UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

September 5, 2000

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
U.S. House of Representatives
2322 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Dingell:

Thank you for your August 3 letter to Chairman William J. Rainer of the Commodity Futures Trading Commission and me concerning press reports about possible frontrunning in Nasdaq 100 stock index futures on the Chicago Mercantile Exchange. In your letter, you requested responses to a number of questions raised by these frontrunning allegations, including intermarket surveillance and enforcement issues that could arise from the development of futures contracts on individual stocks. I believe that the enclosed staff memorandum is fully responsive to the questions you posed to me.

I assure you that I share your commitment to preventing trading abuses from harming investors or compromising the integrity of the securities markets. Any proposed regulatory framework for the implementation of trading in single stock futures must not undercut the essential safeguards that investors in our markets have come to expect. As always, I look forward to working with you and other Congressional leaders on these matters.

Sincerely,

Arthur Levitt

Enclosure

Similar letters and enclosures sent to:
The Honorable Edolphus Towns
The Honorable Edward J. Markey

cc: The Honorable Tom Bliley
The Honorable Michael G. Oxley
The Honorable W.J. "Billy" Tauzin

MEMORANDUM

To: Chairman Levitt

From: Annette L. Nazareth, Director
Division of Market Regulation

Re: Frontrunning Questions

Date: September 5, 2000

The following responds to questions posed in a letter, dated August 3, 2000, to Chairman William J. Rainer of the Commodity Futures Trading Commission ("CFTC") and you, from Congressmen John D. Dingell, Edolphus Towns, and Edward J. Markey.

Q#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 CBOT, and what penalties have been imposed? How do these compare to the penalties imposed in the stock and options markets?

Response:

Under the federal securities laws, frontrunning abuses could constitute manipulative or deceptive activity which could be prosecuted under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5, thereunder. However, the most common forms of frontrunning abuses in the securities markets have traditionally been addressed by the securities self-regulatory organizations ("SROs") as violations of their "Just and Equitable Principles of Trade" or "J&E" rules.[1] The exchanges' J&E rules give them considerable flexibility to sanction member firms and associated persons for abusive or improper activities that may not rise to the level of fraud under Section 10(b) of the Exchange Act and Rule 10b-5, thereunder.

The introduction of equity options trading in the 1970s brought with it concerns about intermarket frontrunning.[2] In response, the Commission ensured that the options exchanges

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1 National securities exchanges are SROs and are required under Section 6 of the Exchange Act to have the capacity to enforce compliance by their members with the federal securities laws and the exchanges' rules. Moreover, all proposed changes to exchange rules must first be submitted to the Commission for approval and exchange operations are subject to routine and cause inspections by the Commission staff.

2 The most common example of intermarket frontrunning in equity options would be as follows. A broker-dealer is about to cross a large block trade (10,000 shares or more) in a given stock for its customers, and the firm knows that the price of this block will move the share price up or down by a significant amount. Before this block prints on the consolidated tape, however, the broker-dealer enters an order in

issued circulars to their members that made it clear that frontrunning would result in J&E disciplinary actions by the exchanges against the traders and their firms. When additional frontrunning concerns were raised with the introduction of index options in the 1980s, the SROs again issued circulars to members that emphasized that J&E disciplinary actions would be undertaken if there was evidence of possible frontrunning involving these options.

The options exchanges have brought a number of J&E disciplinary actions for intermarket frontrunning. For example, from 1981 to 1999, the American Stock Exchange ("Amex") brought 12 disciplinary actions for intermarket frontrunning that resulted in fines ranging from $5,000 to $10,000. From 1983 to 1999, the Chicago Board Options Exchange ("CBOE") also brought 16 disciplinary actions that resulted in fines from $500 to $100,000.[3] In addition, the Philadelphia Stock Exchange has brought two disciplinary actions for intermarket frontrunning, one in 1986 that resulted in a $10,000 fine and another in 1990 with a fine of $20,000. Finally, the Pacific Exchange ("PCX") brought one disciplinary action for intermarket frontrunning in 1989, which resulted in a $15,000 fine.

