KMZ Rosenman
KATTEN MUCHIN ZAVIS ROSENMAN

525 West Monroe Street, Suite 1600
Chicago, IL 60661-3693
312.902.5200 office 312.902.1061 fax

ARTHUR W. HAHN
arthur.hahn@kmzr.com
312.902.5241 direct 312.577.8892 fax

August 13, 2004

Patrick J. McCarty
General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, D.C. 20581

Re: CME Interpretation of Rule 432.D; Submission No. 04-61(a).

Dear Mr. McCarty:

At your request I am writing to supplement my letter to the Commodity Futures Trading Commission ("Commission" or "CFTC") dated July 13, 2004, concerning the above-referenced interpretation to Rule 432.D (the "Interpretation") certified by the Chicago Mercantile Exchange, Inc. ("CME") to the Commission. This letter is written on behalf of LIFFE Administration and Management ("LIFFE"), a recognized investment exchange in the United Kingdom ("UK").

As you know, the Interpretation precludes as a fictitious trade a "prearranged transaction or series of transactions by means of which one or more parties engages in a transaction at CME and reverses that transaction at CME or at another board of trade." According to the Interpretation, lawful prearranged trades, such as block trades permitted by CME Rule 526, cannot be used to facilitate one leg of these "reversal" trades. The CME promulgated the Interpretation in direct response to trades that liquidated a CME Eurodollar strip position using the CME's block trade facility and that established a LIFFE Eurodollar strip position of the same size at the same prices using the LIFFE Basis Trading Facility (a "CME/LIFFE Combination Trade"). Since the issuance of the Interpretation, no CME/LIFFE Combination Trades have taken place.

I. THE INTERPRETATION WAS DESIGNED TO – AND WOULD SUCCEED – IN UNREASONABLY RESTRAINING TRADING AT OTHER EXCHANGES.

The Interpretation bars as fictitious the use of CME's block trade facility for a transaction when that use is related to a transaction employing another exchange's block or basis trade facility. The practical effect of the Interpretation is to eliminate the only commercially feasible means for a trader to convert a large position on the CME to a position on another board of trade. A trader wishing, for example, to gain margin offset opportunities now available at LCH.Clearnet Limited ("LCH")/LIFFE by moving his large Eurodollar position from CME to LIFFE is forced to trade a block size position through the non-block market with the attendant transaction costs and

uncertainties. Confronted with this alternative, the Interpretation essentially locks the positions at the CME.

The timing and narrow application of the Interpretation leave no doubt that the CME intended the Interpretation to eliminate competition from the CME's only competitor for exchange-traded Eurodollar contracts, LIFFE. The Interpretation does not bar transactions where a CME futures position is "reversed" by a cash or OTC position, such as prearranged EBF or EFP transactions. Rather, it is targeted only at other boards of trade, and the only board of trade competing in the relevant market is LIFFE.

This is the exact type of restraint that Section 5(d)(18) of the Commodities Exchange Act (the "Act") was intended to prevent. That section states that "[u]nless necessary or appropriate to achieve the purpose of this Act, [a] board of trade shall endeavor to avoid (A) adopting any rules or taking any actions that result in any unreasonable restraint of trade...." The clear intent of this provision is to preclude boards of trade from abusing their regulatory powers to restrain competition unless justified by a statutory purpose.

No valid statutory purpose is served by the Interpretation. As discussed below, a careful reading of the precedent concerning wash trades and fictitious trades demonstrates that they do not apply to CME/LIFFE Combination Trades. Further, if the CME had good faith concerns that an agreement to re-establish original CME positions in the LIFFE market raises "full information to the market" issues, the solution to the concern is simple: require notification in the CME block transaction report that there is a related LIFFE component.[1] This obvious solution to a possible policy issue was rejected by the CME and instead, the clearly anticompetitive Interpretation was issued.

If the Interpretation is allowed to stand, there will be an unreasonable restraint of trade impacting those market participants who need to use block trading facilities if they need or wish to take advantage of the opportunities provided by the CME's new competitor. Certainly, the CME is not required to affirmatively aid its competitor, but equally it cannot unreasonably use its regulatory powers in a rifle shot fashion to bar its customers from taking their business to a competitor.

