



U.S. COMMODITY FUTURES TRADING COMMISSION

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DIVISION OF  
TRADING & MARKETS

May 6, 1998

Michael R. Koblenz, Esq.  
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New York, New York 10004-1486

COMMENT

COMMODITY FUTURES  
TRADING COMMISSION  
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Re: Application of Cantor Financial Futures Exchange for designation as a Contract Market in US Treasury Bond, Ten-Year Note, Five-Year Note, and Two-Year Note Futures Contracts

Dear Mr. Koblenz:

Commission staff has reviewed the application of the Cantor Financial Futures Exchange ("CFFE") for designation as a contract market. CFFE's application was initially submitted to the Commission by letter dated January 6, 1998, and received January 8, 1998. Commission staff published a notice in the *Federal Register* on February 3, 1998, requesting that the public comment on CFFE's application by April 6, 1998. Commission staff published a subsequent notice on April 10, 1998, extending the public comment period until April 27, 1998.

Commission staff has received and reviewed substantial comment on CFFE's application. While some comments were generally supportive of the proposal, others raised significant substantive issues regarding, among other things, compliance, surveillance, and the open and competitive execution of trades at the CFFE. Parties also have stated that insufficient information has been made publicly available upon which to base comprehensive comments. These comments reflect many of the issues staff has identified during its review, and are consistent with staff's opinion that CFFE has not provided all information and analysis necessary to demonstrate that it would be able to comply with the Commodity Exchange Act ("Act") and the Commission's regulations and standards for a designated contract market.

Please find in the attachment hereto, issues and matters that CFFE must thoroughly address before staff can complete its determination regarding CFFE's compliance with applicable law. Commission staff recognizes that these questions are extensive. On the other hand, they do reflect the information that staff believes

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is still outstanding and the high public importance of the issues raised by your application. Commission staff feels confident that you will be able to provide it with the information it needs on a prompt basis. In this vein, staff is prepared to work with you to see that the record in this matter is complete.

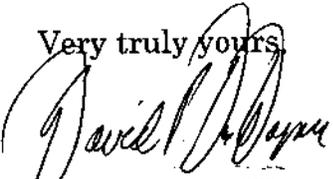
In accordance with the above, Commission staff has determined that CFFE's application is materially incomplete and that a stay on the running of the one-year review period provided in Section 6 of the Act must be imposed with respect to the proposed contracts.

Therefore, please be advised that, pursuant to the delegated authority of Commission Regulation 140.77, the subject proposed application is stayed as of the date of this letter. Commission staff intends to lift this stay when the issues in the attachment to this letter are adequately addressed by CFFE and all submissions necessary to constitute a complete record in support of the CFFE proposal have been received.

Commission staff wants to assure you that this matter has the highest attention of the staff and, when the outstanding information is provided, it is prepared to work with the utmost speed to bring this matter to a very prompt resolution.

As of this date, the Commission will have approximately eight months of the statutory period remaining upon the lifting of the stay imposed by this letter. Please call me at (202) 418-5481 if you have any questions concerning the matters set forth in the attachment to this letter, or other questions concerning the Commission's review of CFFE's application for contract market designation.

Very truly yours,



David P. Van Wagner  
Special Counsel

Attachment to Letter to Michael R. Koblenz from David P. Van Wagner

**I. Governance**

**A. Committees**

1. Proposed Cantor Financial Futures Exchange ("CFFE") Rule 501 would implement the requirements of Commission Regulation 1.63 regarding committee service by persons with disciplinary histories.
  - a. Proposed CFFE Rule 501(a)(3)'s definition of "Exchange Governing Body" and "Exchange Disciplinary Committee" both include certain New York Cotton Exchange ("NYCE") committees. Please explain how a CFFE rule could govern the operation of NYCE and its committees?
  - b. Regulation 1.63 requires that self-regulatory organizations ("SRO") adopt implementing rules with respect to service on arbitration panels and oversight committees. CFFE Rule 501 does not make any provision for CFFE arbitration panels or oversight committees. Please confirm that no CFFE committee would qualify as either an arbitration panel or an oversight committee under Regulation 1.63.
  - c. Other than the types of financial, record-keeping, reporting and decorum rule violations set forth in proposed CFFE Rule 501(d) and (e), please explain why the only CFFE rule violation that would trigger CFFE Rule 501's prohibition would be a violation of CFFE Rule 311. In addition, please explain how persons under CFFE jurisdiction could become subject to the NYCE rules listed in CFFE Rule 501(f)(1).
  - d. Would the CFFE consider a violation of Rule 306 (provision of customer information and risk disclosure statement) some type of record-keeping or reporting rule violation? Please explain.
2. Proposed CFFE Rule 35 would implement the requirements of Commission Regulation 1.64 regarding the composition of SRO governing boards and committees.
  - a. CFFE Rule 35 would establish Regulation 1.64 -- implementing requirements for major disciplinary committees and oversight committees at the NYCE. Please explain how a CFFE rule could govern the operation of the NYCE and its committees. The Division of Trading and Markets ("Division") suggests that a more appropriate approach might be to revise NYCE's rules in this regard. So for example, NYCE's rules could provide that when one of its disciplinary committees considered a matter in which an individual with CFFE trading privileges was charged with a rule violation which caused financial harm to a customer (See Commission Regulation 1.64(c)(1)(ii)(B)), the presiding NYCE disciplinary committee would include at least one person who did not have CFFE trading privileges.

- b. CFFE Rule 35(a)(5) would establish qualification for CFFE public board members. Under that provision, it would appear that persons associated with Cantor Fitzgerald Securities ("Cantor") or Cantor affiliates would be permitted to serve as CFFE public board members. The Division believes that this provision should be revised so that such persons, whether they be officers, principals, employees or service providers for Cantor or its affiliates, would not be eligible to serve as public members of CFFE's board.
  - c. CFFE Rule 35(a)(8)'s definition of "Major Disciplinary Committee" creates an exclusion for disciplinary bodies which take summary actions. Please revise this provision to conform with Regulation 1.64(a)(2)'s definition of major disciplinary committee which does not create an exclusion for committees that take summary actions, but instead creates an exclusion for those occasions when disciplinary committees deal with certain types of minor rule violations.
  - d. The Division believes that CFFE proposed Rule 35(a)(6)'s definition of CFFE non-member should be revised to mean "any person who is neither a holder of CFFE trading privileges nor a member of the Cotton Exchange."
3. CFFE proposed Rule 35(d) provides that, in certain circumstances, CFFE major disciplinary committees must include at least one "CFFE Non-Member." In connection with this provision, would the CFFE ever appoint an employee of NYCE, CFFE, Cantor, or any Cantor affiliate to a CFFE major disciplinary committee and designate him or her as a "CFFE Non-Member"? Please explain.

