

**STATEMENT OF THE AMERICAN STOCK EXCHANGE, INC.  
BEFORE THE COMMODITY FUTURES TRADING COMMISSION  
IN REGARD TO THE APPLICATION OF  
CANTOR FINANCIAL FUTURES EXCHANGE  
FOR DESIGNATION AS A CONTRACT MARKET**

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*Presented August 11, 1998*

COMMODITY FUTURES  
TRADING COMMISSION  
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I am David Yeres of the law firm Rogers & Wells LLP. I am joined by Stephen Storch and William Floyd-Jones of the American Stock Exchange, Inc. ("Amex"). We are here today to present the views of Amex concerning the application of Cantor Financial Futures Exchange ("Cantor Exchange"). The Cantor Exchange is a joint venture between certain affiliates of Cantor Fitzgerald L.P. (the "Cantor Group") and the New York Cotton Exchange, for designation as a contract market for certain U.S. Treasury bond and note futures contracts (the "Application").

Amex is grateful for the opportunity to present to the Commission its views on the Application. With your permission, we request that this written statement as well as Amex's comment letters dated April 3, 1998 and July 15, 1998 be made part of the record of this meeting.

Amex is a national securities exchange, regulated by the Securities and Exchange Commission, and is the only U.S. securities exchange that is both a primary market for listed equity securities as well as a market for equity options, index options and equity derivatives. Amex has been the nation's foremost innovator in structured derivative securities and index share securities. In addition, Amex's wholly owned subsidiary, Amex Commodities Corporation ("ACC"), was designated as a contract market in certain U.S. Treasury note futures in 1989. However, those contract market designations have not as yet been utilized. ACC is now in the process of developing a fully electronic futures marketplace for U.S. Treasury securities. Consequently, Amex is keenly aware of the issues raised by electronic trading markets and, is deeply interested in any Commission action which will potentially affect that marketplace.

Amex strongly supports the goal of permitting innovative futures markets to compete freely and fairly with traditional pit trading markets. Furthermore, Amex supports the objective of prompt regulatory review and favorable action on meritorious proposals. The Commission is to be commended for its openness to innovative market mechanisms, as well as for the speed with which it addresses novel issues, as reflected by its rapid consideration of the

application to date. Amex's support for the Commission's process does not, however, extend to the merits of the Application itself.

Amex has a unique perspective on the Application. ACC previously considered, and withdrew from, a joint venture with Cantor Fitzgerald, L.P. similar to the Cantor Exchange. Amex's principal concern was then, as it is now, that Cantor Fitzgerald, L.P., and several of its subsidiaries, (the "Cantor Group")<sup>1</sup> seek to sidestep regulatory accountability for the Cantor Group's central role in the proposed market. Amex believes that it is unnecessary and inappropriate to sacrifice important accountability safeguards of the Commodity Exchange Act ("CEA") in pursuit of innovation. To the contrary, Amex maintains that market innovation and these CEA protections may, and should, go hand in hand without compromising core standards.

In any event, the Cantor Exchange does not propose an innovative trading system. The proposed telephone order delivery, manual order handling, and electronic order matching systems have been available for many years on securities exchanges. The innovation of the Cantor Exchange is not in its trading system; it is in the ownership structure that insulates the Cantor Group from responsibility for its actions or inactions in operating a proprietary market.

In summary, as presently submitted, the Application does not, we believe, meet the CEA standards for approval. In any event, the Application is materially incomplete, and should, we submit, be completed and put out for public comment once again before contract market designation is reconsidered.

Turning to the Application itself, including several of the Cantor Exchange filings that are publicly available (collectively "the Cantor Exchange Filings"), it is clear that the nominal contract market -- "the Cantor Exchange" -- that will be owned by the Cotton Exchange and its members, is a virtual shell that lacks the traditional attributes of a futures market. Rather, it is the Cantor Group that is at the heart of the proposed market.

According to the Cantor Exchange Filings, one of the Cantor Group companies, Cantor Fitzgerald Securities ("CFS"), acting through its employee terminal operators, will be the exclusive access provider to the proposed market. CFS will select, employ, supervise, and compensate the terminal operators who will handle all orders for the Cantor Exchange futures. The same company will operate and control the computerized trade matching system into which the terminal operators input futures orders. Real time order and trade data appears also to be

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<sup>1</sup> The Cantor Group's complex structure is reflected in Exhibit A hereto which was taken from the CFFE's August 4, 1998 submission to the Commission (the "August 4 Filing").

owned, controlled and distributed by the Cantor Group (although the Cantor Exchange Filings are unclear on this point). Another Cantor Group company, the CFFE L.L.C. will appoint a majority of the Cantor Exchange board.

The Cantor Group, accordingly, is not a simple service provider to the Cantor Exchange, it so completely controls market access, market information, order handling, systems, personnel and corporate governance that the Cantor Group is the exchange, and is the owner/operator of a proprietary trading system. Neither CFS nor the CFFE, L.L.C., however, would be a designated contract market subject to initial and continuing Commission oversight, nor even a Commission registrant of any kind whatsoever. Furthermore, they would not be members subject to the jurisdiction of either the Cantor Exchange or the Cotton Exchange.

