FREEMAN, FREEMAN & SALZMAN, P.C.
ATTORNEYS AT LAW
SUITE 3200
401 NORTH MICHIGAN AVENUE
CHICAGO, ILLINOIS 60611-4207

TELECOPIER
(312) 822-0870

TELEPHONE
(312) 222-5100

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Mr. Richard Shilts
Acting Director, Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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Re: Questions for CME Regarding CME's Interpretation of Rule 432.D

Dear Rick:

Chicago Mercantile Exchange Inc. ("CME") appreciates the opportunity to clarify the basis for its recent interpretation of its long-standing rule prohibiting fictitious trading. Our review of the questions suggests that CFTC staff may have conflated CME's contentions respecting the standards for judging whether its rule interpretation constituted an unreasonable restraint of trade under the antitrust laws and CME's justification for issuing the interpretation. Following, we have set forth the questions in full and our answers.

1. **Would CME Fictitious Trade Interpretation apply to EFPs, EFSs or OTC transactions? If not, please explain the rationale for prohibiting the use of block trades to move a position to another exchange, but not prohibiting the use of similar pre-arranged transactions for the EFPs, EFSs and OTC.**

The Interpretation directly deals with this question, as noted in the bolded language:

RULE 432.D. – INTERPRETATION
CME Rule 432.D. prohibits fictitious trades. A fictitious trade includes 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. CME facilities that permit prearrangement of trades ***(Rule 526 – Block Transactions; Rule 538 – Transfer Of Spot For Futures; and Rule 539.C. – Pre-Execution Discussions Regarding GLOBEX Trades)*** may not be used to facilitate a fictitious trade as defined above. (Emphasis supplied)

CME's interpretation, like most interpretations, was designed to give guidance to market participants on a particular application of the rule. The interpretation was not intended to replace the rule or in any way to limit the application of the rule. CME reserves the right to apply its rules in other contexts to preclude fictitious trading regardless of the trading permutations that may be invented to avoid the rule.

With particular reference to your question, the interpretation applies to all forms of prearranged wash trades. If prearranged, matching EFP transactions were used to establish and liquidate a futures position, without incurring market risk, CME's prohibition on fictitious trading would be violated. If the entire futures portion of the matched transaction were cleared at CME, Rule 432.D. clearly covers the conduct. If the paired transaction were split between two exchanges, the interpretation confirms that Rule 432.D. applies. CME's rules may not govern transactions that take place in the OTC market if a futures position is not involved. The circumstances of the particular incidence of fictitious trading and the impact on the futures markets need to be assessed.

2. **Do you believe there are any differences between the CME Eurodollar futures contract and the LIFFE Eurodollar futures contract with regard to their terms and conditions or other matters not related to the terms? Does the LIFFE combination rule suggest that these contracts are economically equivalent?**

There is no substantive difference between CME's and LIFFE's contracts. As evidence of the lack of difference, we have noted that, at the time of the transaction in question, LIFFE appeared to be directly copying CME's settlement prices to assure that even the settlements were identical.

3. **CME argues that block traders, which are the subject of the interpretation, are benefiting from CME's price discovery function by initially establishing positions on CME and subsequently moving them to LIFFE. What free-rider problem does CME's Interpretation directly address? How often do such problems occur? Can CME provide any empirical evidence for its argument?**

CME's interpretation does not directly or indirectly address the free-riding problem. CME's explanations of the purpose of its interpretation do not include any statement that could be construed as suggesting that the purpose of the interpretation was to preclude free-riding. Reference to the free-riding issue was included in prior correspondence in support of CME's explanation of LIFFE's motives for paying for the transaction and to demonstrate that CME's action was not an unreasonable restraint of trade. The purpose of CME's interpretation, which is to prevent fictitious trades, is clearly stated in CME's prior correspondence with the Commission, which states:

> "This interpretation was adopted to clarify the misapprehension of certain attorneys that a wash trade, as defined by the CFTC and the CME, did not include transactions that made use of the facilities of more than one board of trade. This interpretation is intended to alert market users that CME's prohibition against fictitious trading may not be avoided by reversing the transaction on a different board of trade."

CME's interpretation is aimed at preventing avoidance of its wash trading prohibition by means of splitting the prearranged trade between two exchanges. The potential for inter-exchange wash trading is relatively new and, to the best of CME's knowledge, the problem had not previously been detected.

