



U.S. COMMODITY FUTURES TRADING COMMISSION
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September 5, 2000

The Honorable John D. Dingell, Ranking Member
United States House of Representatives
Committee on Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515-6115

The Honorable Edolphus Towns, Ranking Member
United States House of Representatives
Committee on Commerce
Subcommittee on Finance and Hazardous Materials
2125 Rayburn House Office Building
Washington, D.C. 20515-6115

The Honorable Edward J. Markey, Ranking Member
United States House of Representatives
Committee on Commerce
Subcommittee on Telecommunications, Trade, and Consumer Protection
2125 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Congressmen Dingell, Towns, and Markey:

I am writing on behalf of the Commission in response to your inquiries of August 3, 2000, regarding alleged trade practice abuses on the Chicago Mercantile Exchange (the "CME" or the "Exchange").

- 1. Please describe the laws and regulations which your agency, and the markets it regulates, apply with respect to the practice of frontrunning customer orders, including intermarket frontrunning. Over the last five years, how many enforcement actions have been brought against frontrunning at the CME and the CBOT, and what penalties have been imposed? How do these compare to the penalties imposed for frontrunning in the stock and options markets?**

In the context of commodity futures and options, frontrunning of customer orders occurs when a person or entity establishes a futures or options position based on non-public information regarding an impending transaction by a customer in the same (or a related) futures or option contract. In the context of intermarket trading, frontrunning involves a transaction in a commodity futures contract or commodity option on a futures contract, or in a stock option contract, by a person or entity with "material" non-public information concerning a large customer transaction in the underlying commodity or security.

In either context, if the non-public information used by the frontrunner relates to a buy or sell order received from one of his customers (or some other confidential communication with the customer), any frontrunning in the commodity futures or options markets would be prohibited by the anti-fraud provisions of Section 4b(a) and Section 4c(b) of the Commodity Exchange Act (Act), 7 U.S.C. §§ 6b(a) and 6c(b)(1994), or Commission Regulation 33.10, 17 C.F.R. § 33.10 (2000). Additionally, if the frontrunner is registered (or required to register) as a commodity trading advisor (CTA) or a commodity pool operator (CPO), the frontrunning would also be prohibited by the anti-fraud provisions of Section 4c(1) of the Act.

Fraud arising from frontrunning most often happens in so-called "trading ahead" cases. As the U.S. Court of Appeals for the Seventh Circuit has explained, when a floor broker or other commodity professional trades for his own account ahead of a customer's order, the broker has "committed fraud 'in a classic sense' by causing customers to lose additional profits they would have made except for the improper execution of their orders." *United States v. Ashman*, 979 F.2d 469, 478 (7th Cir. 1993). The fraud essentially arises from the floor broker's failure to disclose to his customers that he is trading ahead of their orders for his own account. "In trading ahead of his customers without telling them what he [is] doing, [the floor broker is] misleading them for his own profit, and conduct of this type has long been considered fraudulent." *United States v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985).

Although the Seventh Circuit's opinions in *Ashman* and *Dial* did not address violations of the Commodity Exchange Act, the Commission has sanctioned frontrunning under Sections 4b(a) and 4c(1) of the Act for similar conduct, even where the frontrunner was not dealing with a customer. In the past five years, two such cases have been filed, both of which involved trading on the CME or the Board of Trade of the City of Chicago (the "CBOT"). In the first case, the vice president of a meat processing firm in Colorado responsible for the firm's futures trading was charged with violating Section 4b(a) by trading ahead of orders he was placing in the futures market for his employer. The CFTC's complaint alleged that, before entering orders for his employer's account, the respondent would place orders for his own account in the same contract and on the same side of the market. The Commission subsequently accepted a settlement offer in which the frontrunner, without admitting or denying the allegations, was subject to the imposition of a ten-year trading prohibition and an order to pay his employer \$50,000 in restitution, as well as undertaking never to apply for registration with the Commission in any capacity.

In the second case, the Commission sued an employee of a firm registered as a CTA and a CPO injunctively for engaging in fraud by trading ahead of orders that the employer was placing in the futures markets. The frontrunner and two other defendants, without admitting or

denying the allegations, settled all charges in this matter; pursuant to the settlements, the court barred the defendants from any activity in the futures industry, permanently enjoined them from further violations of federal commodity laws, and ordered them to pay \$2.6 million in disgorgement. Separately, the individual defendants pled guilty to criminal wire fraud charges based on the same wrongdoing underlying the Commission's civil complaint.

