Mr. Edmund R. Schroeder
Cadwalader, Wickersham & Taft
100 Maiden Lane
New York, NY 10038

Re: Application of BrokerTec Futures Exchange, L.L.C. for Designation as a Contract Market

Dear Mr. Schroeder:

By letters dated May 8, 2000 through June 8, 2001, BrokerTec Futures Exchange, L.L.C. ("BTEX" or "Exchange") applied to the Commodity Futures Trading Commission ("Commission"), pursuant to Sections 5 and 6 of the Commodity Exchange Act ("Act"), 7 U.S.C. §§7 and 8, for designation as a contract market. The Commission has reviewed the materials submitted and has determined to designate BTEX as a contract market, pursuant to Sections 5 and 6 of the Act, 7 U.S.C. §§7 and 8.

Concurrent with designation, the Commission approved, pursuant to Section 5c(c) of the Act, 7 U.S.C. §7a-2(c), BTEX Bylaws Sections 1.1, 2.1 - 2.7, 3.1 - 3.20, 4.1 - 4.5, 5.1 - 5.8, 6.1 - 6.9, 7.1, 7.2, 8.1, 8.2, 9.1 - 9.11, 10.1 - 10.5, 11.1, and 12.1 - 12.13; BTEX Rules 101 - 103, 201 - 210, 301 - 304, 401 - 408, 410 - 414, 501, 601, 701 - 712, 801 - 805, and 901 – 903; and BTEX's Market Maker Program. The Commission has also determined that the contracts submitted by the Exchange meet the requirements of the Act and the Commission regulations, including Guideline No. 1. Accordingly, the Commission approved, pursuant to Section 5c(c) of the Act, 7 U.S.C. §7a-2(c), BTEX's U.S. Treasury Bond, U.S. Long-Term Treasury Note, U.S. Medium-Term Treasury Note, and U.S. Short-Term Treasury Note futures contracts.

The Commission's designation is based upon, among other things, written submissions, explanations, and representations provided by the Exchange describing the manner in which BTEX will operate. The Commission's designation is also based upon written submissions, explanations and representations provided by BTEX and the National Futures Association ("NFA") concerning how NFA would assist BTEX in meeting the Exchange's self-regulatory obligations. BTEX should inform the Commission of any material modifications to the operation of BTEX, the BTEX Trading System, the BrokerTec Clearing Company, L.L.C., the affiliated entity responsible for clearing and settlement functions for BTEX, or BTEX's self-regulatory program, including those services provided by NFA.

In approving BTEX's application, the Commission is not approving the agreement covering compliance and surveillance services between BTEX and NFA. In this connection, BTEX itself remains directly responsible to the Commission for ensuring the performance of all self-regulatory functions required of it as a designated contract market under the Act, including maintenance of an effective affirmative action program, pursuant to Commission Regulation 1.51, and enforcement of the terms of all BTEX Bylaws and Rules.

The Commission notes that in approving Rule 406 – BTEX's block trade rule – the Commission found that the rule's minimum block trade size threshold and reporting time schedule were acceptable for the Exchange's four proposed U.S. Treasury securities futures contracts based upon information provided to Commission staff by BTEX and independent sources. The Commission will review the applicability of these threshold and reporting time requirements to new contracts on a case-by-case basis. In addition, Commission staff will monitor the impact of the BTEX block trading rule on price discovery in the relevant markets.

Sincerely,

Jean A. Webb
Secretary of the Commission

cc: Douglas Harris, BTEX
Edward Rosen, Cleary Gottlieb Steen & Hamilton
Yvonne Downs, NFA

Application of BrokerTec, L.L.C. for Designation as a Contract Market

Concurring Opinion of Commissioner David D. Spears

June 18, 2001

I am voting to approve the staff's recommendation that the Commission designate BrokerTec (BTEX) as a contract market, and approve its proposed Bylaws and Rules, for the trading of 2, 5, and 10-year U.S. Treasury Note futures contracts and U.S. Treasury Bond futures contracts. I view the approval of this application as appropriate because BTEX has met the legal standard for contract market designation under the Commodity Futures Modernization Act and the Commission's designation criteria and core principles thereunder.

