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

November 19, 2004

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

RECEIVED
C.F.T.C.
2004 DEC -1 AM 11: 24

Dear Mr. McCarty:

We write on behalf of LIFFE Administration and Management ("LIFFE") in response to your October 26, 2004, request. We appreciate the opportunity to respond to the Commission's questions regarding the anticompetitive effect of Chicago Mercantile Exchange's (CME) interpretation of Rule 432.D (the "Interpretation"). To put our answers to your questions in context, we commence this response with an overview of our antitrust position.

As more fully explained below, the Interpretation should be invalidated as an exclusionary tactic that forecloses competition, eliminates customer choice and improperly maintains CME's monopoly. This conclusion is based on the following factors:

- The relevant market is the global market for exchange traded and cleared Eurodollar futures and options contracts (the "Eurodollar Futures Market");
- CME enjoys monopoly power in the Eurodollar Futures Market as a result of its dominant market share and at least two significant barriers to entry and expansion. First, the market is characterized by significant "network effects" that arise because liquidity – the life blood of any exchange – grows as trading volumes and open interest increase.[1] Second, because open interest in the Eurodollar Futures Market is principally comprised of related positions across several delivery months ("Strategy Positions"),[2] it is particularly difficult for a new entrant to amass sufficient open interest for long-run

1 "Open interest" is the number of contracts on an exchange that are held open, having not expired or been offset.

2 As used herein, the term "Strategy Position" refers to a Eurodollar futures and/or options position that is composed of multiple legs or contract months and which arises from a hedging and/or trading strategy. A customer may hold a portfolio comprised of multiple Eurodollar Strategy Positions that are not necessarily related to one another (e.g., because they are hedging different risks held by the customer or because they represent the strategies of different trading books). Margin offsets may be available within some individual Strategy Positions and also may be available across Strategy Positions within a portfolio.

liquidity. Both of these factors provide the incumbent exchange with a significant competitive advantage over new entrants.

- The Interpretation arose as a direct response to competition from LIFFE and eliminates the only commercially viable means for customers to convert CME Strategy Positions to LIFFE. Thus, the Interpretation locks in a significant portion of the market, impedes customer choice and effectuates a substantial foreclosure of competition.

- This exclusionary tactic constitutes the improper, willful maintenance of monopoly power, as distinguished from growth or development as a consequence of a superior product, business acumen or historic accident, without any countervailing procompetitive or statutory justification.

In short, the Interpretation runs afoul of the antitrust ban against exclusionary monopolistic practices and is invalid under Core Principle 18.

I. CME is an Incumbent Monopolist in a Market With High Barriers to Entry and Expansion.

For over a decade, CME has held a virtual monopoly in the Eurodollar Futures Market.[3] Open interest in CME's Eurodollar futures contract recently surpassed the 6.4 million contract mark, dwarfing LIFFE's open interest, which currently stands at approximately 130,000 contracts.

CME's monopoly power can be inferred from its dominant market share and at least two significant barriers to entry and expansion, the first of which are the "network effects" that characterize all exchange markets. These network effects arise because the liquidity and, thus, the utility of a given futures contract on a given exchange increases with additional participation and use. Liquidity enables customers to easily initiate, roll-over, expand upon and/or liquidate positions without incurring adverse price movements (i.e., "price slippage"). If a new entrant is to provide the liquidity necessary for long term competitive viability, the exchange must build a

---

[3] A Eurodollar futures contract reflects the London Interbank Offered Rate for a three-month, offshore deposit denominated in US dollars. Our answer to Question 7 explains why the Eurodollar Futures Market is the relevant market for purposes of analyzing the Interpretation's competitive effect. Certain other exchanges have traded Eurodollar futures via open outcry (including LIFFE, which listed Eurodollar futures in 1982 and formally delisted them in 1996 prior to the development of LIFFE CONNECT® and after several years of negligible volumes). In addition, the SGX in Singapore has listed a thinly traded contract since 1984, at which time it entered into a Mutual Offset Agreement with CME that provides customers who execute Eurodollar contracts with the ability to clear and carry such contracts on CME, and vice-versa, in effect creating one fungible market in Eurodollars on CME and SGX.

critical mass of trading volume at tight bid-ask spreads and sufficient open interest to ensure customers that they can easily enter and exit their positions.[4]

A second, related barrier to entry arises from the fact that the vast majority of Eurodollar Futures Market open interest is held as part of some type of a Strategy Position, rather than as outright long or short positions in a single contract month. This is especially true of trades in more deferred Eurodollar quarterly contract months. Using conservative estimates, 70% of total Eurodollar open interest and almost all of the open interest beyond the sixth quarterly contract month is held as part of a Strategy Position.[5] As detailed below, customers virtually never split the contracts comprising a single Strategy Position between exchanges and often desire to manage their entire Eurodollar portfolio on a single exchange for cross-margining opportunity and administrative efficiency reasons. Thus, absent the ability to persuade customers to switch Strategy Positions from the incumbent exchange, a new entrant's opportunities for growth are significantly compromised.

Independent market analysts recognize CME's pricing power, which is demonstrated by the following comment by Mike Ford-Taggart, a CFA and Stock Analyst, who was quoted by *MORNINGSTAR* on October 1, 2004:

> In fact, the Merc has tremendous pricing power. First, it charges higher prices for electronic trades than for open-outcry trades. As more trades are placed electronically, fees will increase faster than volume growth. Second, members pay less than nonmembers to trade, so as more nonmembers access the marketplace through computer terminals, fees should also increase faster than volume growth.

As is industry practice, CME can and does price discriminate among classes of customers. For example, CME has discounted its electronic trading fees to accounts held in the name of a proprietary trading firm or arcade. Hedge funds, banks, FCMs and other firms that hold and/or manage third party funds are not eligible for this discount program.

Although CME is entitled to reap the natural advantages of being the "first mover" in the market and has no duty to affirmatively aid new entrants, the presence of network effects and the prevalence of Strategy Positions warrants particular vigilance to ensure that CME does not abuse its status and authority as a self-regulatory organization to foreclose competition. Indeed, Core

---

4 As we explain in our answer to Question 4, LIFFE pays liquidity providers a stipend to commit to posting two-sided quotations at tight bid/offer spreads. However, this is not a profitable strategy for LIFFE over the long-haul and does not directly address the need to amass a critical level of open interest.

