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August 25, 2004

VIA ELECTRONIC DELIVERY

Ms. Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

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Re: **Proposed Rules for Trading Off the Centralized Market;
69 Fed. Reg. 39880 (July 1, 2004)**

Dear Ms. Webb:

Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to comment upon the Commodity Futures Trading Commission's (the "Commission") proposed rules for off-market transactions. CME recognizes that the Commission does not seek to overhaul or significantly alter the regulatory landscape applicable to off-exchange transactions. The Commission has maintained the requirement that an exchange must "ensure that [permitted off-exchange] trading does not operate in a manner that compromises the integrity of prices or price discovery on the centralized market." Appendix B(a)(2)(ii)(3) to Part 38.

We agree with the Commission's policy favoring open and competitive markets, and believe that off-market trading should not be permitted to impair these important precepts. Open and competitive markets are the key to price discovery, which Congress has recognized as a significant public benefit performed by the futures markets.

CME supports the Commission's efforts to update and refine the rules governing off-exchange transactions, but is concerned about the prescriptive detail that the Commission proposes. Specifically, the Commission proposes "to provide guidance to DCMs with respect to their rules for block transactions[,] the "guidance [of which] provides block trade standards that would be acceptable to the Commission." *Fed. Reg.* at 39881. To that end, the Commission states that the purpose of amending the guidance is "to provide more detail regarding acceptable block trading rules." *Id.*

CME does not believe that additional guidance is warranted. The imposition of additional guidance – layered upon the present guidance – is likely to transform an otherwise flexible Core Principle 9 into a prescriptive, pre-Commodity Futures Modernization Act ("CFMA") mandate. For example, with respect to mandating the acceptable minimum size of block transactions, the Commission proposes that the size "would be no smaller than the customary size of large transactions in relevant markets." The Commission proceeds to define a "large transaction" as one that "may affect the quality of the transaction price. . . ." Thereafter, the Commission states that an "acceptable minimum size . . . would be a transaction size that is greater than 90 percent of the trades in a relevant market."

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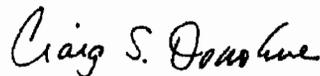
The 90 percent threshold, however, is not only arbitrary, but not responsive to nascent markets where sufficient trends have not developed. While the Commission does propose, with respect to markets in which transaction data is unavailable, an initial minimum threshold of 100 contracts, such a threshold remains arbitrary and unresponsive to market needs. Finally, we note that the Commission even proposes to specify the acceptable minimum size of spread and combination legs. This level of prescription is not consistent with the purposes of the Core Principles, and would contravene Congress' intent "to transform the role of the [Commission] to *oversight* of the futures markets." Pub. L. 106-554, 114 Stat. 2763 (2000) (emphasis added).

In the same vein, with respect to exchanges of futures for physicals (EFPs) transactions, the Commission proposes to codify aspects of a 1987 report by the Commission's then Division of Trading and Markets. The codified guidance would specify the acceptable elements of exchange of futures for commodities or derivatives trades. The guidance, however, is outdated and overly prescriptive. For example, CME presently permits tri-party EFPs, in which the cash leg of the EFP is intermediated by a third-party. Such an arrangement has developed over time in response to the needs of the marketplace. However, the 1987 report—and, in turn, the proposed revision to Core Principle 9—would strictly require that "both legs [be] transacted by the same two parties." (*Fed. Reg.* at 39883.) As with the Commission's proposed minimum size requirement (and the other prescriptions proposed by the Commission), the proposed guidance is not consistent with the principle of oversight embodied in the Core Principles.

In addition, we note that the Commission proposes to permit designated contract markets to self certify rules relating to off-exchange transactions. CME believes that an exchange that conducts the principal auction market for a specific derivative contract has the proper incentive to gauge the impact of rules permitting off-market transactions in the underlying contract and should be permitted to self-certify such rules. A liquid market with efficient price discovery has a reliable interest in ensuring that such trading does not increase the potential for manipulative activity or decrease the value of the price discovery function being performed by that market. In contrast, there is a possibility that new markets, which in some cases may be founded or operated for the benefit of intermediaries, may create off-exchange trading rules designed to siphon transactions that would otherwise contribute to effective price discovery away from the established market. Such markets could not be expected to fashion off-exchange trading rules to protect the important price discovery function, since their purpose may include nothing more than permitting intermediaries to internalize order flow to the detriment of their customers and of the public generally. Contract markets should not be permitted to self certify rules for off-exchange trading unless they maintain a liquid auction market in the underlying contract.

Finally, from a statutory construction standpoint, we note that proposed Regulation 1.38 and the proposed Guidance to Core Principle 9 are substantively identical. The Commission should cure this redundancy by deleting Regulation 1.38.

Sincerely,



Craig S. Donohue