**B. Scope and Origin of Rules**

- 4. Please provide the Commission with a comprehensive listing of all proposed CFFE rules that were derived from current NYCE rules. This listing should identify the number of each such CFFE rule and the number of the corresponding NYCE rule from which it was derived.
- 5. Proposed CFFE Rule 500 provides that "Controversies regarding Disciplinary Rules and the violations thereof" shall be governed by NYCE's Consolidated Rules. This provision should be revised as CFFE's proposed rules do not include any rule or set of rules that are identified as "Disciplinary Rules."
- 6. Proposed CFFE Rule 712(a) prohibits employee disclosure of information that "could assist another person in trading any Contract." The term "Contract" is defined in proposed CFFE Rule 15 to mean contracts listed on the CFFE. This provision is inconsistent with the requirement of Commission Regulation 1.59(b)(1)(ii) prohibiting the disclosure of material, non-public information by an SRO employee when the information disclosed "may assist another person in trading any commodity interest." Regulation 1.59(a)(6) defines commodity interest to mean "any commodity futures or commodity option contract traded on or subject to the rules of a contract market or linked exchange, or cash commodities traded on or subject to the rules of a board of trade which has been

- designated as a contract market." Please revise CFFE Rule 712 so that it complies with Regulation 1.59(b)(1)(ii).
7. Proposed CFFE Bylaw Section 32 has an incorrect cross-reference to CFFE Rule 303-A. Presumably, the correct cross-reference should be CFFE Rule 303-B.
  8. Please submit the fee amounts that should be inserted into proposed CFFE Bylaw Section 32(a) and (b).
  9. Proposed CFFE Bylaw Section 32(a) sets a limit on transaction and execution fees for trades executed by clearing members, while Bylaw Section 32(b) sets a fee limit for "all other trades." Please confirm that the term "all other trades" would include all trades executed by anyone other than a clearing member, including non-clearing member, screen-based traders when they executed customer trades.
  10. In addition to prohibiting certain specific acts, the disciplinary rules of most futures exchanges, including the NYCE, have more general prohibitions of certain types of behavior (i.e., conduct detrimental to the best interests of the exchange, conduct inconsistent with just and equitable principles of trade). Presumably, such disciplinary rules provide futures exchanges with the flexibility to sanction improper behavior that otherwise does not violate any particular exchange disciplinary rule. The CFFE's proposed rules do not include such a general disciplinary provision. Please explain why the CFFE does not believe that such a provision is necessary.
  11. CFFE states that under its trade-matching algorithm the party that hit a bid or lifted an offer would be considered the "aggressor" and, thus, would pay the transaction fee for any resultant trade. If a bidder initiated the first trade during an execution time period, all subsequent bidders would be considered aggressors and, thus, would pay the transaction fees for all trades executed during that execution time period. The opposite would occur if an offeror initiated the first trade during an execution time period. In cases such as these, would subsequent bidders or offerors be aware that they were considered aggressors and that they would be subject to transaction fees? Would the information be discernible from CFFE terminals – either terminal operator ("TO") trading terminals or view-only terminals?
  12. The Division believes that CFFE's transaction fee mechanism needs to be explained in the CFFE Customer Information and Risk Disclosure Statement. The CFFE should amend the statement appropriately.
  13. CFFE proposed Rule 302(b) specifies the types of trades that would be permitted and reported in CFFE's transaction record without being made through the CFFE trading system. Transactions effected to fill missed orders via permissible customer type indicator ("CTI")<sup>1</sup> CTI 4 cross trades, pursuant to CFFE Rule 309(a)(3), are not included in this provision. Please explain how these trades would be reported.
  14. Proposed CFFE Rule 300(c) provide that CFFE's Board may "close CFFE or any contract market thereof on such days or portions of days as will in the Board's . . . judgment serve

to promote the best interest of CFFE.” Would there be any circumstances besides CFFE Rule 17 “emergencies” in which the CFFE Board could decide to close CFFE markets? If so, please explain what those other circumstances could be.

C. Customer Protection

15. Please revise the CFFE Customer Information and Risk Disclosure Statement to disclose:
- a. the possibility that orders may be improperly entered by TOs and how such errors would be corrected by the CFFE;
  - b. that orders will be executed by an electronic trade matching system maintained by Cantor and that TOs will be jointly employed by CFFE and Cantor;
  - c. the extent to which “inferior bids or offers already residing in the trading system” would not be automatically cancelled or rejected by superior bids or offers entered during the exclusive time period;
  - d. which CFFE contracts would have clearing time and/or exclusive time periods and what those periods would be;
  - e. that TOs would not be Commission registrants;
  - f. that proposed CFFE Rule 600, currently cross-referenced in the Statement, would provide that controversies involving persons under CFFE’s jurisdiction—would be resolved pursuant to NYCE’s arbitration rules; and
  - g. the types of orders that the CFFE will accept from authorized traders.
16. Proposed CFFE Rule 600 would provide that controversies with respect to CFFE transactions involving persons under CFFE’s jurisdiction would be governed by NYCE’s arbitration rules. Would the CFFE have jurisdiction over CFFE TOs? Could parties bring an arbitration claim against a CFFE TO under CFFE Rule 600? Please explain why or why not.
17. Proposed CFFE Rule 724 would limit the CFFE’s liability for services performed by TOs. The provision would list the types of actions for which the CFFE could be held liable, including a TO’s negligent cancellation or failure to cancel orders resting in the trading system. The provision does not include in this listing a TO’s negligent failure to enter an order or a TO’s negligent entry of a mistaken order (e.g., incorrect price or quantity). Please explain why these two types of negligent TO actions are not included as bases for TO liability under Rule 724.
18. CFFE has indicated that CFFE TOs would be jointly employed by CFFE and Cantor. Does the CFFE believe that arbitration claims involving CFFE controversies could be

brought against TOs pursuant to the arbitration rules of the National Association of Securities Dealer? Please explain why or why not.

