



# Chicago Board of Trade

Thomas R. Donovan  
President and  
Chief Executive Officer

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October 22, 1999

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OFFICE OF THE SECRETARIAT

Ms. Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
1155 - 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

Re: **Cantor Financial Futures Exchange's Proposal to Adopt Block Trading Procedures, 64 Federal Register 54620 (October 7, 1999) ("Cantor Release")**

Dear Ms. Webb:

The Chicago Board of Trade ("CBOT®" or "Board of Trade") is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") request for comments on a block trading proposal submitted by the Cantor Financial Futures Exchange, Inc. ("CX") dated September 15, 1999 ("CX Submission"). The CX Submission proposes rule amendments to permit futures transactions of a minimum size to be executed privately, away from the market, coupled with delayed reporting of transaction prices (the "Proposed Rules"). CX submitted these unprecedented trading rules in light of the Commission's Advisory on Alternative Execution, or Block Trading, Procedures for the Futures Industry, dated June 7, 1999 (the "Advisory"). The Advisory stated that the Commission would consider non-competitive trading proposals on a case-by-case basis in lieu of proceeding with the rulemaking process the Commission initiated with its Concept Release on Regulation of Noncompetitive Transactions executed on or Subject to the Rules of a Contract Market, 63 Federal Register 3708 (January 25, 1998) ("Concept Release").

The CBOT opposes approval of CX's Proposed Rules on multiple grounds. The block trading proposal is contrary to the public interest because it will lead to market fragmentation and will create new opportunities for trading abuses across related markets. In particular, it could engender a new type of inter-market front running between CX's block trading facility for its U.S. Treasury contracts and the CBOT's U.S. Treasury complex as a direct result of the delayed price reporting for CX block transactions. One exchange should not be allowed to adopt trading practices that could foster abuses beyond its markets to other unwilling markets.

The potential for front running between CX and CBOT markets to the detriment of our market users also has implications for how we must deploy our limited surveillance resources. It is patently unfair that we should have to incur additional costs to protect our markets from abuses caused by trade practices in another market that we do not condone.

If the Commission is receptive to exchanges adopting a broader range of alternative trading practices

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than in the past, we recommend that the Commission develop a framework setting forth the parameters that exchanges may follow. We believe that approach is preferable to considering exchange proposals on a piecemeal basis without any evaluative context. In any event, CX's current proposal demonstrates the need for caution and consideration of the public interest implications of allowing private transactions away from the organized markets. Our specific comments follow.

A. Block trading poses significant risks to the futures markets

The centralized exchange markets serve the public interest by providing liquid trading to businesses and financial institutions throughout the world that rely upon the markets to hedge against the risk of adverse price movements and to discover future changes in interest rates, such as those reflected in the prices of U.S. Treasury securities. Futures and futures options on U.S. Treasury securities are the Board of Trade's benchmark products. The CBOT has previously opposed noncompetitive practices based on our concern that they will divert order flow from the competitive futures markets, thereby jeopardizing the price discovery and hedging benefits which Congress has found to be in the national public interest.

In support of this position, we refer to our letter to the Commission dated September 1, 1998, regarding Regulation of Noncompetitive Transactions submitted together with the expert economic study by Professor Haim Mendelson of Stanford University's Graduate School of Business and Professor Yakov Amihud of the Stern School of Business, New York University titled, "Evaluation of Alternative Execution Procedures in Futures Markets", September 1, 1998 (the "A&M Report"). The A&M Report was our comprehensive response to the block trading portion of the CFTC's Concept Release titled "Regulation of Noncompetitive Transactions executed on or Subject to the Rules of a Contract Market, 63 Federal Register 3708 (January 25, 1998) ("Concept Release"). We are hereby resubmitting that study in support of our comments on the CX Submission. The majority of responses to the Concept Release were generally opposed to noncompetitive trading practices, such as block trading.

The A&M Report sets forth a framework for evaluating trading practices that builds on established principles and empirical evidence from many different markets. The report highlights the tension between the desire to accommodate market participants who wish to consummate trades under trade execution structures that are less regulated, and the harmful effects of market fragmentation that result from splitting order flow. It concludes that a proper balance must take into account the effect of alternative execution procedures on market liquidity, price discovery (or informational efficiency) and market integrity. The A&M Report concludes that market fragmentation reduces liquidity, increases overall trading costs, hampers price discovery and reduces the incentive to provide information to the market. It further concludes that such fragmentation undermines market integrity when it allows trade prices to be worse than the best available bids and offers of the market or when

a class of traders receives inferior treatment.<sup>1</sup>

The specific block trading practices outlined in the CX Submission and discussed below reinforce these points. If rules are approved without conducting a fragmentation analysis, the market will inevitably be eroded as exchanges successively copy non-competitive standards to prevent the loss of order flow. A fragmented market for U.S. Treasury futures will cause unreliable price discovery, make hedging more expensive, and increase the U.S. government's borrowing costs – costs taxpayers will have to bear. To prevent this from occurring, we urge the Commission to analyze fully the CX Submission, and only then establish a market-wide framework for procedures, if these procedures are consistent with the public interest.