5 Although LIFFE is not privy to precise CME customer position data, LIFFE has developed significant expertise in short term interest rate ("STIR") markets. The permutations and combinations of various STIR trading strategies are constantly evolving and can be extraordinarily complex. Nevertheless, extrapolating from its experience, LIFFE is confident that in excess of 70% of the open interest in the Eurodollar Futures Market is comprised of Strategy Positions.

Principle 18 demands that CME refrain from enacting rules or policies that result in unreasonable restraints of trade, absent a legitimate regulatory purpose. Unless Core Principle 18 is strictly enforced, the combination of network effects and self-regulatory authority would insulate CME from competition and strengthen its monopolistic lock on the market.

II. The Interpretation Forecloses Competition in a Significant Sector of the Market

The Interpretation, issued under the pretense of enforcing the regulatory prohibition against fictitious sales, is in fact intended to limit competition in the Eurodollar Futures Market. The Interpretation bans the use of a block trade to liquidate a position on CME if the customer has arranged a second trade that results in a like-sized and opposite position *on a competing exchange*. Significantly, the Interpretation does not bar block trades to liquidate positions if the customer has pre-arranged a second trade that results in a swap or other over-the-counter (OTC) position. The timing and consequence of the Interpretation establish an intent to preclude competition for the patronage of current CME Strategy Position holders, the vast majority of whom established those positions when CME was the only exchange to offer a viable Eurodollar futures product.

Absent the ability to engage in CME/LIFFE Combination Trades, customers with Strategy Positions on CME are essentially locked into CME. A pre-arranged Combination Trade allows a customer to move an entire Strategy Position from one exchange to the other at a privately negotiated price (consistent with the exchange requirements regarding the pricing of block trades). As detailed in the answers to Questions 2 and 4, alternative mechanisms for moving a Strategy Position are infeasible because they require the customer to try to simultaneously liquidate multiple positions in a series of market transactions, resulting in untenable costs associated with price slippage and other market execution risks. Although a CME customer may choose to establish a new Strategy Position on LIFFE, customers are highly unlikely to split an existing CME Strategy Position between exchanges due to the administrative efficiencies and potential margin offset advantages of holding the entire Strategy Position on a single exchange. Accordingly, unless a customer can liquidate an entire CME Strategy Position and transfer it to LIFFE in a single Combination Trade, the customer is all but certain to maintain the entire Strategy Position on CME. For similar reasons, the Interpretation gives CME an annuity of sorts on new business from customers with CME Strategy Positions who desire to replace individual positions within a Strategy Position as they expire or to add incremental positions to a Strategy Position.[6]

The Interpretation precludes LIFFE from competing for a substantial portion of the market. As noted above, LIFFE conservatively estimates that more than 70% of the Eurodollar futures contracts currently held on CME (as well as on LIFFE) are held as part of a Strategy

---

6 Because customers holding Strategy Positions often are taking on or hedging yield curve exposure over a period of time (e.g., two years or more in the case of a bundle), as a front-month position expires, a customer that wishes to maintain its exposure or hedge over the same time horizon would seek to replace the expired position by adding a new back-month position to its Strategy Position.

Position. Because Combination Trades involving Strategy Positions move a significant block of open interest in a single transaction, such trades represent a substantial growth opportunity for LIFFE and a significant threat to CME's monopoly.[7] Precluding competition for Strategy Positions held on CME forecloses LIFFE from a very substantial portion of the market and threatens LIFFE's ability to build the critical mass necessary for long-term competitive viability. As a result, the Interpretation impedes customer choice and promotes CME's ability to maintain monopoly power.[8]

III. The Market Foreclosure Effectuated by the Interpretation Constitutes Unlawful Monopoly Maintenance

By foreclosing rival exchanges from competing in a significant sector of the relevant market, the Interpretation runs afoul of the long-standing antitrust bar against exclusionary, monopolistic practices. The Interpretation contravenes the following fundamental antitrust principles:[9]

- A firm violates the antitrust laws when it acquires or maintains or attempts to acquire or maintain a monopoly by engaging in exclusionary conduct "as distinguished from growth or development as a consequence of a superior product, business acumen or historic accident." *Grinnell*, 348 U.S. at 571.

- The antitrust laws forbid the continuance of effective market control through "unnatural" barriers to competition on the merits erected by a monopolistic firm's own business policies. *United Shoe*, 110 F. Supp. at 344-45.

- A demonstrable harm to competition occurs when a monopolistic firm's exclusionary tactics close to rivals a substantial percentage of the available market opportunities, particularly when such tactics keep usage of rival products below

7 For example, the June 11 trade accounted for 36,120 contracts and, helped boost LIFFE's open interest by 63%, from 56,596 on June 10 to 92,418 on June 11.

8 The lock in of CME Strategy Positions also handicaps LIFFE's ability to attract business from new customers who wish to acquire first-time Eurodollar futures positions. The Interpretation artificially depresses LIFFE's open interest and thus its liquidity, making LIFFE less attractive to new customers due to the significant network effects that characterize the market. Had it not been for the Interpretation, LIFFE is confident that its open interest would have been materially greater than today.

9 *See*, *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295, 344-45 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954) (condemning the customer lock-in effectuated by United's long-term leasing system as "unnatural barriers" that "exclude actual and potential competition"; and "restrict a free market"); *United States v Grinell Corp.*, 384 U.S. 536, 578 (1966) (monopolist's exclusive arrangements struck down as "substantial barriers to competition"); *Eastman Kodak Co. v. Image Technical Services*, 504 U.S. 451 (1992) (policy change that locked copier owners into Kodak parts and service after purchase constituted unlawful tying and monopolization); *United States v. Microsoft Corp.*, 253 F. 3d 34 (D.C. Cir. 2001) (affirming invalidation of a series of exclusionary tactics designed to hinder competition from rivals).

the critical level necessary to threaten the dominant firm's monopoly. *See Microsoft*, 253 F.3d at 70-71 (Microsoft's deals with a majority of the top internet access providers kept usage of Navigator below the critical level necessary to pose a real threat to Microsoft's monopoly).

- Once the anticompetitive effects of an exclusionary tactic by a monopolist are established, condemnation is warranted, absent a countervailing procompetitive justification. In other words, the monopolist must advance "a non pretextual claim that the monopolist's conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or consumer appeal." *Microsoft*, 253 F.3d at 58.

