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DRW TRADING GROUP RECORDS SECTION

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COMMENT

September 28, 2004

VIA ELECTRONIC MAIL

Ms. Jean Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center
8th Floor
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Rules for Trading Off the Centralized Market

Dear Ms. Webb:

The purpose of this letter is to comment on the proposed rules of the Commodity Futures Trading Commission concerning trading off the centralized market. While this letter may be submitted after the last official date for receipt of comments, I would be grateful, assuming final rules have not been promulgated, if the Commission would consider its content.

I. Background/Introduction

I am the founder and Chief Executive Officer of the DRW Trading Group, a proprietary trading organization. Our largest area of trading is in exchange listed fixed income futures options. We are one of the largest traders of these products in the world. I personally have over fourteen years experience trading in a variety of markets.

In a letter to you, dated November 7, 2003, I expressed concerns about the application of U.S. Futures Exchange, LLC ("Eurex US"). Those concerns focused on a market structure that I felt was likely to develop at Eurex US, one that provides for, and even encourages, trading off the centralized market by way of the "call-around market." As I discussed there, the call-around market not only leads to a fragmented market with diminished transparency, but also gives rise to brokerage operations maximizing the value of customer orders to themselves. Brokerage operations accomplish this either by receiving brokerage on both sides of transactions or by internalizing orders. The result is a market structure wrought with potential conflicts of interest. Brokerage operations can execute customer orders with either the

counterparty willing to pay the most brokerage, or internally, neither of which necessarily have the best interests of the customer in mind.

Since the call-around market functions to a great extent through block trades, the issues discussed in my previous letter are relevant here, and, thus, I have attached a copy of that letter and incorporate it herein. This letter will comment on the proposed rules relating to block trades with the focus on the issues of minimum size and reporting times.

II. Comments Regarding the Proposed Rules for Block Trades

A. Block Trades – Generally

I have yet to come across a compelling reason why, as a general proposition, block trades should be permitted. There is an argument that in some cases the centralized market cannot absorb a trade without material disruption. However, many markets have the requisite liquidity, maturity and platform to facilitate trades of all sizes. Having all trades occur on the centralized market would prevent fragmentation and promote efficient price discovery. Prices would be determined openly in the marketplace with the knowledge of all participants. The potential market abuses resulting from the call-around market and internalization of customer orders would, to a large extent, be abrogated. These are compelling reasons why I believe block trades should be completely disallowed.

The Commission cites three purposes of the Commodity Futures Trading Act in its writing on the proposed rules. These are:

- To deter and prevent price manipulation or any other disruptions to market integrity.
- To ensure the financial integrity of all transactions subject to th[e] Act and the avoidance of systematic risk.
- To protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets.

(69 FR 39880 (July 1, 2004)). It is the prohibition of block trades that would better serve the stated purposes. However, short of disallowing block trades, they must be severely restricted.

B. Block Trade Parameters

The Commission has proposed that Appendix B to Part 38 Core Principal 9 (“Core Principle 9”) include the following language:

“A designated contract market that determines to allow trades off the centralized market shall ensure that such trading does not operate in a manner that compromises the integrity of prices or price discovery on the centralized market.” (69 FR 39885).

Exchanges are in a period of intense competition. They are vigorously trying to expand their product lines and preserve market share in their existing products. As such, exchanges are conflicted between upholding the integrity of their markets and attracting or maintaining volume through facilities such as block trades, and lower block trade size thresholds. Caution

must be exercised so that exchanges are not authorized to take liberties in permitting block trades at the cost of compromising the price discovery process and transparency of the markets.

1. Size of Transaction

a. Generally

Since there will be a direct correlation, albeit inverse, between the number of block trades and the minimum size requirement, the size of a transaction is a critical issue. The proposed language to Core Principle 9 states that there must be

“...an acceptable minimum block size. An acceptable minimum block size would be no smaller than the customary size of large transactions in any relevant markets. A ‘large’ transaction is one that may affect the quality of the transaction price due to the significant impact of such a large order on the centralized market. An acceptable minimum block size, for example, would be a transaction size that is greater than 90 percent of the trades in a relevant market. The relevant market should be the subject futures options market, any related derivatives market, and/or the underlying cash market, as appropriate.” (69 FR 39885).

I find several issues with this language. First, there is inconsistency between the notion of “large transactions in any relevant markets” and “significant impact on the centralized market,” and it is unclear which one is the standard for the minimum size of a block trade. A transaction may cause significant impact on a centralized market but would not cause any impact on the relevant market, one that includes all other related derivatives markets and underlying cash markets.