#### B. The CX Submission

As we demonstrated in many of our previous comments regarding CX, CX's clear strategy is to clone the most successful contracts of the CBOT and then skim order flow from the CBOT by allowing certain large customers to engage in non-competitive and preferential trading practices, such as Exclusive Time work-up sessions. The Commission disagreed with our assessment that Exclusive Time work-up sessions offered by CX were non-competitive. However, CX now confirms its non-competitive approach by proposing extremely liberal block trading procedures for futures markets never before allowed by the Commission.

The current CX Submission, like CX's earlier rule filings, does not comply with the form and content requirements of CFTC Rule 1.41 and many aspects of its proposed rules appear to be intentionally vague. We have attached a preliminary list of issues that need to be clarified, and which we reserve the right to supplement based on our continued analysis.

The Commission should approach CX's request with caution as it has in the past with other exchange rule proposals for alternative execution procedures. CX asserts that its proposed noncompetitive block trading rules will benefit several large market participants. Given the liquidity of our markets, we think this is questionable (the A&M study indicates that orders of size can be executed in open exchange markets without being more costly). However, if this were true, the benefit would be reaped at a cost that is much too high to the general public, in the form of fragmented, opaque markets and the potential for new trading abuses not only in CX's markets but in the CBOT's U.S. Treasury complex and in the cash U.S. Treasuries markets.

#### 1. The Commission should apply a public interest analysis to the CX's Proposed Rules

CX claims its proposed block trading rules are consistent with CEA §5(a)(12) and CFTC Rule 1.38. We disagree. Historically the Commission has allowed only a very narrow range of alternative

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<sup>1</sup> See, A&M Report at p. 2.

execution practices under CFTC Rule 1.38 and then only after careful (and time consuming) deliberation. The CX submission proposes a much broader interpretation by requesting rule approvals that implement execution procedures that are currently barred. The Commission should exercise caution as it has in the past. Indeed, we believe CX's proposal is so far-reaching and unprecedented that it could only be approved, if at all, pursuant to the Commission's exemptive authority under Section 4(c) of the CEA. This is particularly warranted with the CX Submission because the CX rules will encourage non-competitive and illegal practices prohibited by Section 4b and 4c of the CEA, such as inter-market front running, manipulation and bucketing abuses.

Section 4(c) requires the CFTC to consider the impact of proposed exemptions to determine whether they are consistent with the public interest. The Commission must also determine that the proposed transactions would not have a material adverse effect on the ability of any contract market to discharge its regulatory or self-regulatory duties under the Act. If exemptions are granted, the Commission should do so by setting out the general parameters for block trading rules. Then automatic approval of rules certified to be within those parameters would be permitted.

Even if a 4(c) review is not undertaken, the standards articulated in the Block Trading Advisory are an implicit recognition by the Commission that block trading proposals under CFTC Rule 1.38 or otherwise must be consistent with the public interest. The Commission's Advisory requires all submissions: (i) to discuss the potential impact of such transactions on the recognized functions of the relevant futures market in light of the countervailing benefits, and (ii) to demonstrate that (A) the proposal is the least anti-competitive means of achieving the objective, (B) the proposed transactions fulfill some particularized need of market participants that the traditional open and competitive execution methods cannot fulfill as well, and (C) such transactions are structured in such a way that complements competitive market. Therefore, any proper review of the CX Submission should consider the impact of such practices on price discovery, competition and harm to the markets. The CX submission fails to address the impact of the Proposed Rules on the CBOT.

2. CX's Proposed Rules, if implemented, would be detrimental to the public interest.

CX's proposed block trading rules will exclude superior bids and offers from consideration. By allowing delay in reporting and dissemination of prices of block trades, the Proposed Rules also will promote new, unprecedented opportunities for inter-market front running, not only between the cash and futures markets, but between different futures exchanges. These new abuses are not currently possible in transparent futures markets. The CX's procedures would make it impossible for primary markets to decide when and how their contracts can be traded. Furthermore, the CX's proposed rules will have an adverse effect on the CBOT's and CX's ability to discharge their self-regulatory duties under the Act. Such trading rules are harmful to market participants, their customers and the general public that relies on an accurate real-time market data for a variety of economic decisions.

a. The execution procedures proposed in the CX submission are anti-competitive and will fragment the U.S. Treasury futures markets

The CBOT has identified the threat of market fragmentation caused by block trading in numerous public comment filings and hearings. The CX has already cloned the Board of Trade's U.S. Treasury futures and futures options contracts and has attempted to entice the Board of Trade's largest customers through noncompetitive Exclusive Time practices. Now it attempts to entice them with more blatant, non-competitive, off-exchange transactions currently prohibited by the Board of Trade and the CFTC. The CBOT and the Commission disagreed in the past over whether CX would be offering block trading through CX's Exclusive Time practices. Now that CX's objective is clear, any reasoned analysis must respond to our market fragmentation concern.