- It is inimical to the purpose of the antitrust laws to allow monopolists to squash nascent, albeit unproven competitors at will, particularly in industries marked by rapid technological advance, frequent paradigm shifts and network effects. *Microsoft*, 253 F.3d at 79.[10]

The Interpretation should be invalidated under these precepts as an anticompetitive, exclusionary tactic that forecloses competition, eliminates consumer choice and maintains CME's monopoly power. Rather than compete on the merits, CME has attempted to squash competition from a nascent competitor by imposing a policy that effectively precludes customers with positions on CME, and particularly Strategy Positions, from switching those positions to LIFFE. As explained in our prior correspondence, CME's assertion that the Interpretation is necessary to enforce the statutory prohibition against fictitious trades is pure pretext and cannot justify the Interpretation's preclusive effect on competition.

The significant barriers to entry and expansion that characterize the Eurodollar Futures Market – the high concentration of open interest in Strategy Positions and the network effects – heighten the Interpretation's anticompetitive impact. Because a substantial percentage of market opportunities reside with customers whose Strategy Positions are virtually locked into CME as a result of the Interpretation (and who may be compelled to place replacement positions and additional positions on CME by cross-margining and administrative efficiency considerations), the Interpretation impedes customer choice and forecloses competition in a substantial portion of the Eurodollar Futures Market. The presence of network effects exacerbates the likelihood that

[10] In *Microsoft*, the court observed that a browser must have a critical mass of users in order to attract software developers to write applications. The court also found that the overwhelming majority of consumers will only use a PC operating system for which there already exists a large and varied set of applications and for which it seems relatively certain that new types of applications and new versions of existing applications will continue to be marketed. Microsoft's tactics exacerbated *indirect* network effects by increasing computer manufacturer costs of offering and promoting rival browsers and making it less likely that third party software developers would develop applications that were compatible with competing operating systems. CME's tactics exacerbate *direct* network effects by increasing to a prohibitive level the switching costs of customers who would otherwise want to move positions to a rival exchange. Thus, the consumer harm in this case is more direct than in Microsoft.

this foreclosure will indeed preclude LIFFE (or any other rival exchange) from gaining the critical mass of open interest and trading volumes necessary to pose a competitive restraint on CME's monopoly power and, potentially, to attain long-term competitive viability.

Allowing the Interpretation to stand under these circumstances significantly undermines customer interests. If LIFFE is forced to exit the market, then there would be absolutely no competitive constraint on CME's exercise of monopoly power.[11] Even if LIFFE remains in the market as a minor player, the Interpretation significantly restricts customer choice, reduces the incentives for innovation and perpetuates CME's pricing power over a large sector of the market. For these reasons, the unnatural barrier to competition erected by the Interpretation under the guise of self-regulatory authority should not be allowed to stand.

IV. Conclusion

The Commission's intervention is necessary to preclude CME from abusing its self-regulatory authority to destroy competition in the Eurodollar Futures Market. The responses to your questions that follow further illuminate the Interpretation's anticompetitive effects and its detriments to customer interests. Under these circumstances, the Interpretation should not be afforded the privilege of self-certification.

Very truly yours,

Arthur W. Hahn

Arthur W. Hahn

AWH:bap60324816

cc: Richard A. Shilts, CFTC
Mr. John Foyle, LIFFE
Mr. Nicholas Carew Hunt, LIFFE
Ms. Verena Ross, FSA

11 LIFFE's entry into the Eurodollar Futures Market has generated important competitive benefits, most notably by prompting CME to reduce fees to many customer classes and spurring CME to invest significant resources to upgrade its Globex electronic trading platform to be more competitive with LIFFE's sophisticated LIFFE CONNECT® platform.

1. Please enumerate the costs of all alternative methods of moving a position from CME to LIFFE if CME block trades are not available for this purpose, including liquidating the position via a transaction on CME's central marketplace. Please compare these costs and compare them to the costs of moving the position via CME block and LIFFE combination trades. If LIFFE's customers must use means other than a combination trade, how much slippage would occur? How long would it take them to completely exit their positions on CME? Would it be feasible for LIFFE's potential traders/customers to simply let their positions on CME expire, rather than moving them to LIFFE?

ANSWER: There are any number of different types of Strategy Positions that a customer may hold, including spreads, strips, bundles, futures/options combinations and numerous permutations of the foregoing. Likewise, there are theoretically a variety of potential methods to transfer Strategy Positions from one exchange to another. However, with the exception of the Combination Trade methodology, all of these alternatives involve the use of the central order book of one or both exchanges and the attendant risk of material price slippage. These costs and risks are compounded in the case of more complex Strategy Positions. Therefore, all of these alternatives are commercially infeasible.

To illustrate this point, consider the cost and slippage differentials had the Strategy Position(s) transferred through the Combination Trade of June 11th instead been transferred by execution in the respective central order books of both exchanges.[1] This position totaled 36,120 contracts across eight successive quarterly contract months, representing a two year time horizon. The table attached as Exhibit 1 details the market execution costs of effecting this transfer by executing a series of trades on a single day in the central order books of both exchanges. As detailed in Exhibit 1, execution of the trade via the central order books would

1 Because June 11, 2004 was a day of mourning for President Regan resulting in shortened trading hours for Eurodollars on LIFFE and CME's Globex trading system the bid/ask spread and trade volume data for that date would not be indicative of normal market conditions. We have therefore, calculated the probable market execution costs of the above referenced Strategy Position as if it had been executed on November 4, 2004 at the prevailing bid/ask prices in each exchanges' respective central order book.

have resulted in the customer incurring at least an additional $1.1 million[2] in market execution costs for the 36,120 contract transfer trade than if the transaction had been effected as a Combination Trade; this equates to approximately $30.25 per contract. In fact, we believe that this estimate may significantly understate the actual difference in cost.[3]

Compare this prohibitive $1.1 million cost to the efficiencies of the Combination Trade, which virtually simultaneously and in a seamless manner permitted the movement of over 36,000 contracts of open interest across eight different Eurodollar expiration months of varying liquidity, where each quarterly contract traded at the same price on the two exchanges. As a result, the customer was protected from price slippage in each of the eight legs of the risk management trade which, given the size of the position involved, was a powerful advantage that could not be replicated by alternative methods of transferring the position.[4]

You also asked about the feasibility for a potential customer of LIFFE to let their CME Strategy Position expire as an alternative to transferring the position to LIFFE through the Combination Trade. This alternative has the effect of locking in to CME a customer with a Strategy Position for a period equal to the time horizon of that position, which could be two years or longer. The denial to the customer of the anticipated benefits that would have resulted

2 A variation of this transfer methodology would be to exit the Strategy Position on CME through CME's central order book and re-establish the Strategy Position on LIFFE through a block trade or basis trade rather than through LIFFE's central order book. This alternative methodology could potentially reduce some of the market slippage costs. Regardless of this potential "savings", the cost associated with even this "alternative" methodology is so high as to render it equally infeasible.

