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Chicago Board of Trade

Bernard W. Dan
President and
Chief Executive Officer

August 15, 2005

Ms. Jean Webb
Secretariat
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Ms. Webb:

Enclosed please find the Chicago Board of Trade's August 10 response to correspondence received from the Futures Industry Association regarding position limits in Treasury futures contracts.

Sincerely,

Bernard W. Dan

Bernard W. Dan

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August 10, 2005

John M. Damgard
President
Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington DC 20006-1823

Re: Position Limits in Treasury Futures During Last Ten Trading Days

Dear Mr. Damgard,

Thank you for your letter regarding the Chicago Board of Trade's recent amendments to Regulation 425.01, which established position limits during the last ten days of trading in expiring Treasury futures, beginning with the December 2005 expiration. As stated in our previous public notice, the amendments were implemented to help ensure that these contracts perform their price discovery and risk management functions in the best interests of the broad spectrum of market users and in keeping with our responsibilities as a self-regulatory organization.

The CBOT's most critical responsibilities are to protect the integrity of its contracts and to provide for fair, efficient and orderly markets on behalf of all market participants. In addition to the interests of certain large participants, whom the Exchange obviously values as customers, the importance of Treasury futures to the U.S. economy and world financial markets demands that we take all necessary measures to protect and enhance the integrity of these contracts.

The Rationale for Position Limits: Measured Response To Market Concern

Large open interest near a contract's expiry and/or large deliveries are not necessarily indicative of a problem, though such conditions are monitored closely by Exchange staff. Treasury futures, like other physically-delivered futures contracts, are not primarily intended as a market for the physical transfer of the underlying securities; however, as you observe in your letter, the possibility of delivery is the fundamental link between the futures contract price and the price of the underlying. It is precisely this convergence of the two prices that makes a futures contract relevant and useful for market participants.

Convergence does not occur in isolation. The liquidity of the underlying cash market and the ease of arbitrage between the futures and cash markets can either facilitate or impair the process. In this case, the cash market for Treasury securities, the repo market and the

futures market are all closely and elaborately linked. A confluence of factors across these markets furnished the context for the decision to establish position limits.

First, the recent and present combination of low yields and a flat yield curve strongly favors delivery of Treasury issues with relatively short durations and short remaining times to maturity; in the case of 10-Year Treasury Note futures, these issues tend to be those that the Treasury sold three or more years ago.

Second, the issue sizes of Treasury securities that are now attractive for delivery into Treasury futures happen to be unusually small, partly as an artifact of the Treasury's reduced borrowing needs during the years of fiscal surplus (1999-2001), and partly due to changes in the Treasury's funding practices.

Third, the notional value represented by open interest in Treasury futures has grown rapidly and dramatically relative to the underlying cash market. It now represents nearly double the proportion of the cash Treasury market as it did two years ago.

Fourth, the increased incidence of fail epidemics since 9/11 in the cash Treasury market, and especially in the Treasury repo market, has eroded trade certainty in the cash Treasury market in ways that impair the ability of market participants to perform cash-futures arbitrage.

Regarding the last of these considerations, in the U.S. Treasury Department's recent background briefing to the Bond Market Association's Treasury Borrowing Advisory Committee on a proposed backstop securities lending facility, Treasury staff identified the following risks of the more frequent and severe fails in the cash and repo markets:

Impaired liquidity in the cash market
Loss of price convergence in the futures market
Operational cost of resolving fails
Ultimately higher borrowing costs for Treasury

Against this backdrop, and in consideration of the Exchange's assessment of past and upcoming contract expirations, the CBOT's decision to implement position limits was a prudent and proactive initiative intended to preserve the integrity of price convergence between cash and futures, to insulate Treasury futures from potential manipulative conduct and the perception of "squeeze" conditions, and more generally, to make fair valuation of these contracts less susceptible to distortion arising from an increasing lack of discipline and trade certainty in the Treasury financing market.

The CBOT and other financial regulators have received communications from a broad array of market participants – many of them representatives of FIA member firms and prominent clients of FIA member firms - regarding the CBOT's Treasury futures and activities in the cash markets. A sampling of analysts' reports written by major investment banks and prominent FIA member firms confirms that some of the most

active and sophisticated market participants were disturbed by conditions such as those discussed above prior to the Exchange's establishing position limits. In light of the manifest concern of a broad group of participants, and following our careful consultation with relevant regulatory agencies and a diverse group of market participants, the CBOT Board of Directors determined to take this action.

Position Limits: Structure, Function and Operation

The CBOT has a statutory self-regulatory responsibility to ensure the integrity of its markets. The Commodity Exchange Act requires the CBOT to comply with certain core principles, one of which unequivocally states that it is the obligation of a board of trade to *prevent* manipulation, price distortion and disruptions of the delivery or cash settlement process. With this stricture in mind, we established position limits precisely for the purpose of reducing the *potential* threat of market manipulation, congestion or price distortions.