The Cantor Exchange Filings require the registration of terminal operators as floor brokers. We believe, however, that the registration of terminal operators alone is not adequate. The more important registration relates to the employer of the terminal operators, CFS. The Cantor Exchange Filings reveal that CFS is not to be registered in any capacity under the CEA and is not subject to Cantor Exchange jurisdiction. Thus, the terminal operators are being treated as though they are independent actors, when in fact they are merely employees and agents of CFS. This fiction works, we believe, to the detriment of the public, since it permits CFS to operate in a regulatory blind spot where it will avoid the regulatory, supervisory and membership responsibilities appropriate to its real role.

Amex believes that under the CFFE structure, CFS and its managers, and not merely its low-level terminal operator employees, need to be registered with the Commission. The CEA, furthermore, provides a registration class that, we believe, fits exactly the role of CFS. Indeed, according to the Application, CFS will be performing through its employee terminal operators the functions of an Introducing Broker ("IB"), that is, it will solicit and accept orders for futures contracts. In fact, the functions to be performed by CFS and its employees fall, we believe, so precisely, within the CEA's definition of an IB that, absent some exemption from the Commission, such registration would be normally required.

The CEA has long relied heavily upon registration as the centerpiece of its regulatory scheme. In fact, an often cited federal appeals court decision states that registration is the "kingpin" of the CEA machinery, and is vital to carrying out its other statutory functions of monitoring and enforcing the Act.<sup>2</sup> In addition to forsaking its rights pursuant to statute and regulation to certain initial information and continuing reporting, by not requiring CFS to be

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<sup>2</sup> See, CFTC v. British American Commodity Options Corp., 560 F.2d, 135, 149 (2d Cir. 1977).

registered, the Commission will be losing its right, conferred by regulation, to inspect the CFS premises and books, and to suspend or revoke its CEA registration in appropriate circumstances. Moreover, without registration CFS is freed from the critical duty imposed upon all CEA registrants to supervise employees.

As part of the Commission's customer protection program adopted in 1978, CEA registered employers and supervisors have been required for the past twenty years to diligently supervise employees pursuant to Commission Regulation 166.3<sup>3</sup>. According to the Commission, "[t]he basic purpose of [Commission Rule 166.3] is to protect customers by ensuring that their dealings with the employees of Commission registrants will be reviewed by other officials in the firm ..."<sup>4</sup> Thus, imposition of the regulatory duty to supervise is a prophylactic measure which "expands the registrant's focus ... to include the broader goals of detection and deterrence of possible wrongdoing by its agents."<sup>5</sup> By not being CEA registered, CFS and its management avoid any obligation under the CEA to supervise the terminal operators. Similarly, because neither CFS nor its managers will be Cantor Exchange members, they cannot be made subject to any supervisory duties under those rules either. Consequently, CFS and its management, will lack the discipline imposed by regulation on all CEA registrants to prevent, detect and report any employee misconduct.

While supervisory obligations perhaps might be less necessary in a fully electronic market, the Cantor Exchange, as now proposed, is not such a market. The ultimate matching of orders for the Cantor Exchange futures will be done through a computer. However, it is clear that this is computer assisted trading rather than electronic trading as that term is commonly understood. Terminal operators will personally accept and handle all orders for the Cantor Exchange futures. This is not a "high tech" trading system. The system includes a high degree of human intermediation in the order flow.

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<sup>3</sup> See, Adoption of Customer Protection Rules, 43 Fed. Reg. 31886 (July 24, 1978). Reg. 31886 (July 24, 1978).

<sup>4</sup> Bunch v. First Commodity Corp. of Boston, [1990-1992 Transfer Binder] Comm. Fut.L.Rep. ¶25,352 at 39,168-169 (CFTC Aug. 5, 1992).

<sup>5</sup> See, Lobb v. J.T. McKerr & Co., ["1987-1990 Transfer Binder] Comm. Fut.L.Rep. (CCH) ¶ 24,568 at 36,444 (CFTC Dec. 14, 1989).

The Cantor Exchange system, that may involve scores of terminal operators soliciting orders, communicating with customers, and free to communicate with one another, is not immune from certain trade practice violations that have occurred in existing pit trading markets. The Cantor Exchange system, however, lacks certain key safeguards of the outcry auction systems. The Cantor Exchange will operate solely on the private premises of CFS, and it will have no public trading pit where (i) many unaffiliated brokers and "locals" trade in plain view of one another, and participants have an economic incentive to identify anti-competitive trade practices abuses by their peers and (ii) an independent floor committee supervises trading. Furthermore, there will be no competition among independent brokers for order flow to operate as a check on trade practice problems, since in the Cantor Exchange system the public has no choice; Cantor is the exclusive access provider.

For all of the reasons stated, registration only of terminal operators is, we believe, inadequate. We believe that CFS and its managers should also be registered under the CEA or CFS itself should seek contract market designation. In addition to the absence of a necessary registration, we believe there are at least six other material aspects of the Application that are incomplete or unclear and should be resolved prior to Commission consideration of contract market designation.