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[1] All basis trades on LIFFE are identified as such by the use of a specific trade type indicator.

II. THE INTERPRETATION IS NEITHER NECESSARY NOR APPROPRIATE TO FULFILL THE PURPOSES OF THE ACT.

Given the clear restraint of trade imposed by the Interpretation, the CME, in a proper exercise of its regulatory authority, must show that the Interpretation is necessary or appropriate to fulfill the purposes of the Act. We respectfully submit that the Interpretation is not necessary for the following reasons: (1) a CME/LIFFE Combination Trade is not a wash trade because the necessary element of a wash result is not present; (2) a CME/LIFFE Combination Trade is not fictitious because it does not distort or mislead the relevant market; and (3) the Commission has approved a NYMEX rule, after full opportunity for comment, which contemplates the movement of open interest between exchanges as does a CME/LIFFE Combination Trade.

Moreover, the Interpretation is not appropriate because: (1) the CME allows the same type of prearranged reversal trades to take place between the CME and OTC markets while banning the trades when an exchange competitor is involved; and (2) if there were a good faith concern about the transparency of back-to-back block trades, an appropriate solution would be a requirement to identify the trades rather than banning them.

A. THE INTERPRETATION WAS ISSUED IN DIRECT RESPONSE TO A CME/LIFFE COMBINATION TRADE, WHICH WAS A LEGITIMATE COMMERCIAL TRANSACTION WITH VALID PURPOSES.

Since the promulgation of the CME block trading rule (Rule 526), traders seeking to establish or liquidate large Eurodollar positions on the CME have been able to avoid the potentially costly and market disrupting consequences of putting block size orders into traditional central markets. The block trade is prearranged between the parties, and the price is set by the parties consistent with a fair and reasonable standard.[2] Often these prearranged block transactions are related to the parties' anticipated or existing OTC positions, where the parties can also contemporaneously prearrange a related OTC trade. Indeed, the negotiated prices at which the futures trades take place are often also a function of the parties' cash market considerations, while respecting the rules of the exchange requiring the prices to be fair and reasonable.

The Interpretation was adopted in direct response to a specific block trade entered on the CME pursuant to its Rule 526. In that trade, a customer sold over 36,000 CME Eurodollar contracts

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[2] The determination is made "in light of (i) the size of such Block Transaction, (ii) the prices and sizes of other transactions in the same contract at the relevant time, (iii) and the prices and sizes of transactions in other relevant markets, including without limitation of the underlying cash and futures markets, at the relevant time, and (iv) the circumstances of the parties to such Block Transaction." CME Rule 526.

across seven contract months through the CME's block trading facility and purchased the same amount of contracts, at the same prices, on LIFFE in a basis trade. A non-customer (affiliate) of the customer's clearing firm took the opposite position. The net result of the CME/LIFFE Combination Trade was a reduction of the customer's CME Eurodollar position by over 36,000 contracts and the establishment of a new position in LIFFE Eurodollar contracts. Similarly, the position of the clearing member's non-customer (affiliate) reflected the opposite result at the respective exchanges. [3] Because the contracts are not fungible, the resultant CME and LIFFE positions did not offset each other, and the parties were left with positions that differed from their positions that existed prior to the trades.

The parties' change in position in a CME/LIFFE Combination Trade is not a mere technicality. Unlike a CME Eurodollar contract, a LIFFE Eurodollar contract is cleared on LCH, is subject to UK client money rules, is subject to LIFFE rules regarding final settlement price calculation, is a UK law contract, and is not subject to Section 1256 treatment under the Internal Revenue Code. All of these elements make the CME and LIFFE Eurodollar contracts legally and commercially different to a material extent. The contracts, thus, are not fungible. As more fully discussed below, without formally fungible contracts, a CME/LIFFE Combination Trade does not eliminate positions and does not produce a "wash result."