In light of the CBOT's history of public comment filings advocating various forms of relief with respect to position limits, it is evident that the Exchange adopted this course only because it strongly believed that it was necessary to do so to preserve the integrity of these contracts given present conditions. And it is not a mere coincidence that the Treasury has also proposed a backstop lending facility at this particular time.

Structure: The structural elements of the new position limits are intended to enhance confidence in the integrity of the markets within the scope of the CBOT's capabilities while exerting the least possible impact upon participants' abilities to use the contracts for their intended risk management function.

> First, the limits take effect ten days before last trading day (rather than throughout the spot month), by which time the substantial majority of the calendar roll is typically completed.
>
> Second, the quantity levels are high enough that, based on historical data (including recent periods of record open interest), relatively few entities would exceed the prescribed thresholds during the contracts' last ten trading days.
>
> Third, the limits apply to both long and short position holders, rather than just the long position holders as in certain other markets.
>
> Fourth, the levels are such that the basis optionality embedded in the contracts remains intact.

With regard to the last of these, you note in your letter that the CBOT has made "abundantly clear" that the terms of its Treasury futures contracts explicitly provide for delivery of any security in the basket of qualified issues. The amended position limit regulation adopted by the Exchange does not preclude multi-asset deliveries, nor was it intended to do so. Rather, it ensures that a single participant (or multiple participants acting pursuant to an express or implied understanding) cannot establish and hold a

dominant and potentially destabilizing position into the last ten trading days of an expiring contract. You assert that structural changes should not be made in the absence of any empirical evidence of market manipulations that distorted prices. The CBOT simply chose, in light of the market conditions noted above, to take the present action to prevent those conditions from adversely affecting our contracts.

Position limits versus position accountability: You rightly point out that Exchange regulations provide for position accountability in these contracts. If the CBOT had believed these standards were sufficient to fulfill its self-regulatory mandate given the aforementioned conditions, without disruption, it would not have established position limits. It is not uncommon for large market participants to establish positions many times the new limits prior to liquidating or rolling those positions. It would be unacceptably disruptive if the Exchange, under the banner of enforcement of position accountability, were to prevent the establishment of positions that in nearly all cases are rolled or liquidated prior to the contracts' last ten trading days.

In any event, the Business Conduct Committee does **not** have the authority to order a position reduction as you suggest in your letter. This power is reserved for the Board of Directors and requires emergency action, the most disruptive action an Exchange or the Commission can take. Thus, establishing position limits in the context of the present environment is the most effective short-term alternative for simultaneously fulfilling the Exchange's self-regulatory mandate, minimizing the impact on the risk management options of our customers, and reducing the likelihood of regulatory interference in the price discovery process.

Position limits and hedges: The position limits as established do not preclude a participant's ability to hedge its interest rate exposure with Treasury futures contracts. Rather the amendments merely limit the *extent* to which such exposure can be hedged *in the expiring contract* during the contract's last ten trading days. As noted above, the great majority of hedgers either liquidate or roll their hedge positions well in advance of a contract's last ten trading days.

Any suggestion that it would be impossible for a dealer to respond to a customer's request to sell large blocks of Treasury securities during the last ten trading days of a delivery month because the dealer would be unable to hedge with futures overlooks the fact that, by that time, volume and liquidity have moved to the next quarterly expiration, and that is where such a position is most likely to be hedged. As a practical matter, significant new positions are rarely established in an expiring contract during its last ten trading days.

Moreover, the position limits should mitigate decorrelation between futures contract price dynamics and price dynamics in the underlying Treasury securities market, at least to the extent that the limits insulate futures contract pricing from misevaluation associated with pricing distortions in the repo market. This, in turn, should directly support the effectiveness of futures hedge positions.

Finally, given the stated objectives of the position limits, hedge exemptions would render the limits largely meaningless as very few large-scale positions in these contracts would fail to qualify for such an exemption.

Position limits and the roll: The FIA argues that the position limits will create a second roll that "itself is likely to *cause* an artificial price." (emphasis in original). First, it is not clear how the long or short will know, as the FIA asserts, that "there is going to be a forced liquidation." Open interest can comprise any number of participants, and the Commission's Commitment of Traders Report you reference certainly does not break out the number or size of positions in an expiring Treasury futures contract. Clearly this report would not provide participants with the information you suggest, and it is not clear how such confidential position information could be otherwise secured. The fact that both longs and shorts have to comply with the limits levels the playing field between the longs and shorts holding positions greater than the limits. With respect to liquidity during the last ten trading days of an expiring contract, there are few circumstances that compromise liquidity more than a dominant position holder, who by virtue of market congestion or whatever other circumstance, may find itself able to exert market power. Position limits effectively inhibit such a scenario and provide all market participants with the confidence of knowing that it is so.