Like the Commission, the regulated exchanges all have rules that prohibit their members from trading ahead of customer orders or engaging in other forms of frontrunning. In the past five years, the CME has brought 11 trading-ahead cases, resulting in fines totaling \$249,000 and trading suspensions as long as one year. The CBOT has brought 20 trading-ahead cases, resulting in fines totaling \$393,025 and trading suspensions of up to four years. None of the CME or CBOT cases involved intermarket frontrunning.

2. Please describe the surveillance systems, books and records requirements, and audit trails which your agency, and the markets it oversees, employ to detect such potential frontrunning abuses and support enforcement of anti-frontrunning prohibitions.

In performing its oversight responsibilities, the Commission routinely reviews transaction records and conducts floor surveillance to detect, among other things, various customer order and market abuses. Trade practice investigations are initiated in each contract market on a regular basis to identify such potential trading violations as trading ahead of or against customers. For this purpose, Commission staff uses an automated database that contains trade data from each domestic futures exchange. Commission staff conducts routine trading floor surveillance daily at random times and more frequently at the open and close of trading. Commission staff also conducts additional floor surveillance during times of extreme price volatility or in anticipation of the release of certain economic reports. In addition to identifying activity that may warrant further inquiry, these activities provide baseline data concerning the activities of market participants.

The Commission also conducts a rule enforcement review of each futures exchange approximately once every two years. During the course of a review, Commission staff examines audit trail and recordkeeping systems, market surveillance, trade practice surveillance, and disciplinary programs for compliance with the Commodity Exchange Act, Commission regulations, and exchange rules. Commission staff make recommendations to each exchange for improvement as appropriate.

In addition to Commission surveillance, the futures exchanges employ a wide range of sophisticated and effective tools to address potential abuses such as frontrunning. The surveillance systems employed by the CME, for instance, include computerized surveillance reports and databases, video surveillance, trading floor surveillance by investigators, back office reviews of member firms, and automated review of trading documents for recordkeeping errors. The computerized surveillance system includes an on-line database of daily trading information that can be sorted to target different members and events and "exception reports" that highlight trades meeting the criteria for potential violations such as frontrunning and trading ahead of customer orders.

Notably, the CME's regulatory surveillance also includes two video systems. The CME, on its own initiative, developed and installed a video surveillance system on its trading floor in 1990. It is the only exchange in North America that uses such a system. The system allows the regulatory staff to view trading activity in any trading pit with state-of-the-art cameras that can pan, tilt and zoom to focus on areas of concern. The CME also has a separate video system that records wide-angle images of trading activity on a day-to-day basis. Although the principal purpose of the latter system is for dispute resolution and, accordingly, the video recordings would normally be saved only for short periods, regulatory staff can preserve and retrieve the recordings for regulatory purposes.

The CME actively enforces its audit trail-related and recordkeeping requirements. As discussed below, the CME's audit trail includes specific customer account identification, an execution time to the nearest minute, and order entry and report times. CME data analysts examine trading cards and floor order tickets at each clearing member firm at least once a year and an automated enforcement program monitors and provides feedback concerning certain member recordkeeping errors.

3. Please describe the facts and circumstances surrounding the alleged frontrunning on the CME.

Based on its meetings with and responses to its inquiries by the CME staff as well as its own review of relevant trading surveillance information, the Commission staff has not yet found factual support for the allegations of frontrunning made in the press articles alluded to in your letter of August 3, 2000. The following summary, based upon the information the Commission has before it at this time, provides an explanation of what transpired in the NASDAQ 100 futures pits during the period covered by the press articles and the CME's explanation of its rationale as to how rumors gave rise to the allegations reported by the press.

The Trader Alert Beeper System ("TABS"), a one-way buzzer alert system, was instituted at CME in 1996 in the Eurodollar futures pit to provide clearing firms' booth personnel with a mechanism to alert a broker's clerk to an incoming hand-signaled order. It was subsequently authorized for certain applications between different pit areas in the Eurodollar pit, in order to provide locals within the same trading group, or brokers within the same broker association, with the ability to get each other's attention in different parts of the same pit or in different pits to assist in the execution of multiple-month spread trades.

On June 28, 2000, the Exchange held a pit space dispute hearing to resolve the rights of a local trader (the "local") to certain space in the crowded NASDAQ 100 pit. The local had been in the pit for a short period of time and was vying for a better location. During the hearing, the local mentioned that he was using the wireless version ("P2P") of the TABS to get the attention of one or two top step brokers (those located on the top step of the pit, the optimum vantage point for trading) for the purpose of signaling them orders for his own account.