In addition, in 1995, the New York Stock Exchange ("NYSE") and the CBOE brought a joint disciplinary action against CS First Boston Corp. and several of its traders for intermarket trading activities in stock baskets and index options that resulted in short-term price swings in both markets. Although the disciplinary action did not characterize CS First Boston's activities as frontrunning or market manipulation, the firm's and its traders' intermarket activities were found to have violated numerous exchange rules setting forth supervisory responsibilities for the firm's business activities and rules governing trading and recordkeeping. The NYSE and CBOE required the firm to undertake measures to prevent a recurrence of this situation and jointly fined the firm $450,000.

In addition to intermarket frontrunning, intramarket frontrunning ("trading ahead") – like that alleged to have occurred on the CME -- can be a problem. Trading ahead occurs when a broker-dealer holding a customer order for a security executes a trade for its

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another market to establish a proprietary position in the options for this stock. When the block prints on the tape and the options prices react favorably to the stock price movement, the firm can close out its options position in order to capture a short-term profit based on the firm's non-public information about its customer's stock transaction. While this type of "customer frontrunning" may be the most common form of this type of trading abuse, the options exchanges have made clear to member firms that their trading in options ahead of their own proprietary block trades in the underlying securities (so-called "self-frontrunning") may also constitute frontrunning violations of the exchanges' J&E rules.

3 The fines issued in intermarket frontrunning actions often pertain not only to frontrunning activity but also related conduct, such as violations of floor conduct rules or requirements for accurate time stamps on orders or other recordkeeping obligations. For example, the $100,000 fine by the CBOE against Susquehanna Investment Group in 1990 was apportioned as follows: $75,000 for the frontrunning conduct, $20,000 for the potential gain from the frontrunning, and $5,000 for violations of floor conduct rules.

proprietary account in that security. To protect against these types of abuses, the securities exchanges have structural protections in place to minimize the opportunities for intramarket frontrunning. In particular, the federal securities laws and exchange rules prohibit floor brokers from trading for their own accounts. Consistent with Section 11(a) of the Exchange Act, absent an applicable exemption, the only exchange members that are generally permitted to trade as principal on the floor both agency and proprietary orders in the same security on the same day (so-called "dual trading") are specialists. Accordingly, specialist operations are given particularly close scrutiny by exchange surveillance and examination staff to review how specialists handle customer orders. The exchanges have brought disciplinary actions against specialists that trade in a manner that disadvantage customer orders and other floor traders that violate restrictions on dual trading. For example, the Amex has brought two final disciplinary actions against floor brokers for trading ahead activity that resulted in substantial fines. First, in 1994, the Amex fined four floor brokers for trading ahead and prearranged trading. Two floor brokers received fines of $100,000 and were permanently barred; one floor broker was fined $50,000 and subjected to a three-year bar; and the fourth floor broker was fined $10,000. Second, in 1996, the Amex fined one trader $50,000 and imposed a three-year bar and another trader was fined $40,000 and received a one-month suspension for trading ahead of customer orders and violations of other floor trading and recordkeeping rules of the exchange.

When there has been evidence of a more widespread breakdown of the prohibitions against dual trading by exchange floor brokers, the Commission itself has taken enforcement actions against the traders as well as against the exchange that has failed to live up to its self-regulatory duty to police its members' activities. In early 1998, the Commission completed an investigation of a number of NYSE floor brokers, which uncovered violations of the federal securities laws and NYSE rules, including trading ahead.[4] The Commission filed a federal civil enforcement action alleging illegal profit sharing arrangements between a registered broker-dealer and eight brokers on the NYSE floor in violation of Section 11(a) and Rule 11a-1 under the Exchange Act and related NYSE rules.[5] The United States Attorney's Office for the Southern District of New York filed its criminal action in May 1998.[6]

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4 The Commission's action was a result of an investigation with the United States Attorney's Office for the Southern District of New York, the NYSE, the Internal Revenue Service Criminal Investigation Division, and the Federal Bureau of Investigation.

5 As discussed above, the federal securities laws and a variety of NYSE rules prohibit floor brokers from trading for their own account while they are on the floor of the exchange. From their unique position on the floor of the NYSE, floor brokers are immediately aware of changes in securities prices, large buy and sell orders for securities, and a host of other information not immediately ascertainable to other participants and investors in the markets. The proscriptions against trading by floor brokers are intended to prevent floor brokers from taking unfair advantage of their unique position.

