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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:

I write, on behalf of LIFFE Administration and Management ("LIFFE"), to reply to the September 17, 2004, letter ("CME Response") submitted by Chicago Mercantile Exchange ("CME") to the Commission in response to my August 13, 2004, letter ("LIFFE Letter") to the Commission.

I. Introduction.

The question before the Commission is the limited issue of whether CME Interpretation of Rule 432.D ("the Interpretation"), which was self-certified by CME, should stand. The Interpretation improperly restricts market participants from efficiently liquidating an open position on one exchange and simultaneously re-establishing a similar position on another exchange. As the LIFFE Letter argues, the Interpretation is impermissible because it violates Core Principle 18 of the Commodity Exchange Act ("the Act"). Core Principle 18 requires that the Interpretation either (i) be necessary or appropriate to achieve the purposes of the Act or (ii) not result in an unreasonable restraint of trade. The Interpretation fails both prongs of this test.

First, the Interpretation does not advance the Act's purpose of precluding wash sales, as claimed by the CME. The transactions that the Interpretation prohibits are executed on different exchanges, in contracts that are not fungible and do not offset. These trades are not wash sales because, as the LIFFE Letter explains, Commission precedent, including the recent energy cases,[1] limits application of the wash sale prohibition to offsetting trades in fungible contracts that result in a financial nullity. CME does not and cannot dispute this principle, and it makes no argument that the trades at which the Interpretation is aimed violate this bright-line rule. Instead,

[1] The "energy cases" include *In the Matter of Byron G. Biggs*, CFTC Docket No. 04-22; *In the Matter of Joseph B. Knauth, Jr.*, CFTC Docket No. 04-15.

CME ignores this critical distinction and argues that these trades are prohibited by the energy cases, which were negotiated settlements in cases where offsetting trades in physical commodities produced no change in position. As described more fully below, CME's argument fails.

Second, the Interpretation is plainly an unreasonable restraint of trade. CME fails to meaningfully address this issue and instead argues that nothing in the antitrust laws requires CME to aid LIFFE. That point is agreed upon, and LIFFE seeks no affirmative assistance from CME or the Commission. Instead, LIFFE contends that CME cannot, absent a purpose that advances the Act, selectively use its rulemaking authority to insulate itself from competition by precluding the only commercially viable means of closing large positions on the CME and opening similar positions on LIFFE (or any other exchange). Far from seeking to impose an obligation on CME to aid anyone, LIFFE asks only that customers be allowed to choose where to trade, uninhibited by the attempts of CME to lock positions into its exchange.[2]

The CME Response attempts to deflect scrutiny from its conduct by focusing on what CME perceives to be LIFFE's ulterior motives and broader agenda. To this end, CME erroneously contends that this dispute is not about the freedom of individual market participants to choose an exchange, but instead "is about freedom to clear and to free-ride" on CME systems. The CME Response further mischaracterizes the issue by suggesting that LIFFE is not attacking just a single, anticompetitive rule, but that LIFFE's "obvious goal" is to "secure the Commission's assistance to revamp the structure of the futures markets." The CME Response at one point attempts to describe LIFFE's position as follows: "[LIFFE is] asking the Commission to force CME to permit the transfer to LCH of open interest...." But no broader agenda is at issue and the Commission should not force the CME to do anything. In fact, LIFFE seeks only to prohibit the CME from restraining its customers from executing block trades at the CME that are otherwise fully consistent with CME rules and the Act simply because those trades are related to other trades executed at a competing exchange. By creating that prohibition, the Interpretation is at

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[2] The CME Response implies that LIFFE paid "Mr. Hahn's FCM client" $100,000 to engage in the trade in question. In fact, the FCM received nothing. A non-brokerage affiliate of the FCM was a principal party to the transaction and was reimbursed costs of approximately $40,000; a non-US hedge fund, also a party to the transaction, was reimbursed costs of approximately $60,000. No market participant would liquidate and reestablish a 36,000 contract position simply because the out-of-pocket expense of the trades was reimbursed. Rather, neutralizing transaction costs allowed other competitive factors, such as capital and operational efficiencies, to affect the decision. This is appropriate competition.

odds with Core Principal 18. In this circumstance, where the CME uses its power to self-certify rules to combat a competitive threat, LIFFE believes the Commission must intervene.