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[3] LIFFE is aware of three sets of transactions that involve the movement of open interest from the CME to LIFFE employing the exchanges' block or basis trade facilities. Commencing with the beginning of trading in the Eurodollar contract and pursuant to General Notice No: 2397, LIFFE initiated a LIFFE transaction fee holiday for all trades using its block and basis trading facility in Eurodollars. The three transactions that were related to CME trades were included in the general transaction fee waiver. The first of the three transactions occurred on April 6, 2004, and involved 2,000 contracts between two banking institutions. The LIFFE fee waiver value on this transaction was less than $1,000 and there was no CME or LCH fee rebate offered or provided. The second transaction occurred on April 23, 2004, and involved 7,000 contracts between a bank and two market makers. The LIFFE fee waiver value on this transaction was less than $1,000 and there was no CME or LCH fee rebate offered or provided. The third transaction occurred on June 11, 2004, and involved in excess of 36,000 contracts between a bank and a European-managed hedge fund. The aggregate value of the LIFFE transaction fees that were waived pursuant to the general fee holiday was less than $6,500. Additionally, pursuant to LIFFE's General Notice No: 2432 issued on May 26, 2004, LIFFE is reimbursing CME and LCH charges in connection with the transaction pursuant to the following schedule:

(i) CME Member side: 8 cents normal exchange fee + $1 block fee:
(ii) CME Member's client (a Fund) side: 64 cents normal exchange fee + $1 block fee + 3 cents NFA fee.
(iii) LCH Transaction fee: 3 cents per contract.

Additionally, a CME/LIFFE Combination Trade does not mislead the market, does not advance any improper purpose, and has legitimate business purposes. For example, traders - depending on other positions in their portfolio and depending on their comfort and confidence in differing methods of execution, i.e., the CME's GLOBEX and Eurodollar pit versus the LIFFE CONNECT® system - may legitimately desire to have their trades carried at one exchange and its clearing house rather than at another. LIFFE offers a full range of short term interest rate contracts denominated in a number of different currencies. A trader actively engaged in these markets could have operational, capital management and margin efficiency reasons for wanting to place his/her trades on LIFFE. Use of the LIFFE CONNECT® system may also be a legitimate impetus to move positions from the CME to LIFFE, because it offers different functionality, such as implied pricing on butterfly trades, which is not available on other systems. Finally, transacting business on LIFFE may be cheaper than dealing on GLOBEX or in the Eurodollar pit. These are competitive features offered by LIFFE and provide legitimate business reasons for a CME/LIFFE Combination Trade.

B. A CME/LIFFE COMBINATION TRADE IS NOT A WASH SALE, BECAUSE SUCH A TRADE DOES NOT LEAD TO A "WASH RESULT" AND BECAUSE WASH SALE PROHIBITIONS HAVE NEVER BEEN EXTENDED TO TRADES THAT IN FACT DO NOT EXACTLY OFFSET.

The Interpretation refers to certain types of trades being deemed a "fictitious trade" without using the term "wash sale." It is nevertheless necessary to analyze the wash trading cases because the Commission has established that a "fictitious sale" includes a wash sale and because the Interpretation uses the undefined term "reversal," which may suggest wash trading. A CME/LIFFE Combination Trade, however, does not violate the wash sale rule. Thus, the CME cannot contend that the Interpretation is necessary to prohibit a CME/LIFFE Combination Trade for that reason.

The Act does not define a "wash sale," and the case law, in addressing a wide variety of underlying conduct, has not developed a completely unified standard for determining what a wash sale is. The decision is often dependent on the facts and circumstances of the case. However, the courts and the CFTC are perfectly clear on the necessity of one element to establish a wash sale: a "wash result."[4] *See, e.g, In re Harold Collins*, [Transfer Binder] Comm.

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[4] The case law identifies a second necessary element to establish a wash sale, namely the absence of an intent to make a *bona fide* transaction. *In re Gilchrist* 1990-1992 [Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,993 at 37,653. However, the case law discussion and application of that second element is not always consistent and the focus may be on the presence of prearrangement, the exposure to market risk, the purpose of the trading or the intent of the participants. Regardless of the focus of this second element of

Fut. L. Rep. (CCH) ¶ 22, 982 (CFTC April 4, 1986) (discussing all factors); *In re Piasio*, Comm. Fut. L. Rep. (CCH) ¶ 28,276 (CFTC 2000) (focusing on market risk); *In re Gimbel*, [1987 – 1990] Comm. Fut. L. Rep. (CCH) ¶ 24,213 at 35,003 n. 7 (CFTC April. 14, 1988) (focusing on prearrangement and purpose); *In re Elliott*, Comm. Fut. L. Rep. ¶ 27,243 (CFTC Feb. 03 1998) (purpose, prearrangement).