6 In the summer of 1998, the Court dismissed the Commission's 1998 complaint as to the defendants, without prejudice, pending resolution of criminal charges brought against those defendants and others by the United States Attorney's Office for the Southern District of New York. Since then, several of the

In a related action, the Commission instituted and settled an enforcement action against the NYSE for its failure to enforce the federal securities laws and their own rules governing trading by floor brokers. In connection with this settlement, the NYSE undertook to correct these deficiencies.[7] Specifically, the NYSE committed to: 1) improve surveillance and regulation of floor members; 2) perform a comprehensive review of NYSE rules and procedures; 3) develop an education program for members concerning duties and prohibitions under the securities laws and NYSE rules; 4) develop and implement new electronic systems to capture information on orders handled by floor brokers; and 5) a commit to maintain its Regulatory Quality Review Department as a substantial, independent, internal audit staff.[8]

Q#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.

Response:

All of the options exchanges have audit trails and surveillance programs in place to detect potential intermarket frontrunning abuses. In the securities markets, the options exchanges are given the primary responsibility to conduct surveillance programs directed at detecting frontrunning a stock trade by trading in the options market. This allocation of surveillance responsibilities reflects the fact that, in options/stock frontrunning, most of the harm and potential gain from these abuses are realized in the options transactions. Both the stock and the options markets, however, have the responsibility to look for intermarket trading strategies that can result in short-term cross-market price movements, such as those that resulted in sanctions by the NYSE and CBOE against CS First Boston Corp. in 1995,

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defendants named in the Complaint have pleaded guilty to criminal violations in connection with their unlawful trading, and have been sentenced. Certain other defendants named in the Commission's 1998 complaint have settled the Commission's charges and are not named in the complaint that was re-filed by the Commission on March 30, 2000.

The NYSE's undertakings were discussed in detail in the *Report to the Honorable John D. Dingell* from the Commission staff, dated July 21, 2000 ("Dingell Report").

8 The securities SROs also have off-floor restrictions concerning trading ahead of customer orders. For example, NYSE Rule 92 prohibits upstairs traders (such as block traders or other traders effecting customer facilitation trades) at member firms from trading along with customer orders except under carefully limited exceptions that do not raise significant investor protection concerns. In addition, in the Nasdaq Stock Market ("Nasdaq"), an interpretation, NASD IM 2110-2 (referred to as the "Manning Rule") prohibits member firms from trading ahead of customer limit orders. Because the concerns raised by Congressmen Dingell, Towns, and Markey appear to be focused primarily on frontrunning on exchange floors, however, we are not providing detailed breakdowns of recent SRO disciplinary actions that have been taken by these SROs for off-floor trading ahead abuses.

discussed above. Moreover, when the surveillance staffs of the stock and options markets created the Intermarket Surveillance Group in 1981, frontrunning and intermarket manipulation were identified in the ISG Agreement as key intermarket trading abuses that ISG members would address. If there are intermarket implications from the activity in question, the ISG member that initiated the investigation should coordinate its inquiries, investigations, and disciplinary actions with other relevant ISG members. The major futures exchanges that trade stock index futures, such as the CME, joined the ISG as affiliate members in 1990. Even before that, however, the CME and the NYSE entered into a surveillance information-sharing agreement and issued a joint circular to members setting forth the types intermarket trading abuses that could result in sanctions by these exchanges.

The stock and options exchanges also use audit trails and surveillance systems, which these audit trails support, to look for instances of potential trading ahead abuses on their markets. These programs are supplemented by exchange staff efforts to address complaints or inquiries by members or investors concerning allegations of trading ahead situations. As discussed above, trading by exchange specialists is given particularly close scrutiny by surveillance staffs to detect instances in which investor orders may have been disadvantaged. NYSE specialists are also subject to periodic exams by exchange staff to determine whether investor orders have been handled fairly and in accordance with NYSE rules and the federal securities laws. In addition, exchange and Commission rules require member firms to maintain trading records, including order tickets and blotters, that would be needed to investigate trading ahead abuses.

On the securities exchanges, audit trails are created by matching transaction tape reports with clearing records. The Commission believes that the transaction tape reports in the stock and options markets serve to improve the accuracy of securities audit trails.[9] The Commission's inspection staff also performs periodic reviews to improve the securities audit trails that support surveillance and investigatory programs to address frontrunning and trading ahead abuses. In addition, routine and cause inspections by the Commission staff review the overall quality of the work produced by the exchanges' surveillance, investigatory, and disciplinary programs. If serious deficiencies in these programs are identified by the inspection staff, referrals would be made to the Commission's Division of Enforcement for appropriate action.