D. CFFE-Cantor Relationship

19. CFFE states that "no Cantor Fitzgerald entity will conduct any proprietary trading on the CFFE in government securities." See Question-and-answer item number 12 of the CFFE's January 6, 1998, submission (question-and-answer items will henceforth be referred to as Q&A #). Please confirm that this prohibition would include CFFE government securities futures contracts.
20. In Q&A #12, CFFE states that all employees of Cantor and of the Cantor entity that would manage the CFFE error account would be "physically separated" from the CFFE TOs. Please describe the precise level of physical separation.
  - a. Would these two sets of persons be on different sides of the same trading room, in different trading rooms, or on different floors of Cantor's facility? Please explain.
  - b. Would the Cantor affiliate employees managing the error account have any means of communicating with a CFFE TO that would be different from the means available to any other authorized trader contacting a CFFE TO?
21. Proposed CFFE Rule 308 provides procedures for the handling of order entry errors by CFFE TOs. Both subsections (a) and (b) of the rule premise the correction of erroneous order entries upon the "CFFE acknowledg[ing] responsibility for the [TO] entering erroneous information."
  - a. Please describe how erroneous order entry determinations would be made by the CFFE.
  - b. Would the CFFE rely exclusively on tape recordings of conversations between TOs and authorized traders to make such determinations?
  - c. What CFFE personnel would be authorized to acknowledge responsibility for erroneous order entries?
  - d. Would there be any time limit by which an order entry error would have to be discovered in order to be corrected pursuant to Rule 308? If so, Rule 308 should be amended to reflect any such time limit.
22. CFFE proposed Rule 308 also provides procedures for the correction of TO order entry errors by a Cantor affiliate specifically established for such purpose.
  - a. Rule 308(a) and (b) state that errors shall be corrected "promptly" upon discovery. Please explain what would constitute prompt correction of an error for these purposes. Would there be any time limit by which an error must be corrected?

- b. Rule 308(b) refers to correcting trades occurring "after the closing." Please explain how such a trade could occur after the close under CFFE's rules.
- c. Would error-correcting trades be given any priority, either by the CFFE TO entering such trades or by the trading system itself? If so, please fully explain the nature of and the need for such a priority. In addition, please explain why such a priority would be consistent with Commission Regulation 1.38 and its requirement that futures transactions be done in an open and competitive manner.
23. Please explain any measures that the CFFE and/or NYCE would adopt to ensure that error accounts are not abused by the designated Cantor affiliate by taking in favorable CFFE trades that were not, in fact, executed in error.
24. Please provide an estimate of the level and source of capitalization for the CFFE and for Cantor Financial Futures Exchange Holdings, LLC, CFFE's holding company
25. Beside transaction fees for CFFE trades, please describe the nature of any financial interest that Cantor or any of its affiliates would have in the CFFE.
26. It has been reported that former Cantor employees have indicated that traders for a Cantor affiliate have in the past gained an unfair trading advantage by obtaining access to certain material, non-public information from terminal screens used by Cantor TOs for the purposes of interdealer brokerage. (Thomas Jaffe, "Between the Wall and the Wallpaper," Forbes, October 20, 1997, p.82.)
- a. Please explain whether such activity occurred at Cantor.
- b. Please describe any measures that Cantor took to prevent any such abuses. Similarly, please describe the measures that would be taken to prevent similar abuses with respect to CFFE trading information by Cantor employees or the employees of Cantor affiliates.
- c. It also has been reported that Cantor hired an outside investigator to determine whether any of the above-mentioned abuses occurred at Cantor. If so, please provide the Division with any report or findings that resulted from such an investigation.
- d. Please provide the Division with the results of any other review that Cantor may have conducted with respect to the abuse of material, non-public information at its interdealer brokerage operations.
27. Please describe any trading activities that Cantor or any Cantor affiliates would be permitted to conduct, either for proprietary or customer accounts, on the CFFE.
28. Please describe any procedures that the CFFE would follow to prevent the improper flow of confidential or sensitive trade information between CFFE, on the one hand, and Cantor and its affiliates, on the other hand.

## II. Membership

### A. General Issues

29. Proposed CFFE Rule 12 defines a clearing member as a "corporation or partnership which is otherwise permitted by the [NYCE] and CFFE to act as a Clearing Member on CFFE." CFFE's rules would not establish any other qualification for clearing members. Please describe what qualifying standards CFFE would follow in granting CFFE clearing membership.

### B. Trading Privileges

30. CFFE proposed Rule 300 states that the CFFE "may, in its sole discretion" provide NYCE members with a dedicated telephone line to a CFFE TO. In Q&A 34, CFFE indicates that it may not be able to provide a dedicated phone line to every NYCE member who requested one.
- How would an NYCE member who did not have a dedicated phone line contact a CFFE TO to place an order?
  - Would an NYCE member without a dedicated phone line to a CFFE TO be at any disadvantage when trading CFFE contracts to NYCE members or holders of CFFE trading privileges who had dedicated phone lines? Please explain why or why not?
  - Please explain why this distinction in the provision of dedicated phone lines to CFFE TOs would be consistent with Commission Regulation 1.38 and its requirement that futures transaction be done in an open and competitive manner.
  - Has CFFE done any preliminary evaluation of how many NYCE members and holders of CFFE trading privileges would request dedicated phone lines to CFFE TOs? If so, does the CFFE anticipate that each such requester, would be able to obtain dedicated phone lines upon the initiation of trading?
31. Proposed CFFE Rule 300, which sets forth requirements regarding the time and place for CFFE trading, indicates that trading may only be conducted through CFFE terminals located at the booths of requesting NYCE members. However, in Q&A #36, CFFE states that "a CFFE Terminal or access to direct phone lines to a [TO] may be located virtually anywhere." Please revise CFFE Rule 300 so that it specifies who may receive CFFE terminals and where they may be located. The rule also should specify any limitations on a terminal's location as it relates to the particular terminal user. For instance, if FCMs must locate their CFFE terminals in a home office or branch office, Rule 300 should set forth this requirement.
32. CFFE proposed Bylaw Section 36 would permit certain persons or entities to submit an application for CFFE trading privileges (i.e., NYCE members, futures commission merchants ("FCM"), introducing brokers ("IB"), commodity trading advisors ("CTA"), floor

brokers, floor traders and clearing members). CFFE's rules do not establish any standards for the granting of trading privileges. Please explain what, if any standards, CFFE would follow in granting trading privileges.