The Exchange, however, had not authorized the TABS to be used to link a local and a broker in the same trading pit. The description of the local's use of P2P apparently was either inadequate or misunderstood by those present at the pit space hearing and rumors began to

spread that the TABS (in particular, the P2P configuration) was being used to frontrun customer orders. These rumors spread notwithstanding the fact that the local held the P2P sending unit and the brokers held the receiving units in the pit. Of course, for the system to be used for frontrunning by the local, one of the brokers with knowledge of customer orders would have needed the sending unit to transmit that information to the local holding the receiving unit, rather than the other way around as was the case here. To date, no evidence has been found that would suggest that either local used the P2P to frontrun customer orders. The Exchange has denied the local's request for permission to continue using his P2P to page top step brokers.

4. **A July 12, 2000 memorandum to CME members from the CME's Managing Director for Regulatory Affairs states that "several questions have recently arisen regarding the permissible uses of the Trader Alert Beeper System (TABS) and other forms of person-to-person communication devices on the trading floors of the Exchange." This memorandum notes that "use of unauthorized communication equipment on the trading floors is prohibited and constitutes a violation of Exchange rules." Please describe the precise nature of the "questions" which have arisen regarding use of buzzers on the CME floor. Has unauthorized use of buzzers been occurring? If so, what actions are being taken with respect to those responsible?**

The CME staff reported that questions concerning the authorized use of the TABS arose following the June 28 pit space hearing referred to in response to Question 3 above. Members inquired generally about its permitted use in the NASDAQ 100 pit and, specifically, whether TABS could be used to connect brokers and locals. As a result of the confusion over the proper use of the TABS, CME's Managing Director for Regulatory Affairs issued his July 12, 2000 memorandum to members clarifying the permissible uses of the system.

As a result of the pit space hearing, the Exchange initiated an inquiry into the use of the TABS and identified every purchaser and verified every use. The Exchange determined the only P2P being used to link a local and a broker was the one employed by the local involved in the NASDAQ 100 pit space dispute. The local had purchased the P2P from a retired local who had previously used it for approximately four months to get the attention of top step brokers to execute his orders. The local still at the Exchange had been using the P2P for approximately three weeks at the time of the pit space hearing. As noted above in response to Question 3, to date, no evidence has been found that would suggest that either local used the P2P to frontrun customer orders. The Exchange has denied the local's request for permission to continue using his P2P to page top step brokers.

5. **A July 13, 2000 memorandum from the CME Chairman and the President and CEO states that beginning on August 1, the CME would "retain specific Video Trade Resolution System (VTRS) logging information indefinitely for regulatory and investigative purposes. Additionally, the Division will have authority to utilize both the VTRS and video surveillance cameras without obtaining prior approval of the President." Why weren't these records already being retained for regulatory and investigative purposes, and why was it that prior approval from the President of the CME had previously been required to utilize these videos for investigative or surveillance purposes? What "logging information" is going to be retained under the**

CME proposal? Does this include the actual videos themselves? If not, what value does this logging information have from a regulatory or investigative standpoint?

As mentioned above, in 1990, the CME installed the only video surveillance system used for regulatory purposes at any exchange in North America. In addition, in 1997 the Exchange installed the Video Trade Resolution System ("VTRS") on one floor to assist in the resolution of trade settlement disputes. In 1999, the CME installed a digital VTRS on its other trading floor, which includes the NASDAQ 100 pit. Given the purpose of VTRS, it is necessary to retain the electronic digital images only for the short period of time during which a dispute might arise. According to the CME, the "logging information" in this system is the digital electronic images, which are usually retained for one day, because of the cost of disk storage space. Nonetheless, the CME's regulatory staff has the authority to move the digital images to a discrete file and save them indefinitely for regulatory purposes as needed.

The use of CME's video surveillance system previously required prior approval from the President in order to address privacy concerns and to provide a procedural safeguard for members. The Exchange determined that use of video surveillance was a significant regulatory decision and that prior approval was needed to prevent possible abuse of the system. Under the prior approval policy, the President approved every request made to use the video surveillance system.