For example, consider the common instance where Exchange A undertakes to list a futures contract (Product X) that is already listed and liquid on Exchange B. It is probable that Exchange A will have very little liquidity, if any, on its centralized market upon launch of Product X. Exchange A is likely to seek a low block trade size threshold taking the position that any larger size would cause a significant impact to its centralized market. In fact, for some time after the launch of Product X on Exchange A, just about any size trade could arguably meet this criterion. Such is not the case for the established market on Exchange B.

Exchange A, as an upstart in Product X, will want to have a very low block threshold to attract volume. Under the proposed rules, Exchange A could argue for a lower block threshold than Exchange B as fewer trades on Exchange B will have a significant impact on its centralized market. A lower threshold has consequences beyond transparency and market fragmentation issues. Exchange A, through its low block trade thresholds, is in effect creating a payment system to incentivize brokerage operations to bring business to Exchange A. Brokerage operations with the authority to direct order flow to either Exchange A or Exchange B will be motivated to take the orders to Exchange A as block trades and either capture two commissions, in essence demanding payment for order flow, or internalize the orders. Because of the lower liquidity on Exchange A, the result is unlikely to be in the best interest of the customer. The lower size threshold not only gives Exchange A a

competitive advantage over Exchange B, but it also effects the decision making process of brokerage operations to the detriment of customers.

There is no better example than the recent action of Eurex US. On September 24, 2004, Eurex US lowered its block trade minimum size threshold for options on all of its U.S. Treasury futures (2-Year, 5-Year, 10-Year Notes and 30 Year Bonds) from 2,500 contracts to 500. (Eurex US Circular No. 40/2004). Options on US Treasury futures are established and liquid at the Chicago Board of Trade ("CBOT"). Execution of a 500 lot in any of these options would be easily absorbed at the CBOT and is entirely too low a threshold for this market. This is a blatant attempt by Eurex US to incentivize brokers to route orders to it, and away from the established market at the CBOT.

To avert these situations, the Commission should clearly mandate consideration of the data from the aggregate relevant market, and not only the centralized market, to determine minimum block order thresholds. Further, it should be made absolutely clear that the relevant market includes related derivatives markets, other futures exchanges, and the underlying cash market. The use of "and/or" and "as appropriate" muddle the requirement for exchanges to consider all relevant information. Exchange A should never have the right to have a block trade minimum size for Product X that is lower than the lowest permissible threshold for Exchange B. Any other result creates artificially low block thresholds given the aggregate relevant market and also puts the best interests of customers at jeopardy.

Next, the phrase "90 percent of the trades in the relevant market" creates further confusion that may ultimately result in an artificially low block trade threshold. It is not unusual for orders to be broken up into many different pieces, while still being executed at the same time. Again by way of example, take an option order, submitted by a customer, to buy 10,000 call butterflies in a liquid market. One pit broker could fully execute this order on the floor of an exchange with one or two local traders. But in this case, the order desk on the exchange floor decides to give the order to four different pit brokers, each receiving a 2,500 lot to execute. Contemporaneously, each of the pit brokers trades a 100 lot with twenty-five different local traders, all at the same price. It could be interpreted that the average trade size is 100 lots, when the marketplace easily absorbed a 10,000 lot order at one price. There are additional factors that cause the size of transactions to be diluted such as the "Average Price System", which allows one large order to be allocated between multiple customers after execution, and pro rata matching algorithms on electronic trading platforms.

Having many small trades, as opposed to a few larger ones, has the effect of lowering minimum block size thresholds under the "90 percent" standard. Clearly this was not the Commission's intent. To rectify this situation, the proposed rules, at the very least, should be changed to reference customer orders or ticket sizes, and not trade size, when establishing block trade quantity thresholds. This clarification to the proposed rules will more accurately define which transactions are acceptable candidates for block trades.

b. Spreads/Options

The Commission proposes that Core Principle 9 state:

"If a contract market chooses to allow block participants to meet the minimum block size requirement by aggregating the component legs of a spread or combination position executed

as a block trade, the acceptable size for each leg should be the size of a large transaction in the relevant market[.]” (69 FR 39885).