33. Presumably persons or entities with CFFE trading privileges would be permitted to trade contracts through CFFE TOs. CFFE's rules, however, do not have any provisions that explain the rights and privileges attendant to holding trading privileges. Please revise CFFE's rules accordingly,
34. Holders of CFFE trading privileges presumably would be subject to CFFE's oversight and disciplinary jurisdiction. Please explain what CFFE rule or other mechanism (e.g., some notice in an application for CFFE trading privileges) would confer this jurisdiction on the CFFE?
35. Would the CFFE have any standards regarding who a clearing member or screen based trader could designate as an authorized trader under CFFE proposed Rule 4? If so, please provide a full description of these standards.
36. Could a clearing member or screen based trader designate a customer or a customer's employee or agent as an authorized traders? Please explain.
37. Proposed CFFE Rule 300 would provide that CFFE would supply a CFFE terminal to any full NYCE member requesting such a terminal. Presumably, obtaining a CFFE terminal also would entitle such a NYCE member to a CFFE data feed. Neither this provision nor any other CFFE rule provision addresses whether NYCE members would be charged for such a data feed. Please explain who would be entitled to a CFFE data feed, whether there would be any charge for such a data feed and whether there would be different levels of charges for such a data feed depending on whether the recipient was a NYCE member or a holder of CFFE trading privileges, or was unaffiliated with the CFFE.

### C. Trading Standards

38. Division staff has informed CFFE that it considers screen based traders to be floor brokers for the purposes of Commission Regulation 155.2. Regulation 155.2 requires contract markets to adopt rules implementing trading standards which prohibit trading ahead of customer orders, disclosure of customer orders, withholding customer orders from the market for the benefit of another person, directly or indirectly prearranging trades, improperly allocating trades among accounts, taking the other side of one's own customer's orders, and direct execution of discretionary trades for the account of another person. Please submit appropriate CFFE rule changes to comply with these requirements.
39. Commission Regulation 156.2(b) requires contract markets to adopt rules defining "broker associations," requires certain contract market members to register as broker association members, and prohibits certain conduct by these members. CFFE has represented that the absence of a physical trading floor would exempt it from these requirements. The Division does not share this view, but believes that the types of abuses made possible by the access that affiliated brokers have to one another's customer orders are not avoided by

the absence of a trading floor. In this connection, please submit CFFE rules implementing the required provisions of the Commission's Part 156 Regulations.

### III. Order Handling

#### A. General Issues

40. Proposed CFFE Rule 307 provides that CFFE orders "shall be agreed to be subject" to CFFE's Bylaws and Rules. The Division believes that this reference is not clear. Please confirm that this term is equivalent to requiring that CFFE orders "shall be subject" to CFFE's Bylaws and Rules.
  - a. Please describe the forms of orders authorized traders may accept from customers (notwithstanding the fact that authorized traders may only place limit and market orders with TOs), and which, if any, forms of orders they may accept on a "not held" basis.
41. The Division understands that each TO would be responsible for handling CFFE orders phoned in by authorized traders over a number of different phone lines, dedicated and non-dedicated. Please explain whether TOs would be able to handle orders phoned in simultaneously from multiple authorized traders. Please explain this capability from both a communications standpoint (i.e., how many different phone lines could a TO handle at one time) and an order entry standpoint (i.e., how many different resting orders could a TO have in the trading system at one particular time).
42. Would the CFFE's communication system have a rollover capability if any authorized trader was unable to reach his or her assigned TO, whether the authorized trader was using a dedicated or non-dedicated phone line? Please explain.
43. Upon receiving and entering a CFFE order from a particular authorized trader, would a TO stay on the phone line with the authorized trader until his or her order was no longer resting on the system?
44. CFFE states in Q&A #48 that "all telephone lines to [TOs] will be taped to provide a ready check against errors or miscommunications."
  - a. Would these tape recordings be retained? If so, by whom -- the CFFE, NYCE or Cantor -- and for how long?
  - b. If the tapes would be retained by the CFFE or Cantor, would they be made available to the NYCE upon request? If so, please describe any procedures the NYCE would have to follow to obtain any tapes.
45. Please describe how CFFE orders would be processed, starting with an authorized trader's receipt of a customer order; to the placing of the order with a TO; to the TO's handling of the order, including the TO's role in the execution process during the exclusive time period; through the transmission of a trade confirmation back to the authorized trader and

the originating customer. This description should cover orders executed during regular trading, as well as those executed during market crossing sessions.

**B. Terminal Operators**

46. In support of its contention that CFFE TOs need not be registered in any capacity with the Commission, the CFFE has stated that TOs would only act on instructions from authorized traders and would always act in a purely clerical capacity when accepting and placing orders into the Cantor trading system. See Q&A #10. CFFE staff also has separately informed the Division that TOs would not be required to enter all orders into the Cantor system. For instance, if a TO received an order that would not better a pending best bid or offer, the TO would so inform the originating authorized trader and not enter the order. The Division believes that this level of TO discretion would be inconsistent with acting in a purely clerical manner.
47. Please address the following questions with respect to the conduct and oversight of CFFE TOs:
- a. Would TOs be permitted to provide authorized traders with any information regarding market conditions? For instance, could TOs express an opinion or even a statement of fact about the direction of the market or the strength of a trend?
  - b. Would TOs be permitted to provide authorized traders with information regarding buying and selling interest that was away from the best posted bid and offer? Would TOs be permitted to provide authorized traders with information regarding the identity of buyers and sellers or persons that had expressed buying and selling interest?
  - c. Would TOs be able to initiate contact with authorized traders or anyone else to advise them of buying and selling interest?
  - d. Would TOs be permitted to initiate contact with authorized traders or other persons under any circumstances? For example, could TOs initiate a call to discuss the cash market and then move on to related futures transactions?
  - e. Would TOs be able to solicit orders or recommend strategies to authorized traders?
  - f. Would TOs be permitted to handle combination orders for both the Treasury futures and the underlying Treasury securities? If so, please explain any CFFE procedural requirements that would apply to the handling of such orders.
  - g. Would TOs be permitted to use any of the information that they received as a result of handling orders for CFFE futures contracts and/or cash Treasury securities other than to enter those orders into the Cantor trading system?
  - h. Please explain how, if at all, a TO's role in handling cash market orders would be different from a TO's role in handling CFFE orders?