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9 It is our understanding that, because last-sale transaction tapes like those used in the stock and options markets are unavailable on the futures exchanges, audit trails in the futures markets must be based on price tapes on the exchanges. Futures price tapes are designed to reflect current bid, ask or transaction prices in the futures pits at any given moment, but these tapes do not attempt to report the price and size of any specific transaction in the pits.

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

Response:

According to the press reports cited in the August 3 letter from Congressmen Dingell, Towns, and Markey, the alleged trading abuses in the Nasdaq 100 futures on the CME may have involved the use of pagers to give selected floor brokers advance notice of large customer buy or sell orders that were being sent to the futures pit. The press reports indicate that this advance notice may have permitted the selected floor brokers to profit by improperly trading ahead of these customer orders. As the agency responsible for overseeing the CME, the CFTC would be better able to confirm the accuracy of these reports.

Q#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?

Response:

As we have indicated in the response to question 3, above, the CFTC would be better able to respond to this question.

Q#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 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?

Response:

This question is more appropriately answered by the CFTC.

Q#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?

Response:

The Commission staff became aware of the CME's investigation through press reports at the end of July. Until we know more about the nature of the alleged trading abuses in Nasdaq futures on the CME, we are unable to determine if these allegations might have significant intermarket regulatory implications. For example, if the allegations are substantiated and the conduct on the CME floor resulted in flow-back effects in the Nasdaq component stocks in the NDX index, we would be extremely concerned over the lack of notification to NASD Regulation and the Commission.

Given the time and attention needed for comprehensive measures to address the cumbersome nature of the current bifurcated regulatory framework, we do not believe it would be productive to have the Congress, SEC, and CFTC devote the resources necessary for such an effort at this time. Instead, as we devote resources to creating a framework under which single stock futures can trade, we must be careful that these products are subject to sufficient regulation so that the regulation of other securities is not undermined.

Q#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?

Response:

As discussed above, there currently is in place an information sharing arrangement between the CME and the NYSE. In 1989, these exchanges entered into an agreement that provided a framework to share surveillance and investigatory information necessary to address potential intermarket trading abuses and the exchanges issued a joint circular to members that set forth the types of trading abuses that would be sanctioned. This arrangement has focused on possible intermarket trading abuses, such as frontrunning and market manipulation, involving broad-based index futures and baskets of NYSE-listed stocks, and appears to have been adequate for this type of "macro-surveillance" of index trading in listed stocks.

In addition, in 1990, the CME and several other futures exchanges became affiliate members of the Intermarket Surveillance Group. As affiliate members of the ISG, the futures exchanges are required to produce, upon request, surveillance and investigatory information to regular ISG members (the securities exchanges and the NASD). A reciprocal information sharing obligation is placed on the securities exchanges and the NASD to respond to requests from the futures exchanges. While the futures exchanges' role as affiliate ISG members provides a useful framework for handling specific information requests that arise in particular inquiries or investigations with intermarket implications, this arrangement does not appear to be comparable to the less formal, routine consultations that occur on a nearly daily basis among the surveillance staffs of the securities SROs.

As we indicated above, the Commission does not yet have sufficient facts about the alleged trading abuses on the CME in the NDX futures to determine if this situation, in itself, indicates that enhanced intermarket surveillance coordination is required among the futures exchanges and the securities SROs. Nevertheless, the Commission remains extremely concerned over the potential intermarket surveillance issues that would be raised by the introduction of single stock futures. As discussed below, the potential price discovery role of these products magnifies our concerns over their possible effects on the stock market and the millions of investors who invest either directly or indirectly in the stock market. Under these circumstances, the Commission would need sufficient oversight, inspection, and enforcement authority to insure that trading in these products does not harm investors and the broader securities market.

Q#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 market? Why should we allow stock futures without these types of audit trails?

Response:

Most of the issues raised in this question appear to be directed to the CFTC. As we indicated in our response to Question 2 above, the Commission believes that, while audit trails do not necessarily have to be produced in a real-time manner, the audit trails must be sufficient to support essential surveillance, investigatory, and disciplinary programs to address potential intermarket frontrunning and trading ahead abuses.