3 We believe that this figure is conservative because in certain of the contract months of the Strategy Position the volume required to be executed in the central order books would have, in all likelihood, caused a material widening of the bid/ask spreads beyond those specified in Exhibit 1.

4 It should be noted however, that at the time of the execution of the June 11th Combination Trade, LIFFE was reimbursing customers for certain costs incurred by the parties ($40,000 to one party and $60,000 to the other party) in executing Combination Trades as described in footnote 2 to our October 1 letter to Mr. McCarty. In the absence of such reimbursements, these costs would need to be factored into the cost of the Combination Trade mechanism.

from holding his/her position on LIFFE for an extended period of time underscores the substantial costs to customers resulting from the Interpretation, which forecloses the only commercially feasible method of transferring Strategy Positions from one exchange to the other.

It is also the case that during the life of a Strategy Position a customer may dynamically manage the position in response to changes in the interest rate environment or the customer's investment or hedging needs. These adjustments, which involve adding to or subtracting from back-month Eurodollar contracts, are accomplished through calendar spreads or other Strategy Positions that overlay the original Strategy Position. The customer could theoretically attempt to make adjustments to a CME Strategy Position on LIFFE, but the administrative burdens and loss of flexibility associated with dynamically managing a single Strategy Position across two exchanges would make this approach unrealistic.

Finally, if one allows a portion of a Strategy Position to expire on CME with the replacement position established on LIFFE, the resulting set of related positions would be subject to two different tax regimes for US tax payers. In this circumstance, the constant consideration of different tax rates, different mark-to-market requirements and possible applicability of tax straddle rules renders management of a Strategy Position split between exchanges impracticable in almost all instances.

2. Why would traders choose to first establish a futures position on CME and then later attempt to move that position to LIFFE, rather than just establishing the position on LIFFE in the first instance?

ANSWER: As detailed in our answer to Question 4, there is no rational reason for a customer who desires a futures position on LIFFE to initially establish the position on CME, only to immediately move that position to LIFFE, rather than establishing the position on LIFFE in the first instance. However, customers who established positions on CME before LIFFE launched its Eurodollar contract may now prefer to transfer their contracts to LIFFE if

Combination Trades are available. Likewise, as investment strategies, fee structures, product attributes, clearing arrangements, liquidity levels and legal environments change over time, a CME position holder may then desire to transfer that position to LIFFE.

3. In a letter to the CFTC, LIFFE asserted that there are several differences between its Eurodollar futures contract and CME's contract. Please explain those differences with regard to their terms and conditions and to any economic differences or consequences not related to the terms. Do Eurodollar futures traders view any of these differences as being economically important? Does the LIFFE allowance of the transfer through the combination rule suggest that these contracts are economically equivalent?

ANSWER: The core terms of LIFFE and CME Eurodollar contracts are identical (i.e. contract size, currency and cash settlement at maturity reflecting the British Bankers' Association ("BBA") three month Eurodollar LIBOR fixing two London banking days prior to the 3rd Wednesday of the relevant calendar month). However, there are numerous distinguishing characteristics that customers may view as economically and competitively significant. First and foremost, CME and LIFFE have very different pricing structures when it comes to transaction and clearing fees and compete for business by offering different fee waivers and other incentives from time to time. In addition, customers may prefer to hold Eurodollar contracts on one exchange or the other based on the following differences:

(i) The different margin offset opportunities that are available within CME clearinghouse as opposed to LCH.Clearnet, which makes CME an attractive choice for customers who hold US treasury futures and options in their portfolios, and makes LIFFE an attractive choice for customers who hold other type of STIR contracts in their portfolios;

(ii) LIFFE's futures-style margined options contracts versus CME's premium-upfront options contracts, which make LIFFE's contracts a particularly attractive choice for customers who desire symmetrical cash flows between options and related futures positions;

(iii) The trading platform on which the contracts are available and the functionality of the platforms;

(iv) CME currently utilizes smaller tick price increments in the front month and in calculating the final cash settlement price than does LIFFE;

(v) the respective clearing systems, including Central Counterparty characteristics, guarantee funds and margin offset potential;

(vi) operational implications, e.g. timing of relevant processing instructions, give-up arrangements, intra-day registration and margining;

(vii) regulatory differences, e.g. client fund segregation regimes, large trader reporting, capital requirements, trading rules (including block and basis trade rules);

(viii) governing law, emergency Board powers, insolvency law and default provisions; and

(ix) different tax treatment of LIFFE and CME contracts for U.S. customers.

In other words, while the Eurodollar products offered by CME and LIFFE are equivalent, the exchanges compete on the basis of price, service, convenience and a variety of other factors.

The "allowance of the transfer through the combination rule" is simply one potential use of LIFFE's Basis Trading Facility (BTF). The threshold for using the BTF is that the two instruments be economically related (but not necessarily identical). This threshold is obviously satisfied in this case, given that CME and LIFFE Eurodollar futures instruments are identical in their core terms. Nonetheless, the distinguishing competitive factors identified above naturally will lead customers to prefer to trade on one exchange rather than the other, and/or to move positions from one exchange and its clearing house to the other, as evidenced by the Combination Trade that occurred on June 11 described above in the Answer to Question 1.

4. Does LIFFE intend that combination trades be used by parties to make a one-time transfer of their positions from CME to LIFFE, or does LIFFE expect that parties can and/or will repeatedly establish positions on CME and then transfer them to LIFFE? If the latter, please explain why traders would want repeatedly to go through a two-step process of establishing positions on CME and then moving them to LIFFE, when they could instead establish the position directly on LIFFE. In this regard, please also respond to CME's "free-rider" argument.

ANSWER: If the Commission strikes down the Interpretation, LIFFE expects that the vast majority of parties who would avail themselves of Combination Trades would be customers who had acquired Eurodollar positions on CME, and particularly Strategy Positions, before LIFFE entered the market.

However, if a LIFFE position becomes more attractive over time after a customer acquires a Eurodollar position on CME, whether due to additional improvements in LIFFE CONNECT, price competition, clearing arrangements, a change in investment strategy, enhanced liquidity or a change of law, a customer should not be impeded from using a Combination Trade to convert that position to LIFFE. We emphasize that the reverse holds true as well: if a customer establishes a Eurodollar position on LIFFE and subsequently desires to instead hold a Eurodollar position on CME, it should be allowed to transfer its position through a Combination Trade without impediment.[5] However, LIFFE intends that Combination Trades be available on an ongoing basis as a mechanism for customers to transfer Eurodollar positions from one exchange to another (whether from CME to LIFFE or vice versa).

