Rule would preclude a broker from executing a customer order and an order for any exchange member, member firm or clearing member in the same session. The CFTC suggests in the Federal Register that this may be justified because the level of experience possessed by a member or clearing member is greater than that of other traders, and therefore the protections intended by the dual trading prohibition need not be extended to them. NYBOT agrees that sophisticated, experienced traders can readily gauge the quality of execution they receive and should be free, if they choose, to have their orders executed by a broker who also trades for his own account. However, they should not be barred from having their orders filled by a broker who only does customer business. By characterizing exchange members as "non-customers" the CFTC requires that their orders be filled by a broker who may trade for himself and for other associated accounts. We fail to see how such a requirement furthers the objective of Section 4j of the Act.

The inclusion of any additional category to proposed Rule 41.27(a)(4) could also dramatically alter the economics of the exchange trading environment. Presumably, a broker that has a customer and "non-customer" base will have to choose between the two. If the "customer" definition excludes all orders for the proprietary account of any exchange member or clearing member, a substantial portion of the broker's customer base could be affected, and it may become more lucrative and desirable to execute "non-customer" business - - that is, to trade for one's own account and for all other categories

of "non-customer" accounts. This, in turn, could leave fewer paper handlers for customer orders, resulting in little competition for that business and possibly poor quality of execution. In light of the fact that the CFTC has no experience with trading in security futures products as yet, it seems premature to implement a rule that is more restrictive than the Act and define "customer" in a way that could alter the dynamics of the trading environment.

On a wholly different point, the Proposed Rule's application of the dual trading restriction only to transactions that are executed by open outcry seems to turn a blind eye to the possibility of dual trading abuses occurring in an electronically-traded market. The CFTC acknowledges in the Federal Register that it has selectively applied the dual trading restriction only to open outcry markets, and seeks to justify that approach by distinguishing the level of control that an order handler has in an open outcry versus electronic market. Specifically, the explanation argues that a floor broker who executes trades by open outcry "not only controls when the bid or offer is exposed to the market, but also controls the price of execution and whom the order is executed against." This is contrasted with a broker holding a customer order for entry into an electronic system, who "only can control when an order is entered into the system." Such distinctions are a red herring because they are irrelevant to the kinds of abuse that dual trading restrictions are intended to address. The ability of a broker to control when an order is entered into an electronic system means that the broker also controls the price - - just as a broker controls price in an open outcry market. In both environments, the time that the order is subjected to the market will affect the price at which it is filled. Thus, the only level of control that is arguably exercised in the open outcry setting, but not in the electronic marketplace, is the choice of whom the order will be executed against. When considering the types of customer abuse that dual trading restrictions are intended to protect against, the ability to select who will be executing the order on the opposite side of the market is irrelevant. Dual trading restrictions are designed to protect against a broker running ahead of his customer's order. A broker holding off entry of an order from an electronic system can trade ahead of that order just as easily as a broker in an open outcry market can hold back on bidding in fulfillment of a customer order. In both environments there will be an audit trail of when the order was received by the broker and when the order was filled. Accordingly, to the extent customers are to be protected against possible dual trading abuse, the opportunity for such abuse exists equally in open outcry and electronic markets where intermediaries handle order entry. The CFTC should not recognize the concern in one market and ignore it in the other. Indeed, if anything, the CFTC should acknowledge that open outcry contract markets have successfully permitted dual trading to exist for years in many futures products in reliance on the credible surveillance, audit trail and disciplinary procedures on which the CFTC granted them exemptions from the dual trading ban pursuant to Regulation 155.5. This track record would strongly suggest that no greater risk of dual trading abuse exists in an open outcry market that would warrant a ban with respect to security futures

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only in such markets. Therefore, we believe that the definition of "floor broker" must be read in the light of the evolution of the markets to electronic trading, and the dual trading restrictions applied to all orders that are intermediated, regardless of the ultimate mode of execution.

NYBOT is pleased to have been able to comment on the Proposed Rule and is available should the CFTC staff have any questions regarding this letter.

Very truly yours,

A handwritten signature in black ink, appearing to read "Mark D. Fichtel". The signature is written in a cursive style with a horizontal line extending from the end.

Mark D. Fichtel