- 6. Please provide a chronology stating when and how the CME, your respective agencies, and the NASDAQ learned of the trading activities described in the aforementioned press articles. Why was the SEC apparently not informed of any CME investigation into this matter prior to the time that our staffs contacted them to request information regarding the matters described in the aforementioned press reports? What does this say about the desirability of perpetuating a bifurcated regulatory scheme for futures based on securities?**

The CME became aware of an unauthorized use of the TABS in the NASDAQ 100 pit at a pit space hearing on June 28, 2000. In the course of its oversight of CME's self-regulatory activities, senior Commission staff have had a number of discussions with senior CME staff concerning trading in the NASDAQ pit. Commission and CME staff participated in conference calls on July 17 and 25, 2000. In the latter call, CME informed Commission staff of the unauthorized use of the TABS. Commission staff also attended meetings with CME staff on August 2 and 14, 2000. This dialogue between the Commission and the CME explored the trading activities and other matters related to the allegations, including, without limitation, the CME's regulation of that market. The Commission intensified its surveillance of this market on July 17, and is closely monitoring CME's investigation of the market.

There is no implication that the underlying NASDAQ securities market was affected or that there was any other intermarket aspect to the alleged trading that would warrant special notification of the SEC or the NASDAQ outside of the regular methods of consultation described below. With respect to the regulatory scheme for futures based on securities, these events do not detract from the efficacy of existing arrangements between futures exchanges and securities exchanges and between the SEC and the CFTC. As described in response to Question 12 below,

the SEC and CFTC routinely share information and have worked together to investigate trading activities and to bring enforcement actions. The exchanges have a similar relationship, as described in response to Question 7 below.

7. What coordinated surveillance procedures exist today between the CME and the primary markets that trade the stocks underlying stock index futures products such as the NASDAQ 100 future? Are these procedures adequate?

The CME has been an affiliate member of the Intermarket Surveillance Group (ISG) since 1990, and it worked with that group on an informal basis for at least five years before the status of affiliate member was created. The ISG is an international group of more than 25 securities, options and futures exchanges. It coordinates intermarket surveillance and compliance efforts and information sharing for investigations into matters that involve interexchange trading activities. In 1989, the CME and the NYSE entered into an agreement regarding intermarket trading restrictions, particularly to deter frontrunning. Within a few years, the Chicago Board Options Exchange ("CBOE") also became a party to this agreement. This long-standing agreement was reviewed by both the CFTC and the SEC and is considered an appropriate policy for dealing with interexchange frontrunning abuses. To effectuate this agreement, the CME has been exchanging confidential trading data daily with the NYSE and the CBOE. The CME also has information sharing agreements with the American Stock Exchange and the NASDAQ.

The exchanges routinely use these data to monitor their markets for evidence of intermarket trading abuses. These routine information exchanges can be augmented with specific information requests made pursuant to the ISG's information sharing agreements. The vast majority of investigations initiated by futures, option and securities exchanges into trading in equity products or individual stocks, however, involve trading that occurred solely on one market. Likewise, the allegations addressed by your letter also involve trading only on the CME and, as noted above, have raised no intermarket surveillance issues.

8. Would improved futures exchange audit trails help deter and detect frontrunning? Isn't it critical to have a real-time audit trail to capture this type of behavior, like the types of audit trails in the securities markets? Why should we allow stock futures without these types of audit trails?

Futures exchanges currently have audit trails that capture substantial information, including information not available to securities exchanges, which facilitate the detection and deterrence of frontrunning. Futures exchange audit trails currently capture information which is not part of securities market audit trails, and enable futures exchanges to use more efficiently a wider variety of information to detect and deter frontrunning and other trading abuses in stock futures than can be used by securities exchanges.

For example, the CME has a transactional surveillance system that contains information relating to the specific customer account identification received up front with each transaction. Securities exchanges can only access specific account information through the after-the-fact process of "blue sheeting." This account information allows the CME to determine the profitability of individual accounts as well as the beneficial ownership of accounts, and to use

that information to detect potential member violations. The CME also can aggregate customer accounts based on the party in control of those accounts to examine the activity of accounts under common control. Further, the CME's large trader database provides information on entities holding large positions and the specific trading accounts associated with the activity. Thus, CME regulatory staff can monitor both the large positions and the related trading activity of these accounts.

Another important component of the audit trail is timing data. Audit trails in the futures markets are required to include a time of execution for each trade to the nearest minute. Both securities and futures markets can capture real time data when trades are executed on centralized electronic systems. For example, the CME's successful E-Mini S&P 500 and E-Mini NASDAQ 100 futures contracts are executed on the Globex system, which is a centralized electronic trading platform which produces real time audit trails. When either futures or securities markets do not centralize the electronic execution of trades, for example certain types of floor trading, the captured times are not "real time." In that circumstance, execution times may be based upon different data, such as the time of report of execution for a transaction. Audit trails in the futures markets are also required to include order entry and report times.