By taking the action it did, the CBOT sought, and succeeded in, providing greater clarity and confidence to market participants regarding the contracts. A sampling of published research from FIA member firms indicates their concurrence:

> "During the past month, we have heard several questions regarding whether or not the CBOT will try to prevent market participants from squeezing futures contracts and have discussed possible options for deterring squeezes available to the CBOT. On Wednesday, June 29, the CBOT answered these questions....While these new limits at the end of the trading period will not eliminate the possibility of inefficient deliveries, they make it more difficult for any one speculator to engineer a squeeze of the contract, because it will probably require multiple accounts taking maximum delivery to engineer a squeeze successfully ... we would not be surprised to see open interest on the December 10-year contract eventually outstrip that of the September contract."

> "With respect to [the CBOT's] motivation, one may suspect it has been the emergence of negative net bases, potential squeeze games and a general disorderly market – all topics which we have discussed at length in recent months. While these have certainly played a significant role, we believe it may be more directly related to the resulting fall in open interest due to some investors avoiding the market....The more important question is whether or not these position limits will eliminate the futures market's problems. Judging from the market's response today, the answer would seem to be yes. Our opinion, however, is that the limits will alleviate, but not eliminate, many of the recent issues in the market. To start with, the 50,000 contract limit on the 10 year contract is not a paltry amount...Perhaps it was the fear of a squeeze by one or two large investors which pushed the net basis so negative in the first place...If this was the case, the comfort of knowing that no one investor will be able to hold such large positions into delivery going forward may remove some of the psychological premium that has recently been priced into the market."

> "The new position limits on Treasury Bond and note futures, along with likely closer scrutiny by the CBOT and regulators, should help improve liquidity and lower volatility somewhat in both the futures and in the respective cash and repo markets for the cheapest-to-deliver (CTD) Treasury securities...The ctd cash issues should trade much closer to fair value on the Treasury curve and futures should trade substantially less rich and much closer to their theoretical fair value..the

extreme levels of richness experienced during the last two months are less likely to reoccur going forward. The dislocations in the repo market and protracted shortages of ctd issues should be lessened by the position limits...Volatility of the calendar spreads should decline and the wild "whipsawing" that occurred in TYM5/TYU5 calendar spread is less likely to occur. We believe that the open interest at expiry for futures should decline toward more historic levels."

The CBOT will, of course, continue to evaluate its Treasury contracts and carefully monitor the conditions that have given rise to its decision to establish position limits. Clearly, the Exchange intends to maintain position limits in these contracts only for as long as the CBOT judges that they are necessary to fulfill the contract function and market integrity objectives outlined in this letter.

Aggregation Issues

The FIA, in its letter, maintains that the aggregation requirements established by the CBOT are unworkable and will inevitably result in violation of the limits. Aggregation is necessary if any position limit is to achieve its intended purpose. The CBOT's requirements in the context of Treasury futures are consistent with those that have long been established in the futures industry whereby multiple positions that are subject to common ownership or control are aggregated for position limit purposes (see CFTC Regulations 150.4(a) and (b)). Indeed, these are the same standards applied in the context of current position accountability regulations for these products.

As the FIA ultimately acknowledges in footnote 9 of its letter, the exemption standards referenced in both Commission Rule 150.3 and CBOT Regulation 425.05 explicitly do not apply to spot-month positions. The adopting Federal Register Release 64 F.R. 24038 states, in part, that:

> "The exemption permits the total positions of the trading entity or vehicle to exceed speculative limits during *nonspot months*, but requires that each independent account controller trading on the entity's behalf to comply with the applicable limits. *During the spot month, all positions of the entity are required to be aggregated and are subject to the spot-month speculative position limit level.*" (emphasis added)

Although Commission regulations 150.3 and 150.4 explicitly apply to position limits imposed directly by the Commission, Part 38 guidance for compliance with Core Principle 5 similarly states, in part:

> "Contract markets should have aggregation rules that apply to those accounts under common control, those with common ownership, i.e. where there is a ten percent or greater financial interest, and those traded according to an express or implied agreement. Contract markets will be permitted to set more stringent aggregation policies."

In short, it is simply incorrect to say that under existing policy in all other contracts, aggregation is required only where there is common control.

The Exchange's aggregation program utilizes the ownership and control information provided by the clearing firm, or in some cases the customer, on the CFTC Form 102 to identify accounts that potentially merit aggregation. The Exchange has made clear in its broadly-attended conversations with FIA representatives and staff, including you, that independently controlled accounts owned by separate legal entities (irrespective of whether they share a parent) will be disaggregated. This, in fact, is a more liberal approach than exists under CFTC or CBOT rules in the context of other products that have position limits in the spot month. Other than that point, the Exchange is not aggregating accounts any differently than it does in any other context, and the Exchange has explicitly stated that, assuming a firm is presently reporting its large trader positions correctly, there is no need for any modification to its reporting procedures.