It is difficult to imagine an instance where a customer who desired a Strategy Position on LIFFE from the outset would use a two-step Combination Trade to establish the position on

[5] LIFFE has not enacted any restriction on such trades.

Doc #:CHI02 (251373-00003) 60325393v7;11/19/2004/Time:18:49

CME and then move it to LIFFE. CME's suggestion that a customer might need to access CME's liquidity to initially establish the Strategy Position is without merit. Customers generally build new yield curve positions with Eurodollars over a period of time. It would be the rare exception for a customer to suddenly find itself with an exposure to hedge that is beyond the capacity of the LIFFE Eurodollar market to accommodate either in the central order book or through LIFFE's wholesale trade facilities. For this reason, there would be no economic justification for a customer to execute a Strategy Position on CME and then transfer the position to LIFFE, even if LIFFE were willing to reimburse the customer's CME execution costs.

CME's assertion that LIFFE is asking the Commission to condone free riding on the "price discovery provided by CME's investment in technology and the skill of its committed market markers" is frivolous and without foundation.[6] LIFFE has invested tens of millions of dollars in building LIFFE CONNECT® which, unlike Globex, was built specifically to accommodate the complexities of trading STIR futures. Moreover, the network distributing access to LIFFE CONNECT® is proprietary to LIFFE and maintained by LIFFE at great expense. Unlike the Globex network, LIFFE's network (LIFFENet) architecture is designed so that no single point of failure can take down the network. This type of network architecture cost millions to build and millions in annual recurring maintenance costs. Far from free-riding on CME's investment in technology, LIFFE's entry into the Eurodollar Futures Market spurred CME to make significant investments to improve its Globex electronic trading platform to

6 The prevention of free-riding is recognized as a countervailing, procompetitive justification for a restraint only when it can be demonstrated that one competitor would otherwise take advantage of investments made by another competitor to develop, promote or distribute a product and that the prevention of this "free ride" is necessary to maintain appropriate incentives for innovation, promotion and/or distribution. *See, Business Electronics Corp. v. Sharp Electronics Corp.*, 456 U.S. 717 (1988). Moreover, the free-riding justification fails when less restrictive alternatives are available. *Chicago Professional Sports, L.P. v. NBA*, 961 F.2d 667, 676, *cert. denied, 506 U.S. 954 (1992).*

reduce its competitive disadvantage when compared to the technologically advanced LIFFE CONNECT platform.

In addition and as is customary to promote competitive levels of liquidity upon the launch of a new futures product, LIFFE has forged relationships with market makers and other liquidity providers and offered stipends and other incentives in return for commitments to post two-sided quotations with a relatively tight bid/ask spread. There is likely to be little or no overlap between CME's market makers and those who have relationships with LIFFE, largely because CME requires its market makers and other liquidity providers to commit "not to act in a market maker or liquidity provider capacity for competing exchange traded short-term interest rate products." Given this lock-in by CME, LIFFE certainly has not free-ridden on the skill of CME's committed market makers and other liquidity providers.

CME's free-riding argument seems to be premised on the false assumption that, absent the Interpretation, customers who desire to acquire Strategy Positions on LIFFE would initially choose to use CME's facilities to execute their Eurodollar orders "in order to be assured of fair, reliable markets and, presumably, to capture all or a portion of the value of CME's advantageous bid-offer spread" and then use a Combination Trade to obtain a LIFFE Strategy Position. The ultimate fallacy of this assertion is evidenced by the fact that the sophisticated customers who would use a Combination Trade to move a Strategy Position from CME to LIFFE would not do so unless LIFFE offered them sufficient liquidity to close out or modify those positions when the need arises.

5. Section 5(d)(18) of the Commodity Exchange Act (Core Principle 18— Antitrust Considerations) states that unless necessary to achieve the purposes of CEA, a board of trade shall endeavor to avoid adopting any rules or taking any actions that result in any unreasonable restraint of trade. In this regard, does LIFFE believe that the antitrust "duty to deal" doctrine applies to this matter? Does LIFFE believe that this issue should be reviewed in an antitrust context as a question of vertical restraint?

ANSWER: LIFFE does not believe that the "duty to deal" doctrine applies in this case. Combination Trades do not require CME to have any dealings with LIFFE whatsoever. In a Combination Trade, CME merely clears a block trade order executed by a customer who desires to liquidate an existing position on CME. The second leg of the Combination Trade, which is a basis or block trade on LIFFE, is strictly among the customers, LIFFE and LIFFE's clearing house, LCH.Clearnet. In the absence of a furtherance of a purpose of the Act, such as the prevention of fraud or market manipulation, CME has no legitimate interest in refusing to allow a customer to liquidate a Eurodollar position through a block trade.

The Interpretation should be viewed as a vertical restraint imposed on customers that has the clear purpose and effect of deterring customers from switching Eurodollar positions to LIFFE, regardless of their preferences. As is explained in the introduction, CME's conduct is improper under exclusionary conduct cases such as *United Shoe, Grinnell, Kodak* and *Microsoft,* all of which involved unilateral actions by a monopolist to lock customers into a product and thereby thwart competition from rivals.

6. An antitrust analysis also requires an inquiry into whether a restraint of trade is competitively significant. Please estimate the percentage of LIFFE's potential volume and potential customers that would use the block trading facility on CME to switch their positions to LIFFE through combination trades. Please estimate the percentage of LIFFE's potential volume and potential customers that would use the block trading facility on CME to switch their positions to LIFFE by means other than a combination trade.

ANSWER: Although it is very difficult to estimate the percentage of LIFFE's potential volume and potential customers that would choose to use the block trading facility on CME to switch their positions to LIFFE through Combination Trades, the Interpretation particularly precludes competition for Strategy Positions (including replacement positions and new positions added to a Strategy Position) held on CME. CME's share of the Eurodollar Futures Market (as measured by open interest) is approximately 98% and, as pointed out in the introduction, the vast majority of the open interest held on CME (conservatively 70%) is held as part of Strategy Positions.[7] Thus, the Interpretation forecloses competition in a substantial sector of the market.