- i. What measures would the CFFE take to ensure that TOs are aware of their proper roles and responsibilities handling CFFE orders?
48. CFFE has stated that all TOs would be registered as government securities representatives ("GSR"), due to their responsibilities in handling orders in the government securities cash market. Under National Association of Securities Dealers Rule 1112, GSRs are permitted to engage in sales and investment advice -- functions that are beyond the purely clerical responsibilities TOs would have in handling CFFE orders. Please explain what steps CFFE would take to ensure that TOs are aware that their responsibilities in handling CFFE orders would be much more circumscribed than their responsibilities in handling cash market orders.
  49. The CFFE states that there would be at least one on-site supervisor for every ten TOs. CFFE's TO supervisor would oversee the TOs and would be registered as a floor broker.
    - a. Who would the TO supervisor be employed by -- the CFFE, NYCE or Cantor?
    - b. Please describe the supervisor's duties and responsibilities.
    - c. Would the supervisor be responsible for overseeing the activities of any TOs in addition to TOs who were trading CFFE products? If so, how many other TOs would the supervisor oversee?
    - d. Would the supervisor ever be a TO himself or herself, whether for the CFFE or for Cantor's cash market operations?
    - e. To whom would the supervisor report problems with CFFE TOs?
    - f. Would the supervisor be authorized to remove a TO summarily? If so, please explain how and for what reasons a supervisor could summarily remove a TO.
  50. In Q&A #29, CFFE indicates that NYCE compliance personnel would be able to remove CFFE TOs for compliance-related reasons. Please explain what role, if any, NYCE would have in the selection of TOs for CFFE trading? What information would Cantor provide to NYCE about a TO's background and qualifications?
  51. NYCE's ability to remove TOs is not reflected in either CFFE's or NYCE's rules. Please describe what, if any, procedural protections would be provided to CFFE TOs that NYCE wished to remove from trading-related positions.
  52. Would TOs be permitted to accept two or more orders from an authorized trader during the same phone call? Please explain any restrictions that would apply to TOs in this regard.
  53. During the Division's visit to Cantor's trading floor, TO's were observed shouting the terms of orders while communicating with customers. Would CFFE TOs be permitted to

so announce the terms of CFFE orders, whether upon entry or execution? If yes, please explain what, if any, measures the CFFE would take to prevent Cantor employees or employees of Cantor affiliates from overhearing any such CFFE order information.

54. Please confirm that TOs would be required to enter CFFE orders immediately upon their receipt by the TO? Would there be any circumstances in which a TO could enter a CFFE order at some point other than immediately upon receipt? For instance, could a TO receive an order which was for less than the best bid price and hold the order for entry until some later point in time when it would qualify as a best bid?
55. If a CFFE authorized trader did not have a CFFE terminal, what, if any, market information could a TO provide to the presumably ignorant trader if he or she called the TO to place a CFFE order?
56. Would CFFE's TO supervisors have the ability to "listen in" to phone conversations between TOs and authorized traders, on either a third line or some other phone-monitoring device, in order to oversee the propriety of the behavior of TOs and authorized traders?
57. While TO supervisors would have the responsibility of monitoring the conduct of TOs, would they also be required to report the suspicious or improper behavior of non-TOs to the CFFE or NYCE? Please explain.
58. Does the NYCE intend to have its staff physically observe the trading activity of CFFE TOs? If so, how often would NYCE staff conduct such observations?
59. Please describe how CFFE TOs would be compensated and by whom. Would any component of a TO's compensation be based on an incentive fee arrangement? If so, please explain any such arrangement.
60. Please describe how CFFE TOs would be compensated for any non-CFFE activities that they would perform for Cantor or any Cantor affiliates, including any incentive fee arrangements.
61. Please describe how CFFE TO supervisors would be compensated and by whom, including any incentive arrangements.
62. Would there be any limitations on the ability of TOs or other CFFE staff to accept gifts from screen-based traders, authorized traders, or customers? Are there any such limitations with respect to TOs accepting gifts from customers in the Treasury securities cash market?

C. Exchange of Futures for Physicals

63. Commission Regulation 1.38(a) requires that noncompetitive transactions such as exchanges of futures for physicals ("EFP") be conducted only in accordance with contract market rules which have been approved by the Commission. CFFE Rule 305 inadequately

addresses issues concerning the elements of a bona fide EFP, and should be revised accordingly. Please refer to the discussion of the elements of a bona fide EFP in the Commission's concept release of January 26, 1998 "Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market" (63 FR 3708, 3711) for guidance.

64. Commission Regulation 1.35(a-2)(3) requires contract markets to adopt rules requiring members to provide, upon request of the contract market, documentation of cash commodity transactions underlying EFPs. CFFE has not submitted such rules. Please explain how the CFFE would implement the provisions of this regulation.
65. Commission Regulation 1.38(b) requires that persons involved in the execution of EFPs identify these transactions as such on all pertinent records. Please describe the recordkeeping and audit trail requirements which would apply to EFP transactions on CFFE, particularly with respect to the records of transactions kept in accordance with Regulations 1.35(a), (a-2)(3), and (e). Please also describe how CFFE or NYCE would enforce such recordkeeping requirements.
66. Please describe NYCE's surveillance programs for monitoring the bona fides of EFP transactions as they will pertain to CFFE futures contracts.
67. Please provide a complete description of how EFP transactions would be conducted on CFFE, and in doing so please respond to the following questions.
  - a. What role would TOs play in EFP transactions?
  - b. Would TOs accept reports of completed EFP transactions, or would they accept orders for EFPs?
  - c. What entities would TOs interact with?
  - d. Could TOs help solicit counterparty interest for an EFP request?
  - e. Could TOs serve as intermediaries between potential counterparties in their negotiation of the terms of the futures and cash legs of an EFP transaction? Please explain.
68. Please describe what role, if any, Cantor or its affiliates would have in the execution of EFP transactions at the CFFE.