4. **If two parties prearranged two offsetting block trades on CME that left them in the same or a similar position as they were in before the trades, would CME prosecute this as wash trading? Has CME in fact brought any disciplinary cases involving wash trading by means of block trades?**

CME would prosecute such conduct as a wash trade. Indeed, engaging in such a transaction on a single exchange by use of block trades is easily detected, and we are not aware of such transactions taking place..

5. **In its September 17, 2004 letter, CME contended that in determining whether or not wash trading activity has occurred, judicial and Commission precedent do not require a finding of customer or market harm. Notwithstanding this interpretation, please address what, if any, specific customer or market harm could result from a LIFFE combination trade if the CME portion of the transaction were carried out in conformance with the block trading requirements of CME Rule 526. In responding to this question, please address the following points:**

   Would the price of such a transaction ever mislead or have an adverse impact on the market given that: (a) CME block trades are required to be "fair and reasonable" under CME Rule 526.D; and (b) block trade prices are commonly understood to be ignored or heavily discounted by the market?

We strongly disagree with your premise that block trade prices are commonly understood to be ignored or heavily discounted by the market. The price of a block trade is as significant a signal to the market as the price of a transaction in the pit or on the screen. It signals that two informed parties, in an arms' length transaction, agreed that price X was fair. It also signals that a major transaction has taken place. However, where the block is fictitious, in the sense that neither party is taking market risk, the signals are false.

If the parties to the fictitious trade select a "fair" price, the trade remains misleading. Without any financial consequence to themselves, "fair" represents a range, not a point. Where the parties are free to set the price within the range, the market is given a false signal. When no large volume "transaction" has actually taken place, the market is deceived.

Do these combination transactions artificially under- or over-state volume and/or open interest at CME, given that the alternative of executing them as separate, independent CME and LIFFE transactions would presumably have the same impact on volume and open interest levels at CME?

The transaction in question was not a real transaction: it was a device paid for by LIFFE to move open interest to LCH to create the appearance that LIFFE was a viable market and LCH was a viable clearing platform for Eurodollar futures contracts. LIFFE itself has informed the Commission that the transaction in question would not have been executed as "separate, independent CME and LIFFE transactions." The transaction overstated volume at both exchanges. LIFFE has a significant interest in creating the appearance of volume as many traders will not use an exchange until certain open interest and volume thresholds are met.

In providing examples of adverse customer or market harm resulting from these combination transactions, please explain why the harm is unique to these transactions and not simply a result of a pre-arranged block trade otherwise permitted under CME's rules.

A legitimate block trade produces genuine information respecting the demand for a transaction at a particular price between two well informed market participants. The Commission is aware of the strong push by market participants to force information about large blocks into the public domain as quickly as possible after the block occurs. This is a very clear statement from the market that such information is valuable and that the parties who withhold the information are gaining an advantage. Where the block is a sham that is agreed to be unwound with no market risk to one or both of the participants, the pricing and the size signals sent to other market participants is false. This notion underlies the CEA's long-standing ban against wash trading and provides the basis for the Commission's recent successful prosecutions in the energy market.

6. **Section 5(d)(18) of the Commodity Exchange Act (Core Principle 18—Antitrust Considerations) states that unless necessary to achieve the purposes of the CEA, a board of trade shall endeavor to avoid adopting any rules or taking any actions that result in any unreasonable restraint of trade. LIFFE in its letter of August 13, 2004 argues that the CME Interpretation is an unreasonable restraint of trade that bars CME's customers from taking their business to a competitor. Knowing the relevant antitrust market is relevant in determining whether an action is a restraint of trade. In this regard, what do you believe is the relevant antitrust market that includes**

CME's Eurodollar futures contract? Does CME have market power in this market?

The relevant market includes other short term interest rate futures contracts and other instruments, including a plethora of OTC instruments, which permit CME's customers to hedge or speculate on changes in short term interest rates. As clearly shown in the attachments to our previous letters, everyone, including the FIA, agree that the relevant market is far broader than Eurodollar futures contracts. For example, a two year note at CBOT is the equivalent of a two year bundle at CME. The history of substitution and cross selling is a clear indication of the scope of the relevant market. CME lacks market power in a properly defined market.

7. **Can CME point to a "duty to deal" antitrust case that did not involve a (desired) contract between the two relevant parties? Specifically, can CME identify a "duty to deal" antitrust decision that involved an "implicit" relationship similar to the one it asserts exists between CME and LIFFE?**

We may not understand this question. LIFFE has not suggested that this is a "duty to deal" case. CME is "dealing" with LCH and permitting cross margining of its Eurodollar contract against Euribor contracts cleared by LCH. LCH has not asked for any expansion of that program. It is noteworthy that CME does not prohibit block trades that are used to move positions. CME's rule against fictitious trading does not preclude a customer from doing one block to liquidate a position at CME and another, independently negotiated block to establish an identical position at LCH.