Even if Combination Trades were used to move a relatively small proportion of the Strategy Positions held on CME to LIFFE in the event that the Interpretation is invalidated, this movement could comprise a significant percentage of LIFFE's potential trading volumes and open interest. By way of example, the Combination Trade that preceded the Interpretation's enactment was relatively small in volume and open interest as a percentage of the total Eurodollar market. This transaction, however, was large in terms of its contribution to the volume and open interest growth of the infant LIFFE Eurodollar offering at the time. In June 2004, LIFFE Eurodollar average daily volume (ADV) were approximately 15,000 and open interest was approximately 50,000. The single Combination Trade that occurred on June 11 boosted LIFFE's open interest by 36,120 contracts (63%). Thus, Combination Trades promised to be an important means for LIFFE to improve liquidity and to become an effective competitive alternative to CME.

Before the Interpretation, LIFFE had good reason to believe that Combination Trades would significantly augment LIFFE's volume, liquidity and customer base. Potential customers had expressed interest in executing Combination Trades (in addition to the two that were executed) that would have increased LIFFE's open interest at the time by approximately

---

7 Although volume and open interest are both important elements in measuring the liquidity (and thus, the viability) of a futures contract, for purposes of encouraging customer participation in a new futures contract, the level of open interest in the contract is critical initially. This is because a prospective customer of a new futures contract that intends to hold open positions for any period of time, as in the case of Strategy Positions, wants to be assured that he or she will be able to exit those contracts in the future. Open interest is the best indicator of that ability because it quantifies the number of other open contracts that are potentially available to be closed out against a customer's open positions. At a certain point, when a sufficient threshold level of open interest has been established in a futures contract, the open interest becomes a less significant measure of liquidity. It is difficult to predict with certainty where the open interest liquidity threshold is for any given futures contract, but with its open interest standing at 2% of the Eurodollar Futures Market, LIFFE reasonably believes that the open interest in LIFFE's Eurodollar contract has yet to achieve that threshold.

two-thirds. Because liquidity breeds liquidity, LIFFE confidently asserts that additional parties would have pursued Combination Trades had this next round of Combination Trades occurred and that additional new customers would have placed positions on LIFFE. CME's imposition of a bar against transfers of positions at this critical stage in the LIFFE Eurodollar contract's development, thus, materially impedes LIFFE's ability to build the critical mass of liquidity and depth necessary to constrain CME's market power and materially increases the LIFFE Eurodollar contract's risk of failure. Under these circumstances, the foreclosure imposed by the Interpretation is indeed competitively significant.

7. What does LIFFE consider to be the relevant antitrust (product and geographic) market and why? Are other financial instruments, such as OTC transactions, included in the relevant antitrust market?

ANSWER: The relevant antitrust market is the global market for exchange traded and cleared Eurodollar futures and options on futures ("Eurodollar Futures"). Eurodollar Futures have a number of unique properties and uses that cannot be replicated by other types of futures or other financial instruments. Eurodollar Futures are based upon the London Interbank Offered Rate (LIBOR) for a three-month US dollar denominated deposit. Eurodollar Futures offer a uniquely flexible hedge opportunity for customers who have exposure to short or medium term dollar denominated interest rates. Neither other exchange traded instruments nor OTC instruments are economic substitutes for Eurodollar Futures.

As far as exchange traded financial instruments are concerned, the only potential substitutes are STIR contracts based on other currencies. However, such STIR contracts are not reasonably interchangeable with Eurodollar Futures due to fluctuations in currency exchange rates, differences in the interest rate environment among different currencies, and other economic fundamentals, such as country or location risk, that affect interest rates. The significant price spread volatility of dollar denominated Eurodollar Futures and other non-dollar denominated exchange traded STIRS is further indication that these products are poor substitutes. (See Exhibit 2.)

As far as OTC interest rate instruments are concerned, there is no basis for including them in the relevant market. Although customers may enter into either OTC instruments (such as forward rate agreements or interest rate swaps) or exchange-traded interest rate instruments to assume or transfer risk associated with changes in the interest rate environment, Eurodollar Futures and OTC interest rate instruments are not substitutes for one another because they perform different functions and possess different attributes. Exchange-traded futures afford customers anonymity, transparency (i.e., the ability to access real-time market prices on a computer screen) and significantly reduced counter party credit concerns, while OTC transactions offer no anonymity, no independent validation of price or value, and require each party to determine the credit worthiness of the other. All of the material terms of an OTC instrument are potentially subject to negotiation between the parties. OTC instruments permit a customer to customize the material economic terms of an instrument such as notional amount, maturity and duration, cash flows, settlement terms and reference rates. Thus, OTC instruments are a very refined risk management tool, permitting a customer to precisely address a specific interest rate exposure arising out of that customer's business. In contrast, Eurodollar Futures contracts cannot and do not offer such precision. Moreover, given their high degree of price correlation to OTC interest rate instruments, Eurodollar Futures are ideally suited to hedge the aggregate interest rate risk that arises out of a portfolio of OTC instruments. Accordingly, rather than being substitutes, OTC instruments and Eurodollar Futures are complements.

8. Can LIFFE offer an economically-based theory illustrating how CME's actions are anticompetitive? Would CME's alleged restraint of trade reduce competition in the relevant antitrust market and, if so, how? Will this reduction be significant? Please explain.

ANSWER: As indicated in the introduction, the Interpretation constitutes an exclusionary tactic by an incumbent monopolist in a market with pronounced network effects to foreclose a nascent competitor from a significant sector of the market, thereby preventing LIFFE from gaining the critical mass necessary to challenge CME's dominance.[8] In particular, CME has attempted to maintain its long-held monopoly by eliminating the most efficient mechanism for moving Strategy Positions, thus increasing the switching costs for customers who hold Eurodollar Strategy Positions on CME to such an extent that switching becomes infeasible.

Because of the nature of the barriers to entry created by network effects, the greatest threat to CME's monopoly comes from the growth of open interest on a rival exchange such as LIFFE. Combination Trades involving large Strategy Positions, such as those that prompted CME to issue the Interpretation, constitute a threat to CME's monopoly because each such transaction significantly augments LIFFE's open interest.[9] The Interpretation eliminates this threat and contributes to the maintenance of CME's monopoly power in the following respects:

- The Interpretation effectively locks in existing Strategy Positions held on CME.
- As explained above, the Interpretation's lock-in effect transcends the Strategy Positions themselves and applies to the replacement of expiring positions and to additional, related positions as well.
- Those customers who prefer to maintain their entire portfolio of Eurodollar Futures contracts (including any additions thereto) on a single exchange will find

[8] As we explain in the Introduction, the liquidity and thus the utility of a futures contract increases as an exchange's trading volume and open interest increase. Thus, the network effects that drive customers toward the dominant exchange operate as a barrier to entry and expansion.