By allowing private negotiation during a block trade negotiating session, the rules allow trades to be diverted from CX's markets and the CBOT's centralized markets, in violation of open and competitive trading principles. This is akin to prearranged trading in the futures pits, a practice that normally leads to criminal penalties. This practice is illegal because it denies customers the opportunity to obtain the best price and see transactions as they are occurring.

CX cited examples of non-competitive trading rules at the Chicago Board Options Exchange ("CBOE"), the London International Financial Futures Exchange ("LIFFE") and the New York Stock Exchange ("NYSE") in support of its proposal. CX's reliance on this precedent is misplaced. All of these markets are the principle markets for the products they allow to be block traded. They have much higher requirements for the size of block trades. CX's system resembles an odd lot system in comparison allowing blocks of only 50. None of CBOE, LIFFE or NYSE permit withholding of information or orders from the public auction markets to the extent envisioned by the CX submission. None of these exchanges allows participants to report transactions after a ten minute delay. Both CBOE and NYSE require block trades to go through the pit, so they are immediately reported. The CBOE requires members trying to place a block order to disclose that order to the pit before execution can take place. LIFFE requires participants to report a trade within five minutes, and the trade is not executed until it is approved by LIFFE. LIFFE has a minimum of five minutes for approval and reporting, and it reserves the right to reject trades not made at fair prices. CX has a fair price requirement, but will not reject trades or break trades that have not been executed at a fair and reasonable price. It is unclear how long CX has to report executed block trades.

The CBOT would like more time to undertake a thorough survey of CX's rules. We believe that if the Commission undertakes a comparative analysis it will find other important differences in CX's approach. It is clearly not the least anti-competitive means of achieving CX's stated objectives.

If multiple exchanges trade or propose to trade the same or similar contracts, the Commission should allow only the exchange with the principle market to adopt alternative execution procedures. Otherwise, the principle competitive market would be open to another exchange "free riding" on the principle exchange's successful contract design by offering a copycat contract and seeking to attach

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liquidity through the lure of noncompetitive trading practices. As the Chicago Mercantile Exchange ("CME") pointed out in its April 28, 1998, comment letter on the Concept Release, when a market seeks to offer noncompetitive trading practices on the principle exchange's markets, "the test must be whether the principle market is adversely affected." Otherwise, exchanges like CX can easily be established for the sole purpose of passing rules that permit upstairs trading and drain liquidity from the true competitive marketplace. We think this is CX's objective (and has been from the outset), and we agree in principle with the CME's position.

The Chicago Board of Trade's complex of U.S. Treasury securities futures and options contracts is the most liquid and successful in the world. If the CX is allowed to trigger market fragmentation by implementing its proposed practices, the liquidity in existing markets will decline, hedging will become more expensive, price discovery will become more opaque, and the U.S. government's costs of financing its debt could rise. The U.S. government and businesses from around the world rely upon the Board of Trade to provide liquid and efficient trading markets in these important risk management instruments. Therefore, the Commission must not underestimate the importance of allowing only the least anti-competitive practices, following a reasoned analysis.

b. Unreasonable time delay for release of price information presents potential for inter-market front-running in the futures and cash markets

In response to the Concept Release, some respondents asserted that execution procedures could be structured in a way to minimize any negative impact on market volume, liquidity, price discovery, transparency and customer protection. Even if this were true under some circumstances, it is not true in CX's case. CX is proposing block trade execution procedures that will have a severely negative impact on price discovery, transparency and customer protection, and are not crafted in a way to minimize that negative impact.

The Commission recognized in the Advisory that if execution procedures for large size or other types of orders use a combination of competitive and noncompetitive trading practices, these could not include the non-competitive practices listed in Section 4c(a). Section 4c(a) prohibits transactions that are used to cause any price to be reported, registered, or recorded which is not a true and bona fide price. The CX's proposed rules allow improper and unreasonably delayed price reporting which will precipitate noncompetitive practices described below, including practices prohibited by Section 4c(a).