The CFTC and Administrative Law Judges ("ALJ") have repeatedly stated that to show a wash sale, the Division of Enforcement ("Division") must "initially demonstrate that the transaction at issue achieved a wash result." *See, e.g., Piasio,* ¶ 28,276 at 50,685; *In re Gilchrist*, 1990-1992 [Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24, 993 at 37,653 ("While the absence of an intent to make genuine, *bona fide* trading transactions is an essential characteristic of a wash sale, it is not the sole characteristic."); *In re Harmon*, Comm. Fut. L. Rep. (CCH) ¶ 29,660 at 55,831 (CFTC 2004); *In re Garber*, Comm. Fut. L. Rep. (CCH) ¶ 29,573 at 55,648 (CFTC 2003); *In re Janson*, Comm. Fut. L. Rep. ¶ 29,040 at 53,527 (CCH) (CFTC 2002); *In re Roesler*, Comm. Fut. L. Rep. ¶ 29,041 at 53,531 (CFTC 2002).

The cases are also clear about what constitutes a "wash result." There must be "(1) the purchase and sale (2) of the same delivery month of the same futures contract (3) at the same (or a similar) price." *Wilson v. CFTC*, 322 F.3d 555, 559 (8th Cir. 2003); *Gilchrist*, ¶ 24, 993 at 37,653; *Piasio,* ¶ 28, 276 at 50,685. By its own terms, this requirement dictates that wash trades must be trades in "the same futures contract." Thus, for example, in *Piasio*, the Commission made clear that "to establish that a wash sale has occurred, the Division must initially demonstrate that the transaction at issue achieved a wash result." *Piasio* at 50,685. Reviewing the purchases and sales of the identical contracts, the Commission concluded that "the record demonstrates that the challenged transactions achieved a wash result." *Piasio* at 50,686.

Given the requirement that wash sales involve "the same futures contract," it is not surprising that there has never been a case in which the tribunal found a wash sale of futures contracts that were not the identical contract, since there could not be an exactly offsetting result. *See, e.g., Piasio*, ¶ 28,276 at 50,680 (purchase and sale of hard red spring wheat spreads at MGE); *Gimbel*, ¶ 24,213 at 35,003 (purchase and sale of stud lumber futures contracts at CME); *In re Bear Stearns Co.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,994 at 37,663 (CFTC Jan. 25, 1991) (400 ounce gold futures spreads on NYMEX); *Elliott*, ¶ 27,243 at 46,000 (offsetting trades in wheat at CBOT); *Harold Collins*, ¶ 22,982 at 31,898 (offsetting trades in Maine potato futures at NYMEX); *In re Citadel Trading Co.*, [1980-1982 Transfer Binder]

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the test, and regardless of its outcome, the first element – a wash result – must also be found or there cannot be a wash trade. Furthermore, although we do not specifically address this element in the text above, a CME/LIFFE Combination Trade is *bona fide* insofar as it is entered into for the reasons discussed in Section II.A. above.

Comm. Fut. L. Rep. (CCH) ¶ 21,238, at 25,177 (CFTC Aug. 31, 1981) (purchase and sale of same contracts on MACE).

Indeed, even the purchase and sale of contracts for the same commodity on the same exchange but for delivery in different months do not constitute a wash sale. *Wilson*, 322 F.3d at 559 (wash result involves contracts for "the same delivery month"). Similarly, in *In re Gilchrist, supra,* the CFTC examined a trading pattern that involved sets of trades in several different contracts at the same exchange. The Division alleged that the subject trading allocated profits and losses in various commodities to create a "money pass" or a "pay back," allowing the traders to come out roughly even. The ALJ determined that the net result of these trades lacked substance and concluded they were a wash sale. On appeal, the Commission overruled the ALJ, finding that the financial nullity was not the result of transactions in the same futures contract and, therefore, the transactions did not constitute a wash trade.