[9] For example, as noted in the introduction, the single Combination Trade that occurred on June 11 increased the Eurodollar open interest held on LIFFE by 63%.

it impracticable to move their portfolios to LIFFE (even if they would otherwise prefer to do so) unless Combination Trades are available.

- By artificially depressing LIFFE's open interest and, thus, its liquidity below the level that would exist if Combination Trades were permitted, the Interpretation handicaps LIFFE's ability to attract new business from *de novo* customers due to the network effects explained above.
- The Interpretation increases rival costs by perpetuating LIFFE's need to pay stipends to market makers and liquidity providers and, thus, impedes LIFFE's competitive viability in the Eurodollar Futures Market.[10/]

Given the large proportion of open interest in the Eurodollar Futures Market that is held in Strategy Positions, the reduction of competition is significant.

The reduction of competition precipitated by the Interpretation harms customers in several respects.[11] First, the Interpretation impedes customer choice by locking in customers who otherwise would have used a Combination Trade to convert their one or more Strategy Positions to LIFFE, thus depriving customers of the benefits described in the Answer to

---

10/ Although stipends are a common means for new entrants in an exchange market to build liquidity, stipends are not an economically viable strategy for LIFFE over the long haul. Rather, such incentives typically are used as a temporary measure until open interest and volume grows and the need for formal market making declines, making stipends unnecessary.

11 At least two recent examples attest to the competitive benefits of uninhibited exchange competition in futures markets:

(i) In 1997/98, Eurex (then the Deutsche Terminbörse), which was one of the first futures exchanges to adopt an electronic trading platform, successfully displaced LIFFE (which had yet to develop an effective electronic trading platform) in the German Government Bond Futures market. This ushered in widespread electronic trading, the major innovation in the futures industry in the last 10 years.

(ii) The announced entry of Eurex US in the US Treasury Futures market encouraged The Chicago Board of Trade to reduce its prices significantly (the CBOT currently charges members who hold a seat in their name zero exchange fee for proprietary transactions in Treasury futures and charges individuals employed by that member only six cents per side).

Question 3. Second, this results in higher costs for many customers in terms of higher margin outlays for those that hold other types of positions on LIFFE where risk margin offsets would be available, if they could transfer some or all of their Eurodollar Futures to LIFFE. Third, the Interpretation's final and perhaps most insidious anticompetitive effect is that it preserves CME's ability to exercise monopoly power, unhindered by competition from LIFFE, at least where the business of Strategy Positions holders is concerned and potentially throughout the market if LIFFE is forced to exit.

9. Could CME's Interpretation Be Used to Protect its Copyright? How Does the Interpretation Protect the Copyright and Can CME Protect Its Copyright Through Court Proceedings Rather Than Through Its Interpretation?

ANSWER: CME's Interpretation does not directly relate to, address, nor focus on the purported copyrights in CME's daily settlement prices. The Interpretation relates to a transaction mechanism. Daily settlement prices and any purported copyright in them relate to daily mark-to-market and margining mechanisms.

For both CME and LIFFE Eurodollar contracts, the final contract (expiry) settlement price is set completely independently of futures trading activity by reference to BBA's LIBOR fixing.

As such, the Interpretation does not create a basis for establishing that CME's settlement prices are the subject of valid copyrights (which is a necessary element of any claim to protect copyrights). Nor does the Interpretation preclude all or specific uses of the alleged copyrighted settlement prices (another necessary element of an action to protect copyrights). Therefore, the Interpretation could not be used to protect CME's purported copyrights.

As discussed above, the Interpretation does not protect CME's alleged copyrights. CME can protect its alleged copyrights through court proceedings in the appropriate federal district court. In fact, legal action to establish valid copyrights and to enforce such rights against alleged acts of copyright infringement are more properly brought, heard and determined in federal district courts. (See 28 U.S.C. Section 1338(a), which confers exclusive original jurisdiction in the federal district courts of copyright cases.)

10. Your letter of October 1, 2004 responds (at page 7, n.9) to CME's suggestions regarding expanded use of the cross-margining agreement, and suggests that it is unrealistic for a non-proprietary customer to use cross-margining. Would you please describe the cross-margining arrangements currently in effect between yourselves and CME? Does the cross-margining agreement permit capital efficiencies and benefits akin to those enjoyed by customers who transfer CME positions to LIFFE? Would LIFFE support expanded use of the cross-margining program to provide customers with its benefits? If not, please explain why. Have any customers, institutional or retail, inquired about expanded use or greater access to the cross-margining program?

ANSWER: In March 2000, LIFFE, CME and LCH.Clearnet (LIFFE's clearing house) entered into a Cross-Margining Agreement as part of a wider set of initiatives between LIFFE and CME. The Cross-Margining Agreement, which is in essence an operational arrangement between LCH.Clearnet and CME, is the only one of these initiatives that is still operational.

In brief, the Cross-Margining Agreement enables eligible clearing members of LCH.Clearnet who are also clearing members of CME to benefit from reduced margin requirements in the form of inter-commodity spread credits only in respect of certain positions held in their proprietary accounts at each clearing house. For eligible positions, each clearing house recognizes the position held at the other clearing house and calls a reduced level of initial margin. This arrangement has the following key characteristics:

- Eligibility is restricted to firms where the same legal entity or a narrowly defined affiliate (wholly owned subsidiary or same parent relationship) are members of both clearing houses.

- The inter-commodity spread credits are available only for LIFFE Euribor contracts carried on LCH.Clearnet versus Eurodollar contracts carried on CME (i.e., no other CME or LIFFE products are covered).
- Only positions in proprietary accounts of members are eligible for participation (i.e., positions of customers are not eligible).
- The level of the spread credit is set jointly by CME and LCH.Clearnet, without LIFFE involvement.

At the time that the Cross-Margining Agreement was established it was recognized that it offered only limited benefits. However, given the different legal and insolvency regimes in the UK and the US, it was believed that any greater benefits could not be achieved within a reasonable timeframe or cost. Furthermore, as the Cross-Margining Agreement was part of a wider set of initiatives, its stand-alone benefits were not the sole criteria for measuring its value.