Q#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?

Response:

The Commission believes that the introduction of single stock futures would raise concerns about potential intermarket frontrunning and market manipulation. Consequently, we feel strongly that, to maintain the integrity of our markets, the Commission should have clear and direct authority over the markets and market participants that trade single stock futures, especially as it relates to audit trails, coordinated market surveillance, and inspection and enforcement authority. Because single stock futures are undeniably a substitute for stocks and stock options, the interconnection among the market for these new products and the secondary markets is clear. We believe that anything less would raise substantial risks for investors and the broader securities market.

Q#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?

Response:

We believe that H.R.4541, as reported by the Commerce Committee would provide the Commission with the minimum oversight, inspection, and enforcement powers for single stock futures that would be consistent with the protection of investors and the broader securities market With such authority, the Commission would be in a position to monitor the development and maintenance of the types of surveillance, investigatory, and disciplinary programs needed to address the potential use of these products for intermarket trading abuses such as frontrunning and market manipulation.

On the other hand, the Commission believes that H.R. 4541, as reported by the Agriculture Committee, does not give the Commission the tools it needs to extend the protections of the securities laws to single stock futures. In particular, this version of H.R. 4541 limits the purposes for which the Commission could enforce the anti-fraud provisions of the securities laws. While the bill specifies that the Commission could enforce §10(b) for the purpose of inside trading and frontrunning, we could not bring a §10(b) action for other types of fraud, such as manipulation and sales practice abuses. Moreover, the CFTC must concur on what information market participants must provide to the Commission. For our enforcement program to work, single stock futures must be defined as securities. This triggers the Commission's ability to use its full array of statutory enforcement tools, such as the ability to investigate and to prosecute fraud. Moreover, we need the ability to conduct examinations and promulgate rules to prevent fraud. This version of the bill does not provide the Commission with this ability.

Q#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?

Response:

We believe that the responses provided to questions 2, 6, 7, and 9, above, explain the Commissions views on these matters.

Q#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?

Response:

Since the introduction of stock index futures in the 1980s, the SEC and CFTC staffs have worked diligently within the existing bifurcated regulatory scheme to coordinate our surveillance and enforcement programs for intermarket abuses. Most inquiries into suspicious trading patterns involving stock index futures and stock baskets have been addressed by consultations and information sharing between the staffs on a case-by-case basis. While this informal arrangement has worked relatively well for inquiries involving index futures, we believe that the greater potential for intermarket abuses in single stock futures would necessitate a more direct oversight, inspection, and enforcement role for the Commission in these new products.

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

Response:

We believe that the expanded oversight, inspection, and enforcement programs that the Commission would need to undertake to protect investors and the broader securities market under H.R. 4541 would necessitate additional funding for these tasks.

Q#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?

Response:

The price discovery role of index futures has been well documented in numerous studies dating back to the October 1987 Market Break.[10] Nevertheless, we need to recognize that the

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10 See, e.g., *Report of the Presidential Task Force on Market Mechanisms* (January 1988). Index options and equity options have not been shown to play comparable price discovery roles. One reason for this may be that, in any particular option, there are dozens of call and put series that react to price changes in the underlying index or stock. In contrast, most trading in index futures contracts is normally concentrated in a single lead-month contract, making it relatively easy for market participants to track price changes in this single contract for comparison with prices in the underlying index. A single stock futures contract would have this same type of structure that would facilitate a price discovery role.

liquidity of a particular index futures contract and the capacity of market participants to effect cross-market trading strategies such as index arbitrage, are key factors in determining the extent to which a particular futures contract influences price movements in the underlying stocks. While it appears that Nasdaq 100 futures may have played something of a price discovery role, at times, in Nasdaq stocks, this relationship is difficult to quantify at this point. The high volatility levels in Nasdaq futures and stocks since March of this year may provide too short a time frame to reach definitive conclusions as to the price discovery role that these contracts may have played during these index price swings. In addition, the Commission currently does not have adequate information on the nature of the alleged abuses in the NDX futures to assess the potential intermarket manipulation implications from these alleged abuses.