The CME's capture of a trade execution time and other timing data, when combined with the specific account information provided with each trade, assists the Exchange in identifying possible frontrunning of a customer's order. As previously noted, the CME has a computerized exception report that isolates potential instances of frontrunning and trading ahead of customer orders. These timing data and exception reports would be used to detect and deter frontrunning schemes in stock futures.

9. What procedures should be in place to detect and deter frontrunning schemes, such as that described in the aforementioned press articles, if stock futures are permitted?

The futures exchanges' existing procedures for detecting and deterring frontrunning would apply to stock futures. As previously stated, the CME, for example, has effective tools in place to address potential abuses such as frontrunning. The CME's computerized surveillance system includes, among other things, an on-line database that stores the output of various exception reports and a comprehensive large trader database. Further, the Exchange uses a video surveillance system, full-time floor investigators, and, as needed, a digital video dispute resolution system. Moreover, data analysts examine trading cards and floor order tickets at each CME clearing member firm at least once a year, and an automated enforcement program monitors and provides feedback concerning member recordkeeping errors.

Finally, CME's audit trail, as discussed above, includes specific account identification information and a time of trade execution. Thus, the Exchange can determine the time of the event as well as the identity of the account owner or controller. In addition, if the CME were to trade stock futures electronically, the Exchange would have real time audit trail data. This audit trail would be an effective tool in detecting and deterring frontrunning for security futures products.

10. Would the SEC have the ability to ensure such procedures are in place for stock futures under: (1) H.R. 4541, as reported by the Commerce Committee; and, (2) H.R. 4541, as reported by the Agriculture Committee?

Section 8 of H.R. 4541, as reported by the Agriculture Committee, provides for consultation between the CFTC and SEC prior to designation by the CFTC of a market on which security futures products may be transacted. It also includes provisions to allow the SEC to exercise specific enforcement authorities regarding these products: Sections 10(b) and 21A of the Securities Exchange Act of 1934 ('34 Act) with respect to insider trading; Section 16(b) of the '34 Act with respect to unfair use of information in short swing trading by a corporate insider; Section 9 of the '34 Act with respect to manipulation of securities prices; Section 10(b) of the '34 Act and Section 204A of the Investment Adviser's Act of 1940 with respect to frontrunning; Section 14 of the '34 Act with respect to the pricing and integrity of tender offers; and Rule 144 of the SEC rules with respect to trading in restricted securities. H.R. 4541, as reported by the Commerce Committee, includes provisions that would permit the SEC to abrogate futures exchange rule submissions in security futures products. Accordingly, both versions of the bill provide for the exercise of regulatory authority over these products by the SEC

11. Does this behavior demonstrate the necessity of coordinated surveillance and oversight of stocks and stock derivative products? Would the need for coordinated surveillance overseen by a single regulatory authority be heightened by single stock futures?

As noted below, the CFTC and SEC currently engage in coordinated enforcement activity. As both agencies have stated, the nature of security futures products indicates the need for coordinated regulatory oversight. However, each agency has responsibility for carrying out its distinct and separate mandate with regard to enforcement authority over these products. Accordingly, each agency should remain the primary regulator for enforcement of its rules and regulations in the markets it oversees.

12. Please describe how the SEC and CFTC coordinate surveillance and prosecution of fraud and manipulation involving stock-index based futures. Would those efforts be adequate if stock futures were permitted?

Upon the initiation of stock index futures trading in 1982, CFTC Chairman Philip McBride Johnson extended a formal invitation to SEC Chairman John Shad to have SEC staff attend weekly CFTC market surveillance meetings when stock index markets were on the agenda. At that time the CFTC surveillance staff also invited SEC surveillance staff to attend quarterly meetings at CFTC headquarters that were being held with staff from the Department of the Treasury, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York to review large trader positions in expiring futures markets in interest rates and foreign currencies. Stock index contracts were added to the agenda of those meetings. Those quarterly meetings have continued since that time, and form the basis for routine information sharing among these agencies on market surveillance issues.