Nevertheless, I have some concerns about the precedent we are setting in approving the "tiered reporting" of trades under BTEX's proposed block trading rule. While such a system appears to be appropriate for the four highly liquid financial futures contracts in BTEX's application, I agree that the staff should monitor closely the operation of BTEX's block trading rule to make sure there are no unanticipated effects on the price discovery functions of the relevant markets.

An even more important issue arises, however, should BTEX or any other exchange seek to apply this same type of system to a less liquid financial contract, or to a contract in a physical commodity, such as an agricultural commodity. In that case, I believe the Commission and its staff should apply the most thorough analysis to assure that the core principles are complied with, that market transparency is preserved and that retail customers are protected.

APPLICATION OF BROKERTEC FUTURES EXCHANGE FOR DESIGNATION AS A CONTRACT MARKET

Concurring Opinion of Commissioner Thomas J. Erickson

June 18, 2001

Today, the Commission is designating BrokerTec Futures Exchange, L.L.C. (BTEX) as a contract market pursuant to the criteria and core principles established by the Commodity Futures Modernization Act of 2000 (CFMA) – and supplanting its prior guidance on block trading by approving a rule with a reporting timeframe that is 48 times greater that the standard previously deemed reasonable by the Commission. Moreover, the Commission is approving a block trading rule that permits blocks of unprecedented size and includes no requirement that the price of such trades be fair and reasonable.

Certainly, the CFMA provides the Commission with broad authority to approve exchange rules that permit the noncompetitive execution of transactions on designated contract markets. However, Section 5(b)(3) requires that exchange rules "ensure fair and equitable trading," and Section 5(d)(9) states that a "board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions."[10] All Commission guidance to date has required that block trades be reported to the exchange within five minutes of the time of execution.[11] Nevertheless, the Commission today is sanctioning a tiered reporting system that permits a delay of 240 trading session minutes for the largest blocks, which means that block trades executed near the end of one trading session need not be reported to the exchange – and to contract market participants – until some point well into the next day's trading session.

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10 The Commission has yet to promulgate final rules that implement the CFMA, but proposed Rule 38.2 explicitly preserves the applicability of existing Rule 1.38 to designated contract markets. Moreover, proposed Appendix B to Part 38 states that a contract market applicant "should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market."

11 The Commission has evaluated several contract market proposals to adopt block trading procedures and has determined that a five-minute reporting window is appropriate. *See* Cantor Financial Futures Exchange (one-year pilot program for block trading of U.S. Treasury Bond, U.S. Treasury Ten-Year Note, U.S. Treasury Five-Year Note, and U.S. Treasury Two-Year Note futures contracts approved by the Commission on February 11, 2000, with a 10-minute reporting window reduced to five minutes within 90 days); Chicago Mercantile Exchange (one-year pilot program for block trading of Five-Year and Ten-Year Agency Note futures contracts approved by the Commission on May 19, 2000, with a five-minute reporting window, and additional contracts subsequently added); Chicago Board of Trade (block trading of contracts initially listed on or after December 31, 1999 approved by the Commission on April 18, 2001, with a five-minute reporting window); and onExchange Board of Trade (block trading of Five-Year U.S. Treasury Note futures contracts approved by the Commission on December 22, 2000, with a five-minute reporting window); *see also* New York Futures Exchange (self-certified one-year pilot program on February 6, 2001, for block trading rules for futures and option contracts on the NYSE composite and Russell 1000 indices, with a two-minute reporting window).

I generally support the staff's determination that BTEX has satisfied the other criteria for contract market designation. However, I question whether an exchange can satisfy the CFMA's requirement that trading be fair and equitable and that markets be competitive and open when its block trading rule permits such a lengthy reporting delay and includes no other safeguards.[12] Given our limited experience with block trading, I nonetheless must take at face value the staff's determination that the BTEX rule meets the minimum standards established in the core principles of the CFMA. I will, however, take great interest in the exchange's implementation of this as-yet-untested rule.