#### IV. Trade Matching

##### A. General Issues

69. Proposed CFFE Rule 832 states that the "clearing time" and the "exclusive time" periods for the CFFE's futures contracts shall be specified "from time to time by the Committee on U.S. Treasury Securities." The CFFE's submission does not specify the length of the

clearing time or exclusive time periods for any of its pending contracts. Please submit the length of clearing time and exclusive time periods for each of the CFFE's proposed contracts. In this connection, please address the following related questions.

- a. Please explain how and why the length of each contract's clearing time and execution time was selected
  - b. Would these exclusive trading rights attach to the particular account for which the initial order was entered, or to the authorized trader who transmitted the original order such that the authorized trader could use this exclusivity to trade for other customers?
  - c. Proposed CFFE Rule 303(b)(1) provides that "only the best bid and offer . . . available at any given time are accepted and posted on the Cantor System." This provision conflicts with Rule 303(a)'s definition of clearing time and exclusive time which would provide some measure of priority to pending best bids and offers even if subsequent "better" bids and offers were entered into the trading system." Similarly, both of these sets of provisions conflict with explanations which CFFE staff has orally provided to Division staff that best bids and offers could be bettered during the clearing time, but not during the exclusive time. Please provide a clear and comprehensive description of the operation of the clearing time and exclusive time periods and ensure that they are accurately reflected in CFFE Rule 303.
  - d. Would it ever be possible for a bid or offer which betters an outstanding best bid or offer to be rejected by the CFFE's trading system? If so, please explain for each of these circumstances why such a priority would not be inconsistent with Commission Regulation 1.38(a)'s requirements that all futures contracts be executed in an open and competitive manner.
70. CFFE proposed Rule 301(g) defines "Close" to mean, among other things, "prior to any recess." Please explain the meaning of the term "recess" in this context.
71. Would a TO be able to cancel a resting order that he or she has entered into the trading system? Please explain whether this capability would differ during the clearing time, the execution time or the exclusive time. In addition, please explain whether this capability would differ depending upon whether the resting order was a first best bid or offer or a joining party bid or offer.
72. Proposed CFFE Rule 829 provides that the hours of trading in the CFFE's proposed contracts would be from 7:30 a.m. to 5:30 p.m. (New York time), and that each trading day would start at 3:00:01 p.m. and end with the close of trading at 3:00:00 p.m.
- a. Would the Cantor system "shut down" at 3:00 p.m. each day and then "start up" again at 3:00:01 p.m.? If so, please explain how the trading system would treat orders that were resting in the system at 3:00:00 p.m. when the system shut down. Would these orders remain in the system and be eligible for execution with the

same priority when the system started up again or would all orders have to be re-entered when the system began trading again at 3:00:01 p.m.? Please explain.

- b. Would resting orders be treated differently if a clearing time, execution time or exclusive time period were underway in a contract at the 3:00:00 p.m. close? Please explain.
- c. Similarly, what would be the status of orders that were resting in the trading system when it stops trading for the business day at 5:30 p.m.? Would the orders remain in the system and be eligible for execution when the system re-commences trading at 7:30 a.m. of the next business day? Please explain.
73. Please describe how resting orders would be affected by a trading system failure.
74. The CFFE Customer Information and Risk Disclosure Statement states that in the event of certain types of system failures "it may not be possible, for some period of time, to enter new orders or to cancel orders that were previously entered." During such a system failure, would it be possible for a TO to determine the status of a resting order and to relay that information to the submitting authorized trader? For example, would a TO be able to inform the originating authorized trader whether his or her order was or was not subject to matching, even though the order could not be cancelled or revised by the TO?
75. Upon the correction of a system failure, would orders that were resting at the time of the failure retain their time and price priorities or would they have to be re-entered into the trading system?
76. CFFE's trade-matching algorithm explanation refers to "hitting bids" and "lifting offers." The Division understands that TOs would input all orders into the trading system with a designated quantity and price. Please confirm that the acts of hitting bids and lifting offers could only be achieved upon a TO inputting an order quantity and price that would match with a pending best bid or offer price.
77. The Division understands that during an exclusive time period certain traders would obtain the exclusive right to trade with each other or other traders who wished to trade at the period's prevailing price. What information, if any, would be provided on view-only CFFE terminals during the course of an exclusive time period? For instance, would the view-only terminal reveal the volume of bids or offers that were eligible for matching? Would it reveal the number of traders who originated such eligible bids or offers? If this information would not be available on view-only screens, could an authorized trader obtain such information from a TO?
78. The Division understands that during the exclusive time period the CFFE trading system would match eligible orders at a set price and would not accept any further bids or offers, even if they bettered that prevailing set price. Please explain how this aspect of the CFFE's trade-matching algorithm would be consistent with Commission Regulation 1.38's requirement that futures contracts be traded in an open and competitive manner.

79. During the Division's March 31, 1998, visit to Cantor's offices, Cantor staff represented that it would provide the Division with a sampling of print-outs of CFFE terminal screen configurations as they might appear during different stages of trading activity. Please provide the Division with these sample print-outs.
80. Please provide a full and complete description of what CFFE price information would be disseminated to the public and to whom it would be made available.
81. Could a resting best bid or offer ever automatically expire due to lack of activity in a contract? For example, assume that Account A posts a best bid for 100 Treasury bond contracts at a price of 100.00 at 9:30:00 a.m. Assuming that the bid was not bettered or executed against, would that bid continue to rest indefinitely in the CFFE trading system or would it automatically expire at any point in time? Please explain.