It was these contacts that led to a successful interagency investigation of a manipulation of the market for an issue of U.S. Treasury notes by a hedge fund. In that case, the CFTC, SEC and

the Chicago Board of Trade jointly investigated and filed charges against the hedge fund for its activities in the cash market for a particular U.S. Treasury note that yielded a profit on the fund's futures position. Based on its years of experience in working with SEC surveillance staff on stock index futures and option markets, the Commission is confident that these same cooperative efforts can be extended to single stock futures, if the ban on those instruments were lifted.

As noted above, the nature of security futures products indicates the need for coordinated regulatory oversight. The staffs of the CFTC and SEC have discussed what authorities each would need to carry out their respective statutory mandates with regard to these products, and the Commission believes that the staffs can develop appropriate coordinated surveillance procedures if necessary, in addition to the systems already in place, to ensure that each agency's enforcement program has the information it requires.

13. Would the SEC and the CFTC need additional funds to adequately perform the additional tasks imposed upon it by H.R. 4541?

The Commission does not believe that enactment of H.R. 4541 would result in requiring additional funds beyond those stated in our current budget projections.

14. Does the trading of stock index futures, such as the NASDAQ 100 futures contract, serve a price discovery function for the stock market? If so, do frontrunning schemes such as those described in the aforementioned press articles constitute a form of manipulation that could impact stock prices? Further, would the potential stock price impact caused by such schemes be more likely if employed with single stock futures?

The NASDAQ 100 futures market may serve a limited price discovery role, particularly when the primary market is closed. During regular trading hours, however, the primary NASDAQ market is so much larger than the NASDAQ 100 futures market that it is not likely that price movements in that future would have much of an influence on the primary market. Average daily volume in the stocks comprising the NASDAQ 100 index was 600 million shares in July, while average daily NASDAQ 100 futures volume was only 25,000 contracts, futures and options combined. Nevertheless, the futures market does closely track the underlying index. Based on interviews with traders who conduct stock index arbitrage and our independent examination of the relationship between NASDAQ 100 futures prices and the value of the underlying index, the Commission has found no periods of sustained mispricing of the index futures over the past six months that would indicate price manipulation.

In fact, no allegations of price manipulation or intermarket frontrunning have been raised in this matter. The press reports related to floor brokers allegedly trading for their personal accounts, either directly or indirectly, ahead of customer futures orders. That type of activity, even if true, should not have more than a transitory impact on futures prices and would have no impact on underlying stock prices. Since the NASDAQ 100 is a broad-based index of large capitalization stocks, it is not a viable vehicle for manipulating the prices of the underlying stocks or for frontrunning material nonpublic information regarding those individual stocks. These press allegations do not raise any specific implications for the intermarket regulation of single stock futures, should the ban on such contracts be lifted by Congress.

- 15. The CME situation reportedly involved an index future, where the material non-public information involves a large futures trade. With single stock futures, material non-public information about a futures order as well as information about an order in the underlying stock can be used to frontrun with futures. If single stock futures were permitted, what effect would frontrunning involving futures have on the integrity of the underlying securities markets? In fact, wouldn't single stock futures magnify the potential for this type of frontrunning?**

Frontrunning orders using material, nonpublic information about a customer order can occur today on a single market or on some combination of equity, option or futures markets. However, such activity is illegal under both commodity and securities laws, and is a violation of exchange rules in both markets. As noted above, the Intermarket Surveillance Group has been established to deal with violations such as intermarket frontrunning when it occurs. The CME and all futures exchanges that trade stock index futures contracts are affiliate members of the ISG. As such, they are committed to sharing surveillance information with other exchanges to detect and discipline intermarket abuses. For that purpose, the CME shares surveillance data daily with the New York Stock Exchange and the CBOE, and it routinely performs analyses of those data to identify potential intermarket trading abuses.

Moreover, those exchanges have in place a long-standing policy statement on intermarket trading abuses that was reviewed by both the CFTC and the SEC. These agreements and intermarket surveillance mechanisms can readily be extended to deal with any potential for intermarket trading abuses for security futures products.

- 16. If the alleged frontrunning scheme described in the aforementioned articles were carried out using single stock futures (under the regulatory structure permitted by H.R. 4541, as reported by the Agriculture Committee), would the SEC have the ability to ensure that futures exchanges have in place adequate surveillance and investigation procedures to police such manipulative activity? What about under H.R. 4541, as reported by the Commerce Committee?**

The CFTC requires that futures exchanges have effective rule enforcement programs, and monitors such enforcement both as part of approving the rules of new exchanges and through periodic rule enforcement audits conducted by CFTC staff. Moreover, both SEC and CFTC staff routinely attend meetings of the Intermarket Surveillance Group. Through those meetings, both agencies have an opportunity to observe and encourage intermarket cooperation on surveillance and compliance issues involving intermarket abuses. In addition, the CFTC and the SEC have an information sharing agreement and have worked together successfully in the past to investigate and prosecute intermarket abuses. These existing mechanisms provide ample assurance that any intermarket abuses will be addressed, either at the exchange level or at the federal level.