To be sure, the CFMA permits an exchange to allow market sophisticates to privately negotiate large transactions either off-exchange or with minimal oversight by the Commission. However, the CFMA imposes the greatest self-regulatory responsibilities upon those that choose to be designated as contract markets and do retail business. The BTEX rule only widens the information gap between so-called "eligible contract participants" and smaller commercial hedgers and retail customers. I believe there is great potential for the rule to negatively affect price discovery and to make investigations of market manipulation less effective. The Commission action today sanctions a less transparent marketplace, which I fear will work only to the disadvantage of retail and more modest commercial participants who will likely suffer from increased market volatility.

/S/____ 6/18/01_________________
Commissioner Thomas J. Erickson Date

[12] The BTEX rule also permits market makers to execute block trades opposite other market makers. Accordingly, BTEX's block trading procedures may create a misleading impression as to open interest and liquidity in the underlying contracts because positions resulting from block trades would not need to be filled in the central marketplace.

June 14, 2001

To: The Commission

From: The Division of Economic Analysis
The Division of Trading and Markets

Subject: Application of BrokerTec Futures Exchange, L.L.C. ("BTEX" or "Exchange") for Designation as a Contract Market pursuant to Section 5 of the Commodity Exchange Act ("Act").

Recommendation: Staff recommends that the Commission designate BTEX as a contract market and approve BTEX's proposed Bylaws and Rules, BTEX's Market Maker Program, and the following futures contracts: Short-Term U.S. Treasury Note, Medium-Term U.S. Treasury Note, Long-Term U.S. Treasury Note, and U.S. Treasury Bond.

Consulting: The Division of Enforcement
The Office of the General Counsel

Processing Information:

Responsible Staff		
Official Receipt Date: 3/29/01	Duane Andresen	418-5492
Review Period Stayed: No		

I. Background of the Applicant

By letters dated May 8, 2000, through June 8, 2001, BTEX, a Delaware limited liability company and an indirect affiliate of BrokerTec Global, L.L.C. ("BrokerTec"), applied to the Commodity Futures Trading Commission ("Commission") for designation as a contract market for the automated trading of futures contracts on short-term U.S. Treasury Notes (2 Year), medium-term U.S. Treasury Notes (5 Year), long-term U.S. Treasury Notes (6 1/2 - 10 Year), and U.S. Treasury Bonds (15 - 30 Year). The Exchange also applied for Commission approval of various proposed rules and bylaws necessary to the establishment of a contract market.

On June 9, 2000, the Commission published a Federal Register notice requesting comments on BTEX's proposed application by July 10, 2000 (65 FR 36667). In response, the Commission received two comment letters.[1]

During the course of the staff's review of the BTEX application, the Commodity Futures Modernization Act of 2000 ("CFMA") was enacted on December 21, 2000. The CFMA established, among other things, requirements for two tiers of regulated markets: designated contract markets and registered derivatives transaction execution facilities. BTEX requested that its application be reviewed under the newly established designation criteria and core principles applicable to designated contract markets and it requested that the Commission approve its four U.S. Treasury futures contracts. Most recently, BTEX requested that the Commission not take final action on its application for contract market designation prior to June 14, 2001.

BTEX contracts would trade on the BTEX Trading System, a fully automated, electronic trading system that has been customized for the Exchange's use from the OM CLICK Exchange System developed by OM Technology AB ("OM"). Access to BTEX's Trading System for members and authorized traders would be through a dedicated network, rather than the Internet. BrokerTec has executed agreements under which OM would manage the data centers and network operations and provide the trading platform, proprietary network, and facilities management and ongoing technical and other support. BrokerTec also has established arrangements to license software from OM. On April 20, 2001, Commission staff visited the Jersey City BTEX site for a demonstration of the BTEX Trading System and a discussion of the security, vulnerability, and operation of the system.

[1] Both of the comment letters addressed BTEX's proposed block trading rule. A discussion of the block trading provisions can be found in Section IV of this memorandum.

BTEX has contracted with the National Futures Association ("NFA") to perform several of the Exchange's self-regulatory duties, including conducting trade practice and market surveillance, as well as investigations in conjunction with Exchange employees.[2] Commission staff's April 20, 2001 visit to the Jersey City BTEX site included a demonstration by NFA of the trade practice surveillance, market surveillance, and investigatory programs that it would operate for BTEX.