**B. Market-Crossing Session**

82. CFFE proposed Rule 303-A would provide for a market-crossing session during which orders which do not meet the CFFE's minimum bid and offer size requirements could be matched. Please provide a full and complete description of the manner in which the market-crossing session would operate. The CFFE's description should, among other things, address the following questions with respect to the market-crossing session.
  - a. Describe the trade-matching algorithm that would be used to match orders at market-crossing sessions and provide an explanation of why the algorithm would be consistent with Regulation 1.38's requirement that futures contracts be executed in an open and competitive manner.
  - b. CFFE proposed Rule 303-A(b) states that the market-crossing session price would be determined in accordance with the principles set forth in CFFE Rule 314. (CFFE Rule 314 sets forth requirements for the establishment of settlement and closing prices.) CFFE staff, however, orally provided Division staff with a different description of how this price would be set. Please ensure that CFFE's rules accurately reflect the manner in which the market-crossing session price would be determined.
  - c. Please describe what measures, if any, the CFFE would use to prevent manipulation of the median price, as that term is used in CFFE Rule 314.
  - d. If, in fact, the CFFE intends to set market-crossing session prices in accordance with CFFE Rule 314's principles, the Division believes that the CFFE should adopt a separate provision in this regard that does not include references to settlement and closing price computations.
  - e. The minimum bid and offer size requirements for each CFFE contract should be reflected in the CFFE's rules.

- f. Would orders which were larger than the CFFE's minimum bid and offer size requirement be eligible for execution at market-crossing sessions?
  - g. When and how often would market-crossing sessions occur? Would CFFE terminals, whether TO terminals or view-only terminals, display any "countdown" to the time for a market-crossing session?
  - h. Please describe what information, if any, CFFE view-only terminals would display with respect to market-crossing session orders prior to their execution. For instance, would view-only terminals reflect the number and size of orders that had been submitted for matching?
  - i. Would CFFE TO terminals display any information with respect to market-crossing session orders prior to their execution? If so, please explain what information would be displayed.
  - j. Would TOs be permitted to provide any such information to authorized traders who spoke with them prior to a market-crossing session? If so, what sort of information could be provided?
  - k. Please describe what information CFFE terminals, both TO terminals and view-only terminals, would display with respect to market-crossing session trading activity upon the conclusion of a session.
  - l. The Division understands that upon the execution of a CFFE order TOs would provide phone confirmation of the order's execution to the originating authorized trader. Would TOs provide any such trade confirmation to authorized traders who originated orders that were executed at market-crossing sessions? Please explain.
  - m. Would orders that were partially filled at a market-crossing session remain eligible for matching at the next market-crossing session or would they have to be re-entered into the system? If such orders would remain eligible for matching at the next session, would they retain their original time priority?
83. Does Cantor's trading system currently use any sort of market-crossing session in its cash market operations?
84. The CFFE Customer Information and Risk Disclosure Statement contains a "Risk Factor: Minimum Trading Requirements" item that states that due to the minimum trading size requirements "bidders or offerors may be forced to execute certain trades on a delayed basis and at prices that may be inferior to the prices that otherwise could be obtained on the CFFE." (emphasis added) If this is an allusion to the market-crossing session, the Division believes that this provision should be amended to disclose that orders for less than the minimum bid or offer size would be matched at the market-crossing session. In addition, the provision should describe the market-crossing session's trade-matching algorithm and when market-crossing sessions would occur.

85. The Division understands that upon the conclusion of an execution time period, all remaining unfilled orders would no longer be eligible for matching and would be removed from the trading system. Accordingly, any orders that were eligible for matching during the execution time period but that were either unfilled or partially filled would have to be re-entered into the trading system to be eligible for matching again. What if the remaining portion of a partially-filled order was less than the CFFE's minimum bid and offer size requirement--would such an order be eligible for matching during regular trading or would it only be eligible for matching during the market-crossing session? Please explain how such orders would be treated.
86. Please confirm that TOs would enter market-crossing session orders into the CFFE trading system immediately upon the TO's receipt of such orders.

C. "Look-Back" Feature

87. Please provide a full and complete description of the CFFE trading system's "look-back" feature that permits parties to CFFE transactions to adjust and/or nullify a trade within some period of time after matching in order to correct mistakes. The CFFE's description should, among other things, address the following items.
- a. Please explain what types of CFFE transactions could be adjusted or corrected pursuant to the look-back feature.
  - b. What role would TOs or any other CFFE personnel have in administering the look-back feature?
  - c. CFFE has indicated that upon a trade's execution, the TOs who input the underlying orders would provide confirmation of the trade to the originating authorized traders. Describe how this trade confirmation process would be coordinated with the look-back feature.
  - d. How would the look-back feature be integrated into the CFFE's price change register and audit trail information?
  - e. Would there be any time limits on the use of the look-back feature (i.e., for how long after a trade could the look-back feature be utilized)? Please explain.
  - f. What measures would the CFFE or NYCE take to prevent abuse of the look-back feature?

D. Technical Issues

88. Please provide the Division with any reports that evaluate the Cantor trading system that would be used for CFFE trading, including any beta testing or mock trading sessions. If any of these reports noted deficiencies in the trading system, please explain what, if any, measures Cantor has taken to address these deficiencies.

89. Please provide a complete description of the measures CFFE, NYCE and Cantor have taken to ensure that their technical systems and the technical systems of each entity on which they rely for any part of their operations are Year 2000 compliant. Insofar as the NYCE and CCC have previously provided this information to the Commission in response to its March 18, 1998, letter, they need not provide the information again.

## V. Compliance

### A. General Issues

90. Would CFFE's trading system record the time of order entry, or just the time of order execution?
91. If an order was entered into CFFE's trading system by a TO and rejected by the system due to price or timing considerations, would the system retain a record of the attempted entry?
92. Are all telephone lines to a TO's workstation tape-recorded (i.e., CFFE lines, cash market lines and personal lines)? If so, are all such tape recordings time-indexed?
93. Who would conduct financial surveillance of CFFE clearing members for compliance with CFFE Rule 403 (Margins)? Please describe the procedures that would be used in this regard?
94. CFFE has stated that the NYCE believes that it would be more efficient for a single CFFE committee which was familiar with the Cantor trading system, such as provided in CFFE Bylaw Section 26, to dispose of certain recordkeeping violations summarily (Q&A #10).
- a. Please describe the types of controversies this committee would be empowered to hear, and whether they would include audit trail violations.
  - b. Please explain whether and how the NYCE compliance department would be authorized to bring cases before this CFFE committee.
  - c. Please explain further why familiarity with the Cantor trading system is vital to determining compliance with CFFE recordkeeping provisions; as opposed to the greater familiarity with the provisions of Commission Regulation 1.35 most likely possessed by NYCE disciplinary committees.