The Cross-Margining Agreement is little used because of the restricted benefits outlined above. Moreover, it offers substantially fewer benefits for clearing members and their customers than the alternative of transferring CME positions to LIFFE/LCH.Clearnet (or vice versa) through Combination Trades because the Cross-Margining Agreement:

- Cannot be extended to customer accounts without significant changes to the legal and regulatory (client money rules, etc.) structures under which CME and LCH.Clearnet operate.
- Requires membership of both clearing houses and a particular corporate structure for members to be able to benefit from it. Such arrangements may not be appropriate for all

members, especially where different legal entities are members of LCH.Clearnet and CME respectively.

- Also requires positions to be cleared in two jurisdictions and held at two clearing houses, with all of the operational, regulatory, legal and other costs that this entails. Some members may prefer to hold all of their positions in one jurisdiction, if that possibility is available to them.

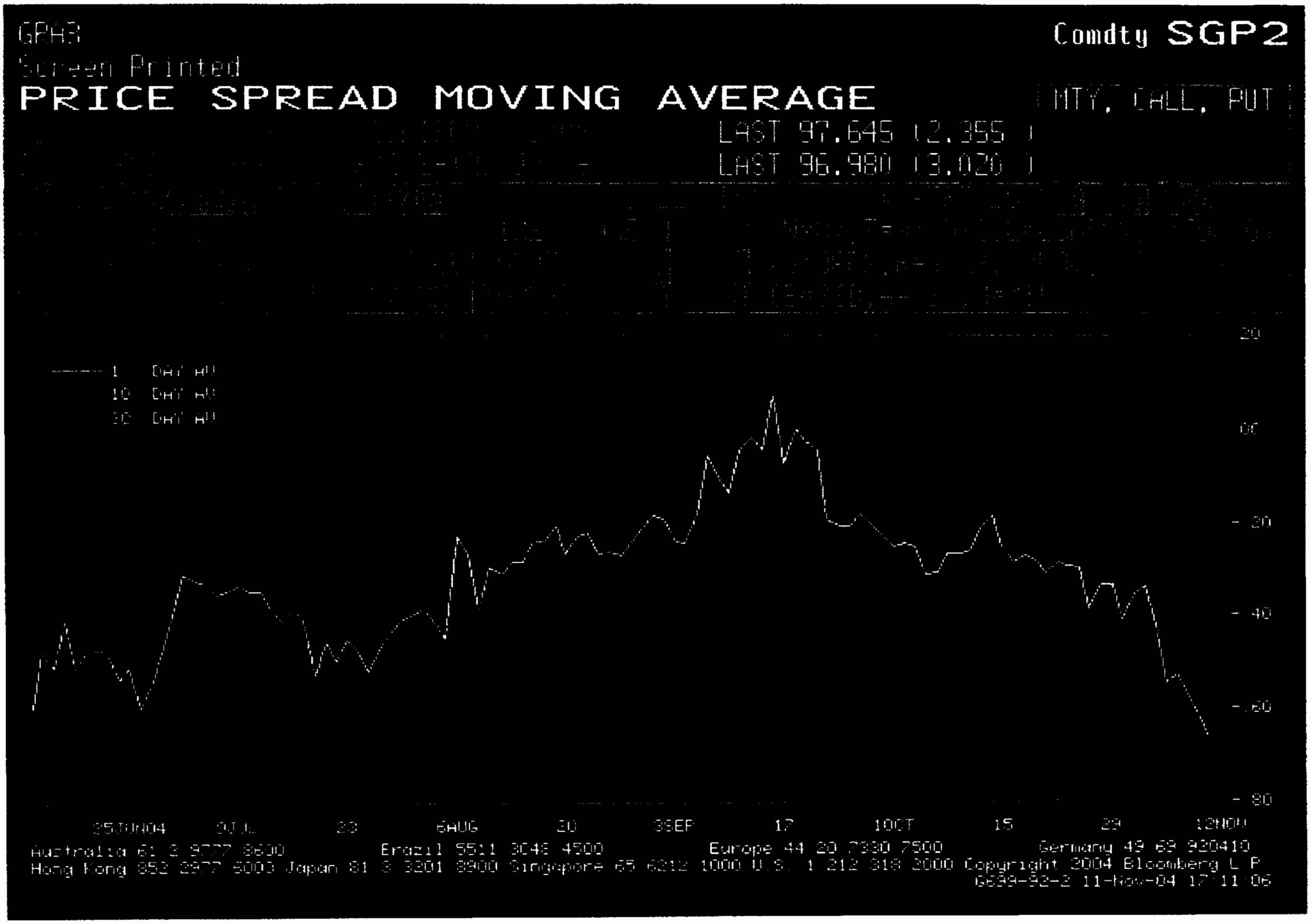
- Is limited only to CME Eurodollar and LIFFE Euribor positions, whereas portfolio margining within a single clearing house may provide margin reductions across more types of contracts.

For all of the above reasons, LIFFE does not believe that it would be commercially justifiable for CME, LCH.Clearnet or LIFFE to invest in an extension of the Cross-Margining Agreement. Nor has LIFFE, to our knowledge, received any requests from customers to extend the facility to them.

EXHIBIT 1

	No' of lots	Estimated Average price CME leg in Central Market	Estimated Average price LIFFE leg in Central Market	Value of an '0.01' $	Cost $
Q1	3592	97.67	97.662	25.0	**71.8K**
Q2	3647	97.44	97.449	25.0	**82.1K**
Q3	702	97.265	97.27	25.0	**8.8K**
Q4	4041	97.08	97.089	25.0	**90.9K**
Q5	3385	96.88	96.885	25.0	**42.3K**
Q6	908	96.71	96.715	25.0	**11.4K**
Q7	15159	96.555	96.572	25.0	**644.3K**
Q8	4686	96.415	96.427	25.0	**140.6K**
Total	**36,120**				**$1,092.200**

- **We took a snapshot of liquidity, ie market depth, in both the CME and LIFFE Eurodollar market, at the most liquid time of day, around 2pm London time on Thursday November 4th.**


GRAB
Comdty SGP2
Screen Printed
PRICE SPREAD MOVING AVERAGE
MTY, CALL, PUT
LAST 97.645 (2.355)
LAST 96.980 (3.020)
1 DAY AV
10 DAY AV
30 DAY AV
20
0
-20
-40
-60
-80
25JUN04
9JUL
23
6AUG
20
3SEP
17
1OCT
15
29
12NOV
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2004 Bloomberg L.P.
G639-92-2 11-Nov-04 17:11:06