A BTEX affiliate, BrokerTec Clearing Company, L.L.C. ("BCC") would be responsible for clearing and settlement functions for the proposed Exchange. BCC has separately applied to the Commission for registration as a derivatives clearing organization ("DCO") pursuant to Section 5b of the Act. That application is more fully described in a separate memorandum to the Commission from the Division of Trading and Markets recommending registration of BCC as a DCO. BCC has contracted with the Board of Trade Clearing Corporation ("BOTCC") to provide certain clearing processing services for trades executed on or through BTEX.

The Commission has not previously approved BTEX as a contract market in any commodity futures contract or option on futures contract. Accordingly, in addition to the terms and conditions of the four proposed futures contracts, the Exchange has submitted to the Commission a proposed trade-matching algorithm, procedures, bylaws, and rules pertaining to BTEX governance, disciplinary and arbitration procedures, trading standards, recordkeeping requirements, and various other material to meet the requirements for a board of trade seeking initial designation as a contract market.

As set forth in Section II of this memorandum, the BTEX application demonstrates compliance with the Act's Section 5(b) Designation Criteria, Section 5(d) Core Principles, and

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[2] As part of its application, BTEX submitted to the Commission a redacted version of the NFA-BTEX Regulatory Services Agreement. In order to assure the completeness of BTEX's application, Commission staff reviewed

Section 5c(b) Common Provisions regarding designation of contract markets. Accordingly, staff recommends that the Commission designate BTEX as a contract market and simultaneously approve the following BTEX Bylaws and Rules: BTEX Bylaws Sections 1.1, 2.1 - 2.7, 3.1 - 3.20, 4.1 - 4.5, 5.1 - 5.8, 6.1 - 6.9, 7.1, 7.2, 8.1, 8.2, 9.1 - 9.11, 10.1 - 10.5, 11.1, and 12.1 - 12.13; BTEX Rules 101 - 103, 201 - 210, 301 - 304, 401 - 408, 410 - 414, 501, 601, 701 - 712, 801 - 805, and 901 - 903; and BTEX's Market Maker Program. Staff also recommends that the Commission approve the following futures contracts: Short-Term U.S. Treasury Note, Medium-Term U.S. Treasury Note, Long-Term U.S. Treasury Note, and U.S. Treasury Bond.

II. Analysis of BTEX's proposed Bylaws and Rules for compliance with the Act's Designation Criteria for Contract Markets.

CONTRACT MARKET CRITERIA FOR DESIGNATION	BROKERTEC FUTURES EXCHANGE, L.L.C. PROPOSAL	COMMENTS
Sec. 5(a) Applications – A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act.	Application Complete.	Acceptable. *See* Attachments.
Sec. 5(b) CRITERIA FOR DESIGNATION		
Designation Criterion 1 *In General* – To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this subsection.	Application Complete.	Acceptable. *See* Attachments.
Designation Criterion 2 *Prevention of Market Manipulation* – The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.	Contracted with NFA for trade practice and market surveillance. NFA has established procedures to detect violations and various trading abuses. BTEX market surveillance staff would monitor overall activity in each market on a real-time basis. BTEX staff would monitor the positions of large traders, deliverable supplies, and futures and cash prices.	Acceptable. BTEX has contracted with NFA to conduct its market surveillance, and NFA has established procedures that would reveal violations of trading rules, including attempts to manipulate futures prices. NFA has established similar trade practice and market surveillance procedures at Merchants' Exchange of St. Louis

unredacted copies of that agreement in the Washington, DC, office of BTEX counsel on March 29, 2001.