The futures exchanges currently have in place audit trails that can provide the Commission with the information needed to detect and deter frontrunning. As noted above, Section 8 of H.R. 4541, as reported by the Agriculture Committee, provides for consultation between the CFTC and SEC prior to designation by the CFTC of a market on which security futures products may

be transacted. It also includes provisions to allow the SEC to exercise specific enforcement authorities regarding these products: Sections 10(b) and 21A of the Securities Exchange Act of 1934 ('34 Act) with respect to insider trading; Section 16(b) of the '34 Act with respect to unfair use of information in short swing trading by a corporate insider; Section 9 of the '34 Act with respect to manipulation of securities prices; Section 10(b) of the '34 Act and Section 204A of the Investment Adviser's Act of 1940 with respect to frontrunning; Section 14 of the '34 Act with respect to the pricing and integrity of tender offers; and Rule 144 of the SEC rules with respect to trading in restricted securities. H.R. 4541, as reported by the Commerce Committee, includes provisions that would permit the SEC to abrogate futures exchange rule submissions in security futures products. Accordingly, it would appear that both versions of the bill provide for the exercise of regulatory authority over these products.

17. Does the highly leveraged nature of stock index futures make it easy (at least compared to stocks and stock options) for manipulators to effect schemes such as that described in the aforementioned press articles? Would the answer be the same for single stock futures?

Comparative levels of margin and the issue of leverage are not related to the allegations that have been raised regarding trading in the NASDAQ 100 futures pit. The alleged trading of floor members ahead of customer orders would have involved intraday trading. Members' positions not carried overnight are not directly margined at the clearinghouse, either on futures or option exchanges. Accordingly, the levels of margin that may apply to positions held for more than a day have no bearing on intraday trading strategies. Furthermore, the trading abuses alleged in this case are not a form of price manipulation.

With respect to a member's trading on the floor of an exchange, it is not necessarily accurate that stock index futures are more highly leveraged than stock index options. The higher securities option margin levels set pursuant to Regulation T apply only to non-member customers. The margining system that the options industry applies to members, TIMS, is a portfolio margining system that is very comparable to the system that the futures industry applies to all market participants, SPAN. CBOE market makers have their overnight positions "margined" under a variant of TIMS called risk-based haircuts. The SPAN and TIMS margining systems utilize comparable methodologies to assess risk in a portfolio and yield comparable levels of margin for comparable positions.

18. What is the impact of low stock index futures margin requirements on the ability to profit from a frontrunning scenario like this? If stock index futures margin requirements were equivalent to stock index options (premium plus 15%), would the ability to profit from this behavior be drastically reduced? Would low margins for single stock futures heighten the potential to profit from a frontrunning scheme? Please provide us with your opinion on the effect of high leverage on the ability to engage in frontrunning.

Stock index futures margins are not a factor in the profitability of the alleged frontrunning scheme because the trading involved would all be done within a few minutes of the customer order being revealed to a floor broker. Clearinghouse margins only apply to positions carried

overnight. As noted above, comparative levels of margin and the issue of leverage are not relevant to the allegations that have been raised regarding trading in the NASDAQ 100 futures pit, and would not be relevant in evaluating frontrunning allegations in similar situations.

19. The aforementioned press reports indicate that the CME now plans to prohibit the practice of "dual trading" during the first and last hour of the trading day, and that the allowable percentage of personal trading by brokers throughout the day will be decreased to 10% from 15. Are these reports accurate? If so, please explain why stricter restrictions—or a complete prohibition—on dual trading were not in place previously. Do you believe the proposed restrictions are adequate, or should more be done? Why, for example, should dual trading be barred in the first and last hour of the trading day, but then permitted at other times? How do the current and proposed dual trading restrictions compare to the dual trading restrictions contained in the Commerce Committee and Agriculture Committee versions of H.R. 4541?

The CME's dual trading restriction was voted into effect by its members in 1991. It is designed to protect customers while maintaining market liquidity and effective price discovery. Under Exchange rules, dual trading is restricted in any contract month that is "mature and liquid," which is defined by, among other things, an average daily pit-traded volume of 10,000 or more contracts.