### B. NYCE Role

95. Commission Regulation 1.51 requires each contract market to use due diligence in maintaining a continuing affirmative action program to secure compliance with the provisions of numerous sections of the Commodity Exchange Act, various Commission Regulations and contract market rules. The Agreement between NYCE and CFFE provides that NYCE shall perform the regulatory responsibilities with respect to the CFFE in the manner and to the extent it performs its self-regulatory responsibilities for

NYCE and the other subsidiaries and divisions of NYCE. Please provide a complete and detailed description of how the CFFE would be integrated into NYCE's compliance program, including a description of any ways in which such measures might vary from the manner in which NYCE oversees its own trading activity (e.g., special measures to monitoring the conduct of TOs, TO supervisors, Cantor employees and Cantor affiliates and their employees).

96. Would NYCE's compliance and market surveillance staff add any analysts/investigators to handle the additional workload of regulating CFFE? Similarly, would NYCE allocate any additional funds to its compliance program to provide the resources necessary for adequate monitoring of CFFE trading? Please provide a description of any such additional measures.
97. Please describe any automated trade surveillance that would be conducted on CFFE. Include in this description a listing and description of all computer-generated exception reports, if any, that would be used to detect abuses including, but not limited to, trading ahead, prearranged trading, preferential or noncompetitive trading, payback trading, and improper cross trading.

C. Regulation 1.35 Issues

98. The Division believes that CFFE proposed Rule 316(b) requires clarification in two respects. First, the requirement that the CFFE "ensure" that a written record be prepared by the submitting clearing member or screen based trader upon receipt of a customer order gives the impression that the CFFE would take some steps to ensure compliance before TOs entered such orders. Second, the provision does not seem to put any affirmative duty upon screen based traders or clearing members to comply with the written record requirement. Please make appropriate clarifying revisions to CFFE Rule 316(b).
99. When and how would the CFFE supply audit trail data to the NYCE? Please describe any other information that CFFE would supply to NYCE in connection with its oversight of CFFE trading?
100. Commission Regulation 1.35(a-1)(3)(ii) requires contract markets to conduct surveillance to ensure compliance with the recordkeeping requirements of Regulation 1.35(a-1)(2). Regulation 1.35(a-1)(2)(i) codifies the requirements for order ticket preparation, and would be implemented on the CFFE by its proposed Rule 316. What routine reviews would be conducted to ensure compliance with these recordkeeping requirements? Please describe how often and how expansive these reviews would be.
101. If CFFE records would be incorporated into current NYCE order ticket and audit trail reviews, describe how and to what extent this would be accomplished. Please include in this description whether and how the trading system's trade-timing data would be compared with timing data recorded on underlying trade documentation (i.e., time stamps on order tickets prepared by screen based traders, and time indexing on TO phone line tapes) to ensure the accuracy of these records and their consistency with one another.

102. Commission Regulation 1.35(e) requires contract markets to maintain a single record containing for each trade the date, time, quantity, underlying commodity or future, price, delivery month, expiration date, put or call, strike price, members buying and selling, clearing members, and CTI.
- Would the CFFE's trading system maintain all of this information as a single record?
  - Where, in what format, and for how long would this information be stored?
  - Who would have access to this information, and under what circumstances?
103. Commission Regulation 1.35(f) requires a contract market to assign some means of identification to each of its members and member firms and to include such identification in the record of each transaction. Please explain how CFFE would comply with this requirement. In this connection, please address the following related items.
- Would CFFE use alphabetical, numeric, or alphanumeric identification codes such as those used on NYCE?
  - Which entities would be assigned identification codes?
  - Would authorized traders have individual identification codes either apart from, or as a subgroup of their screen based traders?
  - Would TOs have identification codes?
  - Would the identification of all of parties to a transaction (i.e., screen based traders, authorized traders and TOs) be reflected in the CFFE's Regulation 1.35(e) record?
  - Would the trading system accept orders which did not include some or all of this information?
  - Would the trading system accept orders entered without specific account identification?
104. Could account identifiers or any other trade information in the CFFE's Regulation 1.35(e) record be changed after execution of a trade? If so, what information would be recorded regarding the change itself, the party making or requesting the change, and the timing of the change? Would the originally-recorded trade information which was replaced or deleted be kept as a part of the transaction record?
105. Commission Regulation 1.35(g) and (h) establish certain requirements for the timing of transactions and changes in price. CFFE has represented that it would record the exact time of each transaction. In what increments would trade times and price changes be recorded?

106. Commission Regulation 1.35(i) requires that contract markets use the information retained pursuant to Regulation 1.35(e) in its rule enforcement program, and report to the Commission on the accuracy of that information and its use in the rule enforcement program. Please describe how this information would be used by the CFFE.
107. Commission Regulation 1.35(l) states that a contract market which can demonstrate an alternative means of trade recordation which eliminates the opportunity for alteration or fabrication of trading records may petition the Commission for exemption from the requirements of certain subparagraphs of Regulation 1.35(a-1). Please provide a written explanation of how CFFE's automated trading system would qualify for exemption from the relevant provisions of Regulation 1.35(a-1).
108. Please explain how spread transactions would be reported on the CFFE times and sales registers. Would there be a separate spread report, or would the legs of each spread appear as exceptions in the regular times and sales register?

## VI. CCC Issues

109. CFFE has represented to Division staff that CCC, rather than the New York Board of Clearing, would be CFFE's clearing organization. Currently, CCC does not have rules governing the handling of customer funds, either by CCC or CCC clearing members, in accordance with the requirements of Commission Regulations 1.20 through 1.29. Will any proposed amendments be made to the CCC Bylaws and Rules to address these requirements?
110. The CFFE's submission indicates that the CCC will clear and settle all CFFE transactions. Please provide a detailed description of how CFFE matched trade data would be transmitted to the CCC. How often would such data be sent to the CCC throughout the trading day.
111. Please provide the Division with a time line covering the various steps that would be involved in clearing and settlement CFFE contracts. The time line should particularly describe when clearing guarantees would attach to CFFE transactions.
112. What trading records of CFFE members would be kept by CCC? Would reports be generated and reviewed detailing which trades were executed for customer accounts and which were executed for house accounts?