	See Attachment F (NFA-BTEX Regulatory Services Agreement).	("MESL") and OnExchange, two previously-designated contract markets
Designation Criterion 3 *Fair and Equitable Trading* – The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and [sic] the capacity to detect, investigate, and discipline any person that violates the rules. Such rules may permit off-exchange transfer trades, Exchange of Futures for Physicals, Exchange of Futures for Swaps, and intermediation.	BTEX Rules 206 (Duties of Members), 207 (Prohibited Conduct by Members), 401 (Trading Sessions), 403 (Handling of Orders), 406 (Block Trades), 407 (Exchange of Futures for Physicals), 408 (Exchange of Futures for Swaps); Part 7 (Disciplinary Proceedings). NFA-BTEX Regulatory Services Agreement. BTEX letter dated April 17, 2001.	Acceptable. BTEX has contracted with NFA to conduct its trade practice surveillance and investigation programs. Information regarding prices, bids, and offers will be available to market participants and the public on BTEX's website. *See* Discussion at IV (Block Trading Explanation).
Designation Criterion 4 *Trade Execution Facility* – The board of trade shall (A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.	BTEX Rules Part 4 (Trading). Description of BTEX Trading System (Exhibit F to Application). BTEX User Manual.	Acceptable. Orders would be executed in accordance with an algorithm that gives first priority to orders at best prices, and then gives priority among orders at the same price based on time of entry into BTEX. This priority of execution is similar to that previously approved by the Commission for other electronic trading systems. BTEX would accept "iceberg" orders, where only a portion of a larger order initially would be visible and subject to matching. Once the visible portion is matched, a second portion automatically would become visible and subject to matching. The process would continue until the entire order was executed. This provision is similar to that previously approved by the Commission for CME GLOBEX. BTEX has provided sufficient documentation and other information for Commission staff to conclude that the BTEX system would comply with the IOSCO principles for screen-based trading systems. Functional demonstration and mock trading conducted on April 20, 2001 for Commission staff from the Divisions of Trading and Markets and Economic Analysis, Office of

		General Counsel, and Office of Information Resources Management, verified operation of system in accordance with IOSCO principles.
Designation Criterion 5 *Financial Integrity of Transactions* – The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.	BTEX Rules 202 (Eligibility), 204 Denial of Membership), 205 (Grant of Membership or Clearing Membership), 206 (Duties of Members), 406 (Block Trades), 407 (Exchange of Futures for Physicals), 408 (Exchange of Futures for Swaps). BCC Bylaws Article VII (Clearing Members). BCC Rules Part 2 (Clearing Membership) and Part 5 (Margins and Premiums). BCC-BOTCC Processing Services Agreement.	Acceptable. To become a BTEX member, an applicant must, if an individual, be of the age of majority and be of good character. If an entity, the applicant must be duly organized and in good standing, have good commercial standing and business experience, and have such operational capabilities as BTEX may determine to be appropriate. An applicant must also be a Class B shareholder of BTEX or an affiliate of such a shareholder. To become a Class B shareholder an applicant must, among other things, be an "accredited investor" as defined in Rule 501(a) of Regulation D of the Regulations of the SEC under the Securities Act of 1933. To become a clearing member, the member also must be an entity and either (1) have capital of not less than $50 million, (2) have a guarantee of the applicant's obligations from an affiliate of the applicant which has capital of not less than $50 million, or (3) be either a category 1 Dealer Netting Member (net worth of at least $50 million and excess net [or liquid] capital of at least $10 million) or a category 1 FCM Netting Member ($50 million in net worth and $10 million in excess adjusted net capital) of the Government Securities Clearing Corporation. The applicant also must be approved for membership in the BCC. A non-clearing member would be required to deliver an agreement whereby a clearing member agreed to accept all transactions effected by that member that are not accepted for clearance by any other clearing member and to deposit with BTEX either $100,000 in cash or $105,000 in U.S. Treasury Bills as security.

		BCC would be responsible for clearing and settlement functions for BTEX. BCC has contracted with BOTCC to provide certain clearance processing services for trades executed on or through BTEX. BCC bylaws and rules are addressed in a separate Division of Trading and Markets memorandum recommending designation of BCC as a DCO.
Designation Criterion 6 *Disciplinary Procedures* – The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.	BTEX Rules Part 7 (Disciplinary Procedures). NFA-BTEX Regulatory Services Agreement.	Acceptable. Disciplinary procedures would be consistent with 17 CFR Part 8. With authorization of BTEX's Compliance Director, NFA would investigate possible rule violations and present written investigation reports to the Business Conduct Committee. Enforcement staff could impose summary fines of up to $10,000 for failure to make timely payments, failure to make timely and accurate reports, or failure to keep records. Fines may be appealed.
Designation Criterion 7 *Public Access* – The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.	BTEX letter dated April 17, 2001.	Acceptable. BTEX Bylaws, Rules, and contract specifications would be posted on the Exchange's website.
Designation Criterion 8 *Ability to Obtain Information* – The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.	BTEX Rules 206 (Duties of Members), 207 (Prohibited Conduct by Members), 407 (Exchange of Futures for Physicals). BTEX letter dated April 17, 2001.	Acceptable. Members would be required to file reports and furnish timely information as prescribed and/or requested by BTEX. BTEX has represented that it would participate in the Commission's Exchange Database System project by routinely providing trading information to the Commission. BTEX has represented that it will become a party to the International Information Sharing Memorandum of Understanding and Agreement dated March 15, 1996, and the Joint Audit Committee's Agreement for Services.