An amendment to the Cantor Exchange rules made just last week (the "August 4, 1998 Filing") creates a new rule (301-A) which can be read as a provision to free CFS from the vicarious or "secondary" civil and regulatory liability imposed by statute on all employers for any CEA or Commission rule violations of their employees and agents. The new rule says that for purposes of the relevant section of the CEA (Section 2(a)(1)(A)(iii)), CFS's terminal operator employees are agents of the Cantor Exchange and by implication not agents of CFS. This would be a change of major significance. We urge the Commission to obtain clarification on this point and to reopen the public comment period once clarity is obtained.

The Cantor Exchange by-laws and rules by their terms extend the Cantor Exchange's arbitration and disciplinary jurisdiction only to persons with "Trading Privileges" which does not appear by its definition in the Cantor Exchange rules to include the terminal operators. Yet, other portions of the Cantor Exchange rules purport to subject terminal operators to compliance with various the Cantor Exchange rules. It is, therefore, unclear whether terminal operators will be subject to Cantor Exchange disciplinary proceedings or arbitrations. Clarity, and opportunity to comment, on this important point is, we believe, surely necessary.

Another fundamental point left unclear is what is meant by the Cantor Exchange filing that seems to say that terminal operators may solicit orders and may engage in marketing

but shall not give advice. These distinctions are not obvious. For example, we believe that soliciting an order, by definition, is giving advice and any regulatory scheme that seeks to permit order solicitation and prohibit "advice" is inherently contradictory. This, too, requires clarification and opportunity for comment.

CEA Section 5a and the Commission Regulation 1.51 require exchange trade practice rules to be buttressed by an adequate surveillance and compliance program. The Commission's July 28, 1998 rule enforcement review (the "Review"), of the Cotton Exchange, which will provide the Cantor Exchange with its compliance program, leaves uncertain whether the Cantor Exchange can comply. The Review states that the Cotton Exchange presently has a "diminished ability to perform its self-regulatory responsibilities", because of the loss of a number of compliance staff investigators. The Review recommends that the Exchange report within 60 days of its plans to hire additional investigators. Even a very well staffed exchange compliance program would be greatly challenged by a new market and new method of trading that combines futures and cash market activity in a mixed telephone/electronic trading system. In light of the Review, we submit that prudence and protection of the public require that the Commission delay consideration of the Application until it has received, and been satisfied by, the Cotton Exchange report.

Because of the Cantor Exchange's novel structure, the single greatest amount of "insider information" about orders and expected orders will necessarily be held by the terminal operators. The terminal operators and others permitted to have this information are prohibited by a Cantor Exchange rule amendment appearing in the August 4 Filing from disclosing such inside information outside the permitted group, thus, creating a so-called information firewall. Policing the firewall is a critical and substantial undertaking. The CFFE filings do not, however, provide any plan or indicate the availability of any resources for this job. Based upon the August 4, 1998 Filing (see Exhibit A hereto), there appear to be at least two dozen Cantor Group companies, some of which are partnerships involving multiple partners. Since none of the companies or partners, with one exception, will be Cantor Exchange or Cotton Exchange members, it is unclear how, if at all, the Cantor Exchange plans to surveil or otherwise police this critical restriction. We urge that the Application be treated as materially incomplete unless and until the Application provides to the Commission a satisfactory plan explaining how, and with what resources, it intends to police the firewall.

The Cantor Group appears to control the real time price discovery mechanisms of the Cantor Exchange. Although the Application is unclear on this point, we believe that one of the Cantor Group entities will collect, organize and redistribute information regarding all the Cantor Exchange futures orders and trades. Yet, we are aware of no basis to believe that any such entity will be subject to Commission oversight. Furthermore, no Cantor Exchange rule

limits or otherwise prohibits discriminatory information access or pricing, and the Cantor Exchange Board, being dominated by Cantor Group appointees, cannot be relied upon to restrict any such anti-competitive practices. We believe that the Commission should treat the Application as materially incomplete until it obtains information sufficient to assure that no impermissible discriminatory access and pricing may occur.

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Amex believes that technological advances and the attendant lowering of economic barriers to entry are likely to lead to a proliferation of new futures markets and market operators. In that scenario, the Commission would go from overseeing a handful of large, well established traditional exchanges, to perhaps dozens of fledgling markets, each with its special trading system. Once any new exchange is granted a lowered regulatory standard, the Commission must in fairness apply these same lower standards to all existing and new markets alike. Permitting CFS and its affiliates to operate a public futures market without either being a designated contract market or a Commission registrant, in our view, would set a dangerous precedent.

Amex and other commentators have identified numerous deficiencies with the proposed the Cantor Exchange beyond those that I have described today. Commentators also have identified numerous unanswered questions regarding the proposed the Cantor Exchange. In Amex's view, the known deficiencies coupled with the significant unknowns warrant the rejection of the Application or at least a finding that is materially incomplete.

Thank you for your attention, we are available to answer any questions or work with you or your staffs; as you may desire.

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# Exhibit A

Cantor Fitzgerald Incorporated (Nevada)