II. The self-certified Interpretation was a strategic, competitive response aimed at trades that liquidate open positions at CME and establish positions at LIFFE, not a legitimate attempt to achieve a purpose of the Act.

On June 11, 2004, a customer at CME sold a "strip" position[3] comprised of approximately 36,000 CME Eurodollar contracts at the CME utilizing the CME's block trading facility. The same customer opened a "strip" of 36,000 LIFFE Eurodollar contracts, using LIFFE's basis trade facility. Both trades were prearranged/pre-negotiated, as permitted by the rules of each exchange. CME immediately objected to the trades which effectively moved that customer's open interest to a competing exchange. Several weeks later, CME issued the Interpretation.

CME, apparently, denies that it issued the Interpretation in response to the competitive threat posed by LIFFE. That protest rings hollow, however, as the CME, without denying the competitive impact of the Interpretation, argues at great length that any competitive impact is acceptable because CME has no affirmative duty to aid its competitors by forgoing restraints on the liquidation of CME positions. Instead, CME tells an unlikely story about how it only recently realized that the multiple listing of futures contracts had modified the landscape of futures trading and that it was "inspired" to issue the Interpretation not by the manifestation of a competitive threat from LIFFE, but by several recent CFTC enforcement cases. Notably, the Interpretation does not prohibit closing a CME position and the effective reversal of that position in the OTC market via a block trade or EFP. The failure to include OTC instruments, which are similar or nearly identical in market risk exposure (e.g., an FRA settling to the BBA three-month Eurodollar LIBOR fixing on a so-called IMM date) is another signal that this Interpretation is driven by commercial rather than regulatory considerations. The Interpretation singles out only reversals that occur on other boards of trade.

CME's true motive is unambiguous. The Interpretation is aimed at trades by CME's customers that close positions on the CME and open similar positions on other exchanges.

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[3] Transactions in respect of the Eurodollar contract are particularly relevant because, unlike other contracts such as bond and stock index based instruments, a typical user's open interest is spread over many delivery months. Liquidating and reestablishing such positions through the open market therefore imposes substantially greater costs and risks.

III. Because the trades at which the Interpretation is aimed are not in fungible contracts, they do not produce a wash result and cannot be wash sales under any CFTC precedent.

As described in the LIFFE Letter, the trades in a Combination Trade are not wash trades because they do not produce a wash result. CFTC authority, confirmed by the recent energy cases, appropriately establishes that a wash result is essential to finding a wash trade. Because a Combination Trade involves trading in two different and separate futures contracts and results in changes to two different futures positions that do not offset, there is no wash result and, thus, no wash sale.

CME does not attempt to respond to this argument. Instead, it chooses to contest arguments that LIFFE has not advanced. First, CME wrongly states that it is LIFFE's position that "bad motive" is required for there to be a wash trade. LIFFE did not make this claim. The controlling case law, which LIFFE acknowledges, is clear that a wash sale does not require bad intent. Although a Combination Trade has a legitimate business purpose, LIFFE does not maintain that such a purpose would legitimatize an otherwise improper wash trade.

Second, CME wrongly claims that LIFFE argues that there cannot be wash trading across different trading platforms. LIFFE made no such claim and, as in the energy cases cited by CME, there indeed can be wash trades in fungible commodities traded across different platforms. Lacking any other authority, the CME necessarily attempts to convert the energy cases, which involve different platforms, into a precedent for this case, which involves different marketplaces and contracts. But as described in the LIFFE Letter, the energy cases only serve to confirm the importance and necessity of a wash result. The trading in the energy cases could be described as wash sales because the traders, while entering trades in separate off-exchange platforms, were trading between the same counterparties in identical contracts for cash commodities with "the same price, for the same quantity, for the same delivery point and delivery term." *In re Knauth*, Comm. Fut. L. Rep. (CCH) ¶ 29,762 (CFTC May 10, 2004). The two trades offset each other perfectly, leaving the participants with no obligation to each other under either contract. By contrast, the Eurodollar trades in a Combination Trade do not offset. Far from canceling each other out, the trades result in two changed positions in two distinct marketplaces. CME does not and cannot respond to this distinction.[4]