This method for dealing with spreads is overly simplistic and will result in unwarranted block trades. Take the example of a call butterfly. The risk associated with this option spread is a fraction of that of the outright underlying future. Such a butterfly has very little directional or other risks. Hence, the marketplace can normally absorb many more butterflies without disruption than outright futures contracts. Similarly, outright options often times carry far less risk than their underlying futures contracts. Currently, exchanges do not recognize the relative risks and normally have one size threshold apply to a futures contract and all its options. This creates an unnecessarily large set of block eligible trades.

To address this, I recommend that the Commission require exchanges to develop a workable methodology to assess relative risks of outright futures, spreads and outright options and apply such relative risks to determine minimum block trade sizes. While this may put a burden on exchanges, they have the requisite resources, experience and know-how to implement such a methodology. Complexity should not be a deterrent to protecting the markets.

2. Reporting

The Commission proposes in Core Principle 9 that “[a]cceptable contract market rules would require reporting of the block trade to the contract market within a reasonable period of time.” To preserve market transparency, the standard for “reasonable” should mean as close to immediately after the completion of the trade as is possible. Currently, the time period for reporting block trades in Eurodollar futures and options at the Chicago Mercantile Exchange is fifteen minutes. (CME Rule 526(f)). At Eurex US, the effect of its reporting rule is that block trades do not have to be reported to the market for fifteen minutes as well, and in the case of a block of 2,500 Treasury futures contracts, thirty minutes. (Eurex US Rule 415(h)). These time frames are entirely too long, and there is no justification for them. To avoid such a situation, the Commission should set a maximum time limit of five minutes.

Furthermore, the Commission should address what happens during the period commencing with the negotiation of the trade, through consummation and until dissemination. Market participants with knowledge of a block trade have a material informational advantage over those that do not and should be required to abstain from acting on such information before it is printed on the applicable exchange. OneChicago has addressed this very issue by attempting to restrict market participants with non-public information relating to a OneChicago block trade from making offsetting trades in OneChicago products or related products. OneChicago also purports, until information has been made public, to restrict parties from trading related offsetting trades in its products if they have information of a block trade on another Intermarket Surveillance Group participant exchange. (OneChicago Rule 417). To preserve fundamental fairness in the markets, all exchanges should be required to effect similar standards.

3. Ongoing Evaluation

Markets, as well as their specific futures and options contracts, evolve over time. Given this, I urge the Commission to regularly review its standards for block trades and adapt them as the markets change. Moreover, and particularly since the proposed rules permit self-certification, the Commission should mandate that exchanges likewise review their block trade rules and minimum size thresholds on a regular basis. The rules relating to block trades should be as dynamic as the markets they aim to protect.

III. Conclusion

If the Commission is unwilling to completely ban block trades, it must at the very least regulate them carefully. In the current competitive environment, the logic of the marketplace dictates that many exchanges, if given the opportunity, will take actions to facilitate block trades when not appropriate. Without strict guidelines, an exchange that is listing an established contract will set low block thresholds thus creating an incentive for brokerage firms to bring order flow to it in lieu of a competing exchange. Block trades enable brokerage operations to receive two commissions or internalize an order, and, ultimately earn greater revenues than for trades executed on the centralized market. In no case should an upstart exchange be permitted to have a block trade minimum that is lower than the threshold on an existing exchange.

While in certain cases my comments may add complexity to the rules concerning block trades, they are measures worth taking to preserve the integrity of the markets. Freely permitting block trades, or allowing them in unintended or unwarranted circumstances, carries the risk of compromising the transparency, openness and fairness of the futures markets. The Commission must proceed carefully and prudently with the outlook that under-regulation of block trades will yield far worse outcomes for US markets than over-regulation.

Thank you for your consideration.

Very truly yours,



Donald R. Wilson, Jr.
Founder and CEO
DRW Holdings, LLC

Attachment



DRW TRADING GROUP

DRW HOLDINGS, LLC

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November 7, 2003

VIA ELECTRONIC MAIL

Ms. Jean Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center
8th Floor
1155 21st Street, N.W.
Washington, D.C. 20581

Re: U.S. Futures Exchange, LLC

Dear Ms. Webb:

I write to express my concerns regarding the application of U.S. Futures Exchange, LLC ("Eurex US"). My comments focus on the issues of transparency, payment for order flow, internalization of orders and general fairness. While my comments relate primarily to options, I will also address certain aspects of futures. My concerns are based on the likelihood that Eurex US will promote a market structure similar to the one Eurex has fostered in Europe, where there is a fragmented market and a complete lack of transparency.