The "wash result" requirement also has been recently applied in the context of physical commodities traded in bilateral agreements. In *In re Knauth*, Comm. Fut. L. Rep. (CCH) ¶ 29,762 (CFTC May 10, 2004), for example, an energy contracts trader and a counterparty agreed to trade with each other on an electronic trading platform and to immediately execute an equal and opposite trade via the telephone "at the same price, for the same quantity, for the same delivery point and delivery term." *Id.* at 56,197. Since the two trades, which were each completed in bilateral agreements, exactly offset each other, they were "noncompetitive trades and were engaged in to produce, and did produce, a financial nullity." *Id.* at 56,198. Although the two trades appeared to be executed in two "markets" (*i.e.*, by means of an electronic platform and a private conversation) they were each bilateral agreements between the same parties with exactly the same terms that completely offset each other, resulting in a nullity. As such, they were determined to be illegal wash sales.

This definitive "wash result" test is an appropriate method of distinguishing fictitious trades from *bona fide* trades, because the result of a simultaneous or near simultaneous purchase and sale of the same contract on the same exchange with the same clearing house at the same price or nearly the same price produces an economic result that is unambiguously without substance. There is no basis for extending that assumption of a financial nullity to contracts that do not offset and that trade in different marketplaces with different clearing houses. Such an extension would be reaching into "new territory" and is not necessary to prevent any identified abuse. Trades in the same contract result in no change in the trader's position; trades in different contracts at different exchanges and clearing houses necessarily result in new and different positions subject to different rules, liquidity, risk, pricing and trading mechanisms. In a CME/LIFFE Combination Trade, the parties end up owning a new and different CME position and a new and different

LIFFE position than existed before the trade. As such, a CME/LIFFE Combination Trade does not produce a "wash result," is not a wash sale, and is not prohibited by the Act.

C. A CME/LIFFE COMBINATION TRADE IS NOT OTHERWISE "FICTITIOUS" BECAUSE IT DOES NOT MISLEAD OR DISTORT THE MARKET.

The CME may separately attempt to justify its Interpretation as an appropriate extension of Section 4c(a)'s general prohibition of a "fictitious sale." The guidance regarding fictitious trades does not include a bright line test. Nevertheless, the loosely defined prohibition on fictitious trades, which was developed in a time period before the advent of permissible, prearranged block trades, does not apply to a CME/LIFFE Combination Trade. There is nothing fictitious about a CME/LIFFE Combination Trade and the CME should not be allowed to prohibit it through implementation of the Interpretation.

The Act does not define fictitious sales, and the Commission and courts have provided little clarity to the concept. To provide some framework of analysis, though, the Commission has stated that the term "fictitious sale" is a general category which includes, at a minimum, the unlawful practices specifically enumerated in Section 4c(a), such as "wash trading," which has been previously discussed. *In re Thomas Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,194 at 45,742 (CFTC Dec. 10, 1997) ("*Collins II*"). The CFTC has also identified the broad category's "central characteristic," which is "the use of trading techniques that give the appearance of submitting trades to the open market while negating the risk or price competition incident to such a market." *Harold Collins*, ¶ 22,982 at 31,902. Further case law exposition has concluded that the definition of "fictitious sales" includes "those sales purportedly executed on an exchange which distort and/or mislead the commodity markets and their participants." *In re Thomas Collins, et al.*, Comm. Fut. L. Rep. (CCH) ¶ 26,981 at 45,742 (CFTC March 5, 1997) ("*Collins I*").

These attempts to define "fictitious sales," outside of the wash trade context, were developed before prearranged block futures were allowed and they were designed to protect the integrity of a central market with only one way to execute trades, namely the open outcry system. To be applicable to the modern block trade-inclusive market which embraces privately negotiated non-competitive transactions, the focus must be on whether CME/LIFFE Combination Trades distort or mislead the wider, integrated market so as to render the trades fictitious. To answer that question, it is appropriate to analyze what participants in the market understand when a block trade is reported and whether that understanding is materially different in the instance of a CME/LIFFE Combination Trade.