Under the Proposed Rules, the parties to block trades conducted away from the centralized market are not required to report these transactions to CX for ten minutes. During this ten minute lapse, parties to a transaction could very easily enter the CBOT's market or the cash market and execute transactions with the benefit of this unreported information. Knowing a block order will raise the price of a contract, a market participant could enter the CBOT market and buy that contract at a lower price. Or, having sold a large quantity of contracts, and knowing the price will fall, a

participant could enter the CBOT market and sell additional contracts to other unknowing traders who will buy at an unreasonably high price, reaping an illegal gain on the sale. Even if CX participants do not engage in these front-running abuses, other market participants will not have the benefit of their unreported information for at least ten minutes, and consequently may not execute their transactions at the best price.

For trades executed within the last ten minutes of the trading day, the details of the block trade would not have to be reported until immediately before the opening of business on the following trading day. Although CX does not clearly define when the next "opening" occurs, the delay is clearly much longer than ten minutes. The potential exists for the market to move considerably before the next "opening" when the block trade would be reported. Since, the CBOT's electronic trading system is open for twenty-two hours each day, parties to the CX trade will be able to trade in the CBOT markets for an extended time before their price is reported on the CX system the next morning, and the CBOT and CX will not have full information until ten minutes after the CX opening on the following day.

c. CX's proposed rules will make it impossible to fulfill SRO surveillance obligations

The CX rules will make it impossible to ensure that all trades (both the block trades that are the subject of this comment and trades concurrently executed in centralized markets) are executed at competitive prices. The potential for front-running abuses is compounded by the fact that these transactions would take place on two separate exchanges that cannot detect abuses taking place on another trading floor on a real-time basis. Because these trades take place in private bilateral negotiations, CX's audit trail and trade surveillance system will not detect whether trades are being reported promptly. At best, the CBOT will only receive CX's market information on a delayed basis. CX will not be able to monitor for abuses of its traders in the CBOT's markets. Do the CBOT's regulatory responsibilities include being forced to coordinate on inter-market surveillance with CX to help CX skim CBOT order flow and implement practices that we oppose as harmful to our markets? This has potentially serious ramifications for our surveillance activities and how we allocate limited resources which we are still evaluating. We plan to supplement our comments once we have analyzed this matter further.

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Conclusion

Before considering any block trading proposal, the Commission should establish, through rulemaking, permissible standards for block trading procedures. This particular submission illustrates the potential for harm from individual proposals, not made pursuant to standards, that propose far reaching changes. The CX's Proposed Rules, if approved, will create opportunities for harm to other markets that have never existed in the past, raising dire implications for markets that have taken no part in crafting these rules.

Respectfully submitted,

A handwritten signature in cursive script, reading "Thomas R. Donovan". The signature is written in black ink and is centered below the typed name.

Thomas R. Donovan

**PRELIMINARY ISSUES RELATING TO  
THE CX's PROPOSED RULES**

1. CX has not presented any information regarding the impact its Proposed Rules will have on the CBOT's markets where the same products are traded.
2. The CX submission touches very briefly on competition with OTC and cash markets. How will the block trading transactions proposed by CX complement the CBOT's competitive market? How will non-competitive trading promote competition within the futures markets? How will fragmentation make the futures markets more competitive with OTC and cash markets?
3. The CX submission asserted that block trading provides benefits to large customers. How will it benefit other market participants? How does CX propose to address protection of other customers from potential abuses made possible by the Proposed Rules? How will closing other participants out of the bidding process and withholding trade information benefit these other participants?
4. It is unclear how CX proposes to undertake inter-market surveillance. What procedures, if any, does CX have in place to ensure that manipulation and fraud specific to its new block trading procedures will not occur?
5. How can CX justify the use of small fifty-contract lots for "block trading" when other markets require much larger sized lots for block trading? Is the CX merely a facility for off-market, odd lot transactions?
6. The Proposed Rules (at Rule 305-A(a)(3)) state that customers and third parties who have their orders matched with each other by a Clearing Member, Screen Based Trader or Foreign Screen Based Trader cannot make a market in Block Trades (unless they are Primary Market Makers). Why does CX exempt traders from any responsibility for determining whether Customers or parties for which they are acting are complying with this rule? Why does CX specifically state that trades executed in violation of this requirement would not be rescinded?
7. The Proposed Rules (at Rule 305 - (a)(4)) state that the prices of block trades must be fair and reasonable in light of the size of the block trade and the price and size of their trades in the same contract at the relevant time. Why then does the CX submission state at page 9 that Primary Market Makers will be expected to, and effectively have to, offer "attractive prices" to CX participants. CX seems to blur the distinction between fair and reasonable prices and attractive prices.
8. How can CX support its statement that its block trading rules are substantially similar to LIFFE's trading rules, when LIFFE polices transaction prices, approves all transactions, allows only five minutes for reporting, and requires block trades to consist of thousands of contracts?