I. Background

A. About DRW

I am the founder and Chief Executive Officer of DRW Holdings, LLC ("DRW"). Through its operating subsidiaries, DRW engages in proprietary trading across a wide range of markets. I have personally traded options in many different markets for fourteen years. My trading has occurred both in Europe and the United States and has transpired both on and off exchange trading floors. During this period, I have seen the development and deterioration of several different markets and exchanges.

DRW is an active participant in options on fixed income futures throughout the United States and Europe. The scope of our involvement includes Eurodollars traded on the Chicago Mercantile Exchange, U.S. Treasury products traded on the Chicago Board of Trade ("CBOT"), Euribor traded on the London International Financial Futures and Options Exchange, and European government bonds (Bund, Bobl and Schatz) traded on Eurex Deutschland ("Eurex Europe"). Through the third quarter of this year, our market shares are: Euribor options 22%; Bund, Bobl and Schatz options 16%; Eurodollar options 17%; and Treasury options 7%. I believe these levels of activity make DRW the largest proprietary trader of options on futures in the world. DRW is also an active participant in the underlying futures markets and has been a significant participant on Eurex Europe since the inception of the exchange.

B. About Eurex Europe

Although Eurex Europe is technically an electronic exchange, options listed on it do not, for the most part, trade electronically. In fact, through the first nine months of 2003, only 10% of the Bund, Bobl and Schatz options traded electronically. The other 90% of the options traded as block transactions either in the "call around market" or through internalization of orders by brokers. A block trade is a privately negotiated futures or options transaction executed apart from the public auction market. Futures transactions may go through the call around market where the transaction is unusually large or the futures strategy is complex, involving more than one futures contract.

The call around market in Eurex Europe products works as follows. A broker that has received an executable order from a customer (either in futures, options or a combination) will call one or more market makers to obtain a price at which the order could trade. The broker then selects one or more market makers with which to cross the order. Sometime thereafter, the broker will notify Eurex Europe that a block trade has occurred. By transacting in this manner, the broker charges brokerage to both the customer and to participating market makers, in effect earning double brokerage.

II. Substantive Issues

A. Payment for Order Flow to Brokers and Internalization of Orders

The call around market described above creates a form of payment for order flow, such that market makers must pay to have brokers trade with them. This process raises several concerns:

1. There is no centralized price discovery mechanism. The result is a fragmented market. Whether on a trading floor or on a computer screen available to market participants, a centralized place for price discovery leads to a transparent market. On Eurex Europe, market participants are unable to make informed decisions as they possess only a portion of the available information.
2. Frequently trades on Eurex Europe are executed in the morning and are not reported to the exchange until the end of the day. This "no tape" environment further precludes market transparency. Market participants are not only unaware

of transactions on a timely basis, but it becomes increasingly difficult, if not impossible, to scrutinize whether trades were done at fair prices.

3. The market makers, from whom the liquidity in any market derives, must pay brokerage to the brokers. This is mandated payment for order flow in that a market maker who refuses to pay brokerage will no longer get calls from brokers and will be precluded from participating. This form of payment for order flow increases the transaction costs of the market makers, and recent experience has shown this increase to be material. The market makers pass this increase along to the customers by quoting a wider bid-ask spread. The result is a less efficient marketplace.
4. The brokers have a conflict of interest. The worse the execution by the brokers, the more market makers are willing to pay in brokerage, ultimately hurting customers.

There is another mechanism by which an order can be executed on Eurex Europe. The broker can, rather than selling an order to market makers in the call around market, internalize the customer's order by taking the other side of it. In this case, the broker clearly has a conflict. The worse the level of execution, the more profit for the broker. On futures exchanges in the United States, this practice is generally prohibited. On Eurex Europe, it is oddly encouraged.

The well-developed call around market and the practice of internalization of orders both result directly from Eurex Europe's rules relating to block trades. The block threshold, i.e. the minimum number of contracts to qualify for a block trade, for Bund, Bobl and Schatz options is 50 contracts per trade. Almost all orders are greater than 50 contracts. Therefore, almost all orders are eligible to be traded as blocks and can go the way of the call around market or be internalized by the brokers.