Clearly many FIA firms are involved in markets that currently employ position limits and have had little difficulty complying with the relevant regulations. Recognizing, however, that market participants have not recently had to comply with position limits in these contracts, the Exchange has offered to assist any position holder or clearing firm in understanding how the Exchange presently aggregates accounts through its aggregation program and to provide its current and recent aggregated position data if desired. Exchange Market Surveillance staff have had a number of such meetings with FIA members, and firms have generally indicated a high degree of comfort with how their accounts are being aggregated, irrespective of whether they support the decision on the position limits.

Although as a historical and empirical matter, very few positions would have been impacted by these limits in the last ten trading days, all accounts that have held positions of this size are likely to have had discussions with Exchange Market Surveillance representatives in past expirations in the context of its regular monitoring of positions as contracts approach expiration. In keeping with the Exchange's regular market surveillance activities, these representatives will routinely be in contact with large position holders well before the date that such limits take effect, or promptly in the very uncommon circumstance that a position suddenly becomes large well into the expiry month.

Finally, your concerns regarding the capacity of FIA member firms to adequately monitor for potential intraday violations are probably overstated given a proper understanding of aggregation standards and given the small number of accounts that are apt to be in a position to breach the limits. Despite this, as a practical matter, the Exchange receives position information on an end of day basis. While position limits, as a rule, apply on an intraday basis, the Exchange would need a compelling reason to examine an account's intraday activity. More broadly, the FIA should rest assured that the position limits have been implemented for the specific purposes outlined in this letter, and that any inadvertent breaches of the limits will be handled in that context, as with other products that have position limits.

In summary, the Exchange does not believe the enforcement of these limits puts it or its customers in an untenable position, and it certainly does not expect the rash of violations the FIA appears to inexplicably anticipate.

Jurisdiction, Process and Dissemination

In its letter, the FIA expresses "deep reservations" concerning the process which accompanied the amendments to Regulation 425.01 and you voice concern that it lacked the transparency essential to permit the CFTC to fulfill its responsibilities under the Commodity Exchange Act. As an initial point, the CBOT's adoption of amendments to Regulation 425.01 was self-certified in a manner fully consistent with applicable Commission regulations and core principles[1]. Secondly, as stated earlier, the CFTC was very involved with the CBOT in its monitoring of recent Treasury futures expirations and was certainly privy to the CBOT's motives for instituting position limits. Moreover, relevant government authorities were aware of the CBOT's deliberation over whether to impose position limits, and were duly advised as required once the Exchange made its decision to proceed.

The CBOT obviously has every incentive to consider unsolicited as well as solicited input from its market participants to ensure that the contracts we list and the rules we develop meet their needs and furnish the integrity, efficiency and reliability that they have come to expect from our contract markets. Our decision to establish position limits thus incorporated feedback from a diverse group of market participants, some of which was developed in a carefully controlled and confidential process that reflected the sensitive nature of the topics under discussion.

The decision and the announcement were made in a manner consistent with how other rule amendments are established. The CBOT took care to ensure the integrity and confidentiality of the ultimate decision by the Board of Directors to impose position limits. The announcement itself was made following the close of the e-cbot market on June 29th. As you know, the FIA received a separate e-mail at the time of the announcement, alerting the FIA to the amendment.

The Exchange has noted the FIA's recommendation that a more inclusive process for soliciting feedback and a more extensive plan for notification would have been beneficial. These ideas merit consideration, and the Exchange will certainly examine its process in the context of future actions to ascertain whether the process might be improved while maintaining its integrity.

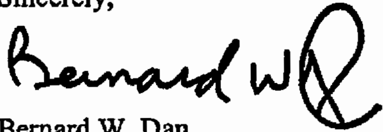
The FIA also questions whether procedures provided for in the Commodity Exchange Act and Commission regulations for self-certification of rules adopted for contracts that have open interest are "appropriate." The Exchange complied with these procedures. Nevertheless, mindful of the concerns about open interest, the CBOT determined to defer implementation for five months, to the December 2005 contract. At the time of the announcement, open interest in the December contract was a small fraction of typical

[1] A copy of these amendments was also filed with the Secretary of the Treasury.

peak contract open interest; in three of the four Treasury contracts the total December 2005 open interest was below the position limit established for any single entity.

We hope that this response has been helpful in clarifying the CBOT's decision.

Sincerely,



Bernard W. Dan
President

Charles P. Carey
Chairman

cc: Honorable Reuben Jeffery III
Honorable Sharon Brown-Hruska
Honorable Walter L. Lukken
Honorable Fred Hatfield
Honorable Michael V. Dunn
Richard A. Shilts
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