As best we understand LIFFE's objection to CME's Interpretation, LIFFE demands that CME permit prearranged, paired purchase and sales transactions, which CME would otherwise characterize as fictitious trades, if those transactions are beneficial to a competitor seeking to make inroads on a portion of CME's business. In effect, LIFFE is asserting that a firm violates the antitrust laws when it operates its business in a manner that is not most favorable to competitors. Looking past its rhetoric, LIFFE's position is equivalent to asserting that the antitrust laws require every successful firm to help competitors get a foothold in the industry. Presumably Merrill Lynch has a duty to turn over its customer lists and to transfer customer positions to a newcomer to help it get started. It is black letter antitrust law in the United States that even a monopolist has no duty to conduct its business in a manner that would benefit a competitor. If you are asking whether there are any antitrust cases that hold that a monopolist firm has no duty to conduct its business in a manner that would benefit a competitor, the answer is "Yes." But CME is far from a monopolist or even a dominant firm in the relevant market.

8. **In your September 17, 2004 letter, you state that LIFFE routinely infringes on CME's copyrighted settlement prices. Is CME's Interpretation meant to protect its copyright? If so, how does the Interpretation protect the copyright, and can CME protect its copyright through court proceedings, rather than through its Interpretation?**

The Interpretation was not issued to protect CME's copyright. CME's reference to LIFFE's systematic infringement in our prior letter was in support of CME's contention that the LIFFE contract was identical to the CME contract. Towards this end, LIFFE went so far as to infringe CME's copyrighted settlement prices in order to insure that the two markets move in lock step.

9. **In your letter dated September 17, 2004, you asserted that "CME has chosen a common business model: it sells execution and clearing as a block." How did the combination trades allow LIFFE's customers to avoid CME clearing charges? Is pre-arrangement necessary to avoid CME's clearing charges? Finally, can CME avoid this problem by adjusting the relative prices of execution and clearing?**

CME's Interpretation is focused on preventing wash trading, not on impairing any customer's right to trade on LIFFE. Nothing in CME's rules in any way constrains a customer's choice of trading venue.

10. **Your letter to the CFTC suggests that the same benefits could be obtained if LIFFE expanded the existing cross-margining agreement between the two exchanges to non-proprietary customers. With respect to that agreement:**

CME's letter specifically states: "A large majority of the traders who "hold large Eurodollar" positions at CME and who seek to gain margin offset opportunities between CME and LCH's Euribor may do so directly. A cross-margining agreement is in place between the two clearing organizations; it has been effective for many years and is currently being used by a number of firms." CME referenced certain large traders who are classified as firm accounts and who wish to offset CME Eurodollar positions against LCH Euribor.

When was the agreement entered into, and what contracts does it cover? What institutions and proprietary customers currently take advantage of the agreement?

CME entered into the LCH cross margining agreement in April 2000. The agreement covers cross-margining of proprietary and non-customer activity – house origin activity – of joint and related clearing members across the two markets. The products included are currently limited to CME Eurodollar futures and options on futures and LIFFE Euribor futures and options on

futures. CME considers the identity of the users of the system to be confidential information and will supply it under separate cover if the Commission requests.

What benefits does the agreement provide for a customer holding Eurodollar positions executed on CME and cleared there, and simultaneously holding comparable contracts executed on LIFFE and cleared through LCH? Would CME be interested in having the CFTC approve expansion of this arrangement to cover retail customers?

As noted above, the cross margining arrangement does not apply to customers subject to segregation. There are also no cross-margining benefits for anyone holding a LIFFE Eurodollar position as those products are not covered by the agreement.

CME's interest in expanding the program to customers is contingent on a number of factors. LCH has been hesitant to devote any resources to upgrading the cross-margining program in the past due to the light participation and limited benefits available as a result of its internal priorities. For example, CME asked to expand the program to include the proprietary and non-customer activity of joint and related clearing members in the CBOT interest rate products. There has been no progress on that CME initiative.

Finally, would you please provide us with a copy of the master agreement governing the program?

We will confidentially provide the agreement to you under separate cover.

Very truly yours,

Jerrold E. Salzman

JES:raf

Enclosures