Eurex US's proposed rules set the block threshold at 50 contracts per trade for Bund, Bobl and Schatz options, and 2,500 contracts per trade for Treasury options. Many strategies in Treasury options contain multiple options. For example, a butterfly spread, a common strategy, contains four options per spread, so that an order for a butterfly would be block-eligible if the quantity of the order is for a minimum of 626 butterflies. Currently, many orders in Treasury options on the CBOT are greater than 2,500 contracts. Thus, if traded on Eurex US, a significant percentage of the total Treasury option volume would be block-eligible. In contrast, the CBOT does not permit block trading in any of its Treasury products (futures or options).

Block trading should be entirely prohibited. It is the primary enabling factor in the existence of the call around market and the internalization of orders. As discussed above, these practices are likely to result in fragmented markets lacking in transparency. Further, brokers will have conflicts of interest. Brokers will be incentivized to route orders to Eurex US rather than to the CBOT as they will be able to either extract payment for order flow or internalize their orders. It is also my concern that Eurex US will lower its block threshold requirements shortly after launch, and these undesired practices will become even more widespread.

B. Cross Trades

Even if block trades were prohibited on Eurex US, the cross trade rule as proposed by Eurex US will facilitate the practices of payment for order flow and internalization. As proposed, a broker that has an executable order could, rather than execute it immediately, solicit an order from a market maker to take the other side of the customer order. Unlike a block in which a broker notifies the exchange of the transaction, in a cross trade, the broker first enters the market maker order electronically in the order book. The broker then waits the required time (15 seconds for options and 5 seconds for futures). Finally, the broker enters the customer order, thereby crossing the customer and market maker orders, thus replicating a block transaction. As an alternative, the broker can take the place of the market maker in this scenario, and thereby internalize the order flow.

C. Payment for Order Flow by Eurex US

Payment for order flow can also go from exchanges to brokers. This is another way in which brokers can be distracted from acting in the best interest of their customers. Eurex US has proposed to set aside certain of its revenues for distribution to its highest volume brokers. This is similar to the strategy that Eurex Europe used to wrest the Bund futures contract from the LIFFE exchange in 1997 and 1998. Around that time, Eurex Europe paid large sums of money to brokers in London with a goal to have them route all of their orders to Eurex Europe. This practice creates yet another conflict of interest for brokers.

Eurex US has also proposed certain incentive payments to liquidity providers. Liquidity providers generally trade for their own account, and, therefore, payments by exchanges to them do not create any conflicts of interest with other market participants.

III. Effect on Eurex Europe Volumes

There is evidence to suggest that the practices discussed above have hampered the growth of the fixed income option markets on Eurex Europe. When Bund futures and options were traded actively on LIFFE in 1995, in an open outcry setting, Bund Options traded 22% of the Bund futures volume. Through the third quarter of this year, fixed income options on Eurex Europe have traded only 10% of fixed income futures volume. As another comparison, CBOT Treasury options have traded 23% of futures volume year to date.

Additionally, from 1999 to the present, while the CBOT's Ten Year Note option volume grew at a rate of 44% per annum, Eurex Europe's Bund options grew at a rate of only 2.4%. This is further evidence that the call around market and internalization of orders inhibits use of the markets.

IV. Conclusion

Although competition among exchanges can be positive for futures markets and their users, it is important that certain issues be carefully considered before approving a new exchange. Paramount is whether an exchange will ultimately provide a centralized, transparent marketplace where prices can be efficiently discovered and all market

participants are treated fairly. The Commodity Futures Trading Commission recognizes this by stating in its mission statement that:

The agency protects market participants against manipulation, abusive trade practices and fraud. Through effective oversight and regulation, the CFTC enables the markets to serve better their important functions in the nation's economy providing a mechanism for price discovery and a means of offsetting price risk.

If Eurex US successfully recreates the market structure of its European counterpart, then these principles will be abandoned. All market participants will be disadvantaged by a lack of transparency. Payment for order flow and internalization of orders will not only create conflicts of interest, particularly towards customers, but will also lead to higher transaction costs for all market participants. As a result, hedging activity will decline, resulting in greater earnings variance, and ultimately lower economic growth.

For the reasons discussed herein, I respectfully request that the 180-day statutory time period for reviewing the application of Eurex US be stopped and restarted only when Eurex US proposes a business model supporting rules and market practices that ensure an open and transparent marketplace.

Should you wish to discuss the foregoing, please feel free to contact me.

Very truly yours,

A handwritten signature in black ink, appearing to read "Donald R. Wilson, Jr.", with a long horizontal line extending to the right.

Donald R. Wilson, Jr.
Founder and CEO
DRW Holdings, LLC