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[4] The CME does not mention the wash result requirement until the final paragraph of its twelve-page letter, where it does so only to misdescribe a wash result as "a buy and sell without incurring market risk." Although market risk is relevant to other portions of the wash sale test, it does not affect the requirement that there be a wash result. CME's attempt to blur the amorphous concept of market risk into the clear standard for a wash result is

CME fails to cite any authority refuting LIFFE's contention that there is no wash trade without a wash result or a single case finding a wash sale that ended with open positions. The importance of this requirement is demonstrated by the proceedings in *In re Gilchrist*. In *Gilchrist,* the Administrative Law Judge determined that prearranged transactions structured to achieve a profit for one trader and losses for others through prearranged trades in futures on different commodities were wash trades because they left the parties with little or no economic risk. On review, the Commission reversed the Initial Decision, concluding that, although the trades were improper for other reasons, there was no wash trade because there was no wash result, *i.e.*, the traders' positions in distinct commodities remained, even if the economic risk of obtaining those positions had been eliminated by the prearranged deal.

IV. Because the Interpretation precludes competition, has no pro-competitive justification, and improperly serves to maintain the CME monopoly, it violates Core Principle 18 and the antitrust laws.

Congress understood that the Act's grant of self-regulatory authority armed exchanges with a potentially powerful anticompetitive weapon. Core Principle 18 was intended to minimize anticompetitive abuses of rulemaking power by precluding rules that would result in an unreasonable restraint of trade, unless "necessary or appropriate to achieve the purposes of the Act." Through this language, Congress barred rules and actions that would restrain competition under the false pretense of self-regulation.[5] Predatory abuses of the exchange's rulemaking authority, such as the Interpretation, fly in the face of Core Principle 18 and require a Commission response if the Core Principle is to have any meaning in this era of self-certification by self regulatory organizations that operate as for-profit entities.

The Interpretation imposes an unreasonable restraint of trade.[6] As the CME Response asserts and as the LIFFE Letter acknowledges, the antitrust laws normally do not require CME to

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unsupported by the body of law addressing wash sales, which requires the purchase and sale of "the same futures contract." The presence or absence of market risk is an entirely separate inquiry.

[5] Unlike Section 1 of the Sherman Act, which bars *contracts, combinations and conspiracies* in restraint of trade, Core Principle 18 expressly applies to *unilateral* rulemaking and actions by exchanges that result in "any unreasonable restraint of trade." Thus, by its title ("Antitrust Considerations") and its terms, Core Principle 18 captures predatory and exclusionary conduct in restraint of trade that would constitute unlawful monopolization or attempted monopolization under Section 2 of the Sherman Act.

[6] CME accuses LIFFE of misreading Core Principle 18 to preclude actions that unreasonably restrain trading rather than actions that constitute an unreasonable restraint of trade. While one of the headings in the LIFFE Letter

"affirmatively aid its competition." However, the antitrust laws unequivocally prevent a dominant firm from engaging in predatory or exclusionary conduct that precludes competition without an overriding, pro-competitive justification. Indeed, it is axiomatic that "the use of monopoly power, however lawfully acquired, to...gain a competitive advantage...is unlawful." *United States v. Griffith,* 334 U.S. 100, 107 (1948).[7] Simply put, a firm runs afoul of the antitrust laws when it refuses to compete "on the merits" and instead engages in exclusionary conduct "that reasonably appear(s) capable of making a significant contribution to creating or maintaining monopoly power." *See,* 3 III Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law, ¶ 651f (2d ed. 2002).

Rather than compete on the merits after LIFFE announced its entry into the exchange-traded Eurodollar market ("the Market") and customers began to use Combination Trades to liquidate CME positions and establish similar positions on LIFFE, CME issued the Interpretation to lock in positions and preclude the competition posed by Combination Trades. A monopolist's change in policy or practice to squelch a competitive threat without an overriding business justification has been condemned time and again under the antitrust laws.[8/] This is exactly the type of predatory conduct that the Interpretation -- which does not advance the Act's purpose of prohibiting wash trades -- represents.