If the liquidity of single stock futures proves sufficient, it is possible that these futures could develop a price discovery role for certain stocks that could raise concerns over potential intermarket trading abuses. As discussed above, a factor in the price discovery role of a particular futures contract is the capacity of market participants to effect cross-market trading strategies, such as arbitrage. At present, the mechanics of simultaneously effecting cross-market trading strategies in the 100 Nasdaq stocks underlying the NDX future may be an obstacle to having this contract achieve a dominant price discovery role. Market participants would not, however, face the same difficulty in effecting cross-market trading strategies in a single stock future and the single stock underlying it and related options. As a result, arbitrage and related cross-market trading strategies involving stock futures could quickly transfer price movements in the futures to the underlying stock, thereby reinforcing the price discovery role of the stock futures. This development, in turn, could provide increased opportunities for persons to use the futures market to effect intermarket manipulations that would harm investors and the integrity of the broader securities market.

Q#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?

Response:

We believe that the discussion in our response to Question 14, above, concerning the potential for intermarket manipulations involving stock futures, would be equally applicable to the issues concerning intermarket frontrunning raised in this question.

Q#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?

Response:

As we indicated in our response to Question 10, above, we believe that the regulatory structure permitted under H.R. 4541, as reported by the Agriculture Committee, would not provide the Commission with the necessary oversight, inspection, and enforcement tools needed to determine whether adequate safeguards are developed and maintained for stock futures. H.R. 4541, as reported by the Commerce Committee, provides the minimum regulatory tools required by the Commission for this effort.

Q#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?**

Response:

Our response to Question 18, below, addresses these issues.

Q#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 you opinion on the effect of high leverage on the ability to engage in frontrunning.**

Response:

Lower stock index futures margin requirements would make it less expensive for a futures commission merchant to frontrun customer orders than if the margin levels were higher. More specifically, if stock index futures margin requirement were equal to stock index options, the ability to profit from frontrunning would be reduced by the additional amount of money required to be deposited. Accordingly, low margins for single stock futures would make it less expensive to frontrun customer orders. While high leverage (which means lower margin), would make it less expensive to engage in frontrunning, higher margin levels alone would not necessarily prevent frontrunning.

Q#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?

Response:

The CFTC is better positioned to answer about the accuracy of such reports. It should be noted that among the issues under the securities laws identified by the President's Working Group on Financial Markets *Report on OTC Derivatives* for resolution prior to lifting the ban on single stock futures were those related to the activities of floor brokers. Under H.R. 4541, as reported by the Commerce Committee, transactions on securities and futures exchanges would be subject to dual trading restrictions. The restrictions applicable to floor brokers on securities exchanges would be those contained in Section 11(a) of the Exchange Act and the restrictions applicable to floor brokers on commodity futures exchanges would be those contained in Section 4j of the Commodity Exchange Act. Under H.R. 4541, as reported by the Agriculture Committee, there would be no prohibitions on dual trading.

Q#20: The July 13, 2000 CME memorandum states that as of August 1, 2000, "quantity restrictions on GLOBEX2 or 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 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 the trading and information dissemination systems to assure that any market for single stock futures or stock index futures keep pace with demand?

Response:

The Commission believes that increased automation in order-routing, order-execution, and recordkeeping systems benefits both the markets and investors in several ways. For example, the experience of expanded automation in the securities markets over the past few decades indicates that these changes significantly reduce the transaction costs that are paid by investors. Reduced trading costs, in turn, usually result in increased trading volume and liquidity levels in these markets. Expanded automation in price-reporting mechanisms also benefits investors and the markets by enhancing the transparency of a market. In addition, expanded automation can improve audit trails for surveillance and investigatory programs.

The Commission has sought to foster expanded automation in the securities markets in a number of ways. For example, we have sought to promote governance structures in the securities exchanges that do not provide floor traders with the ability to veto all proposed automation enhancements that they might view as threats to their franchises despite the potential benefits for investors and the exchange as a whole. Moreover, we recognize that short-term cost concerns at the securities markets may reinforce a reluctance to invest in expanded systems capacity that would be necessary for the protection of investors and the integrity of the markets during peak volume periods. Accordingly, the Commission staff routinely reviews capacity levels in the securities markets in order to quickly identify and address any significant deficiencies. In addition, SROs are expected to provide a "systems change notification" to the Commission staff prior to any significant change or enhancement to technology supporting their trading systems.