Early this year, the volume threshold for the dual trading restriction was reached for the lead month of the NASDAQ 100 futures contract, but the CME Dual Trading Committee determined that the contract had not met the "mature and liquid" standards of the Exchange's rule. Therefore, the Committee voted not to recommend that the Exchange's dual trading restriction be implemented in that contract.

Nonetheless, in February 2000, the CME acted to enhance the execution of customer orders in the NASDAQ 100 pit. Given the significant space limits in the pit (200 members wanted to trade in a pit which accommodates 150 people), the CME decided that only brokers for whom 85% or more of their activity was filling orders for others would be permitted to trade from the optimum vantage point in the pit, the top step.

In the beginning of April 2000, CME's Board formed a group to analyze, among other things, regulatory and trade practice issues in the NASDAQ 100 pit. Based upon that group's proposals, the Exchange decided to take two actions with respect to dual trading. First, the Exchange further restricted personal trading by top step brokers such that personal trading could not account for more than 10% of a broker's activity. This restriction is similar to that in place for other stock index products at the CME. Second, the Exchange prohibited brokers from trading for their personal accounts during the first and last hours of the trading session. The CME chose to limit dual trading during the time periods when the market was sufficiently liquid that personal trading by brokers would be unlikely to be necessary to the orderly functioning of the market (60 percent of contract volume is in the first and last hours of the trading day). Given the volatility in the market, the Exchange believed that brokers would be better able to serve their customers effectively during those periods if they concentrated on filling customer orders.

Dual trading was permitted at other times in order to maintain liquidity in the market. The Commission believes that this was a reasonable and adequate approach to the particular characteristics of this market at that time.

With respect to the proposed dual trading restrictions, both the Agriculture Committee and Commerce Committee versions of H.R. 4541 would specifically prohibit dual trading in single stock or stock index futures. The Commerce Committee version would provide that security futures products be subject to the dual trading prohibitions of Section 4j of the Commodity Exchange Act; the Agriculture Committee version would repeal Section 4j, and would provide a specific prohibition that a floor broker may not trade security futures products for his own account and for customer accounts during the same trading session.

20. The July 13, 2000 CME memorandum states that as of August 1, 2000, “quantity restrictions on GLOBEX®2 for the E-mini NASDAQ 100 futures contracts will be eliminated.” One of the aforementioned press articles indicates that, while the CME was lifting current restrictions on the number of NASDAQ 100 futures contracts that can be traded via computer, similar restrictions were not being lifted with respect to certain S&P index futures contracts. The article goes on to suggest that while investors might benefit from a move to electronic trading, opposition from floor traders and technological capacity issues were preventing or delaying such a change. What capacity issues surround the trading of stock index futures? How are the futures exchanges planning and preparing for increases in capacity needs? Are these plans adequate? How would these plans be affected by allowing for the trading of single stock futures? How would they be affected by the decimal trading requirement contained in the Commerce Committee version of H.R. 4541? What oversight role should the SEC and CFTC have to assure that timely capacity upgrades are made in trading and information dissemination systems to assure that any market for single stock futures or stock index futures keep pace with demand?

There currently are no concerns regarding GLOBEX®2 capacity and the trading of stock index futures. The CME this year has tripled the capacity of its matching engine and is planning yet another doubling of capacity by the end of 2001. The GLOBEX® system has a robust, scalable architecture that supports parallel and modular expansion. The CME has informed the Commission that its system is capable of handling any foreseeable increase in products created by allowing the trading of single stock futures.

To maintain high reliability and customer confidence, the Commission requires that the Exchange continuously monitor and ensure that its systems continue to have ample capacity to handle the trading of its products. Since futures contracts already are traded in decimals, the decimal trading requirement contained in the Commerce Committee version of H.R. 4541 would have no impact on Exchange planning for increases in capacity needs. To ensure that timely capacity upgrades are made, the Commission reviews systems when they are put into place and reviews subsequent material changes for consistency with the ten Principles for the Oversight of

Screen-Based Trading Systems for Derivatives Products promulgated by the International Organization of Securities Commissions, and adopted by the Commission on November 15, 1990.

Please let me know if the Commission can provide you with any additional information.

Sincerely,

A handwritten signature in black ink, appearing to read "William J. Rainer". The signature is fluid and cursive, with a prominent initial "W".

William J. Rainer
Chairman