CME's assertion that the Interpretation imparts no competitive harm makes short shrift of the very real injuries that consumers will suffer if the Interpretation is allowed to stand. As the LIFFE Letter establishes, the Interpretation eliminates the only cost-effective means of liquidating a large Eurodollar position on the CME and establishing a similar position on LIFFE. Although a trader might liquidate a strip position on CME through an open outcry transaction and purchase a comparable position on LIFFE, the market risks and costs of large open-market

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used the "unreasonably restraining trading" phraseology, the text of the LIFFE Letter explained that the restraint on trading imposed by the Interpretation results in an unreasonable restraint of trade.

[7] *See also, United States v. Grinnell Corp.*, 348 U.S. 563 (1966) ("the willful acquisition or maintenance of [monopoly] power as distinguished from growth or development as a consequence of a superior product, business acumen or historic accident" by a monopolist is unlawful); *United States v. Microsoft Co.*, 253 F.3d 34 (2001) (same).

[8/] *See, Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585* (dominant competitor's change in prior practice of joint marketing of ski passes with purpose and effect of harming small competitor held to be antitrust violation); *Eastman Kodak Co. v. Image Technical Servs.*, 504 U.S. 45 (1992) (change of policy requiring use of Kodak service and parts *after* its customers were locked into Kodak copiers violated the antitrust laws); *C. R. Bard, Inc. v. M3 Systems, Inc.*, 157 F. 3d 1340 (D.C. Cir. 1998) (monopolist that revised biopsy gun design to exclude competing replacement needles without any product improvement engaged in unlawful predatory conduct); *Microsoft,* 253 F. 3d at 61-62 (Microsoft's revision of license restrictions to bar OEM from promoting rival browsers in boot sequence held to be anticompetitive).

transactions make such a transaction impracticable.[9] Thus, the Interpretation increases conversion costs so significantly that conversion is no longer a viable option.

While this specific competitive harm alone warrants the Commission's intervention, the Interpretation's ultimate potential harm to competition is even more nefarious and far-reaching. LIFFE is a nascent challenger in the Market, which CME previously had to itself. Before LIFFE disturbed CME's monopoly, over 80% of CME trades were executed through high-cost pit trading. With a lock on the Market, CME did not need to increase efficiency or reduce fees to attract customers until LIFFE announced entry into the Market, with 100% electronic trading. Shortly thereafter, CME implemented a number of initiatives to move Eurodollar transactions to an electronic platform, reducing the customer's total cost of executing trades. The CME now executes over 65% of all Eurodollar trades electronically and the cost of trading is significantly less than what it was before LIFFE entered the Market.

Although consumers are better off as a result of LIFFE's entry into the marketplace, LIFFE's position remains precarious. LIFFE's competitive survival in the Market depends, in part, on its ability to compete for the open interest that currently resides at CME. LIFFE is more than willing to compete for this business on the merits. However, every roadblock to fair and open competition, including the Interpretation, jeopardizes LIFFE's viability in the Market and threatens to deprive customers of the competitive benefits that LIFFE's presence in the market promises in the future.

V. Conclusion.

The CME Response is correct that recent changes in the regulation of futures and the proliferation of marketplaces has changed the landscape of futures trading. Those charges have generated new competitive forces, which have led to considerably lower costs for market participants and significant advances in market access through the use of innovative technology. For these advances to continue in an age of self-regulation, the Commission does not need to force the CME to take any action. But if the self-regulatory and Commission oversight

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[9] There is no factual basis for – and considerable reason to be skeptical of – CME's claim that there is "sufficient liquidity on GLOBEX and in the CME's pits to trade out of the position at genuine market prices better than the block price. . ." Furthermore, it is not helpful to suggest that a non-proprietary account holder seeking cross-margining of positions executed at LIFFE and the CME can ask to CME to "expand the scope of the program." The CME's attempt to describe these "real choices" fails. By foreclosing Combination Trades, the Interpretation deprives CME customers of the potential competitive benefits associated with holding a LIFFE position cleared at LCH, including more efficient use of capital and management of positions.

framework envisioned by the Act is to remain robust, LIFFE believes the Commission must act to prevent the CME from improperly using its power to self-certify rules.

Very truly yours,

Arthur W. Hahn

AWH:cal60312224

cc: Mr. John Foyle, LIFFE
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