If a CME Eurodollar block transaction additionally involves a prearranged "reversal" of CME positions into the OTC market, CME market participants would see that a block trade was executed on the CME but they would not be made aware of the related OTC component. They understand, however, that the block transaction took place between large, sophisticated market participants, and that the price they agreed upon could legitimately have been a function of related cash market transactions of which they are not informed. The exact same quality of information is available from the CME in a CME/LIFFE Combination Trade when a CME block transaction is reported with an undisclosed, related LIFFE Eurodollar exchange for futures block trade. Just as the existence of an undisclosed OTC "reversing block trade" does not mislead participants in the integrated market, a CME/LIFFE Combination Trade equally does not mislead that market. Market participants understand that reported prices in the block market may be a function of the cash market needs of the parties to the privately negotiated trade as opposed to a function of the price discovery process arising from the pure market forces inherent in open outcry pit trading.

Simply stated, market participants do not receive or expect to receive disclosure of transactions conducted in other cash, OTC or futures markets that are related to block trades. The absence of such disclosure certainly does not make such block trades fictitious. Furthermore, even though CME/LIFFE Combination Trades are not fictitious, if the CME was concerned about additional clarity in the block trade market, their concern could be resolved by simply requiring disclosure of the related trade as they have chosen to do with EFP transactions. For either reason, the existing Interpretation should not be allowed to stand.

D. A CME/LIFFE COMBINATION TRADE CANNOT BE DEEMED "FICTITIOUS" BECAUSE THE CFTC HAS PREVIOUSLY APPROVED A RULE AT THE NYMEX WHICH ALLOWS FOR THE SAME TYPE OF TRANSACTION.

Precluding enforcement of the Interpretation would also be consistent with prior CFTC rulemaking approvals. As you know, the Commission previously approved NYMEX Rule 6.21D, permitting Exchange of Futures for Futures ("EFF") transactions. In these transactions, qualified market participants could, for example, liquidate a position in Brent Crude Oil futures on another exchange and establish through a prearranged non-competitive EFF transaction a position in Brent Crude Oil on NYMEX. The price of that trade could, by agreement, exactly match the price of the futures trade on the other exchange. The CFTC sought comment on whether this rule would enhance competition between exchanges, affect price discovery on either exchange, or create an incentive to engage in improper practices. *In re New York Mercantile Exchange, Inc. Petition*, CFTC Request for Comment, 67 Fed. Reg. 41698 (June 19, 2002). That rule-making procedure addressed the same issues now raised by the Interpretation. Following

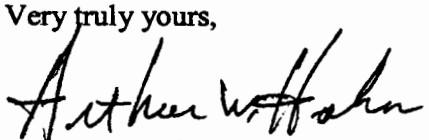
the comment period, the CFTC approved the rule. Although that rule was subsequently not put to use by NYMEX and does not bind the Commission in this matter, it is a strong indication that the type of trades at issue here are not prohibited by the Act.

III. CONCLUSION.

There is nothing "fictitious" about the trades that are the subject of this debate. They are not wash trades, they do not mislead or distort in the context of the block market, and they are done for a valid economic purpose. Far from being improper, such transactions foster the type of competition that leads to innovation and efficiency that significantly benefits market users. The fact that the legs of a CME/LIFFE Combination Trade are legally prearranged does not change the essential *bona fides* of the transaction. The Commission has specifically permitted contract markets to adopt rules permitting noncompetitively executed transactions in the form of EFPs, EFSs, EOOs, EFFs, block trades and pre-execution communications; the CME has adopted rules permitting block trades, EFPs, EFSs and pre-negotiated GLOBEX transactions; and, most notably, the CFTC approved NYMEX Rule 6.21D which contemplated moving open interest between exchanges pursuant to an exchange of futures for futures trade.

The issue presented in this matter is a narrow one: Under existing law, may an exchange self-certify a rule interpretation that is palpably anticompetitive where, upon analysis, there is no persuasive support for the assertion that the interpretation is necessary or appropriate to further the purposes of the Act? We submit that the Interpretation, in its current form, should not be afforded the privilege of self-certification.

Very truly yours,



Arthur W. Hahn

AWH:cal60298025v.7

cc: Mr. Nicholas Carew-Hunt, LIFFE
Mr. John Foyle, LIFFE
Ms. Verena Ross, FSA
Mr. Craig Donohue, CME