III. Analysis of BTEX's proposed Bylaws and Rules for compliance with the Act's Core Principles for Designation as a Contract Market.

CONTRACT MARKET CORE PRINCIPLES	BROKERTEC FUTURES EXCHANGE PROPOSAL	COMMENTS
Sec. 5c(b) Common Provisions Applicable to Registered Entities **(1) In General** – A contract market or derivatives transaction execution facility may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity. **(2) Responsibility** – A contract market or derivatives transaction execution facility that delegates a function under paragraph (1) shall remain responsible for carrying out the function.	Trade practice surveillance and market surveillance activities would be contracted out to NFA.	Acceptable. BTEX would remain responsible for compliance with the core principles for which the relevant functions are contracted out to NFA.
Sec. 5c(c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS – **(2)Prior Approval –** **(A) In General –** A registered entity may request that the Commission grant prior approval to any new contract or other instrument, new rule, or rule amendment. **(B) Prior Approval Required –** notwithstanding any other provision of this section, a designated contract market shall submit to the Commission for prior approval each rule amendment that materially changes the terms and conditions, as determined by the Commission, in any contract of sale for future delivery of a commodity specifically enumerated in section 1a(4) (or any option thereon) traded through its facilities if the rule amendment applies to contracts and delivery months which have already been listed for trading and have open interest.	BTEX Bylaws Articles I - XII and BTEX Rules Parts 1 - 9.	Acceptable. BTEX has requested that the Commission approve each of its proposed Bylaws and Rules in connection with its designation as a contract market. The Divisions of Economic Analysis and Trading and Markets recommend that the Commission approve such proposed bylaws and rules pursuant to Section 5c(c)(2)(A) of the Act, since they do not violate any provision of the Act or the Commission's regulations. The Divisions also recommend that the Commission approve BTEX's Market Maker Program.
Core Principle 1 *In General* **–** To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this	BTEX Rules and Bylaws, generally. Statement of Affirmative Representations. BTEX User Manual. Description of BTEX Trading System. BTEX	Acceptable. *See* Attachments.

subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.	Membership Application. NFA-BTEX Regulatory Services Agreement. BCC-BOTCC Processing Services Agreement. BTEX letter dated April 17, 2001.	
Core Principle 2 *Compliance with Rules* – The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.	BTEX Rules 201 (Status of Members), 202 (Eligibility [for membership]), 203 (Applications for Membership), 204 (Denial of Membership), 205 (Grant of Membership or Clearing Membership), 206 (Duties of Members), 207 Prohibited Conduct by Members), 403 (Handling of Orders), Part 7 (Disciplinary Procedures). NFA-BTEX Regulatory Services Agreement. BTEX Membership Application. Statement of Affirmative Representations.	Acceptable BTEX has outsourced its trade practice surveillance program to NFA. Commission staff has verified that NFA's surveillance program is substantially similar to the program that it already provides to the MESL and OnExchange that were previously approved by the Commission. NFA would use its automated Market Surveillance System to perform market surveillance for BTEX. Data would be safely stored and retained pursuant to Commission Regulation 1.31. Disciplinary procedures would be consistent with 17 CFR Part 8. *See* discussion at IV (NFA-BTEX Regulatory Services Agreement).
Core Principle 3 *Contracts Not Readily Subject to Manipulation* – The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.	BTEX Rules 301-304 specify four (4) financial futures contracts to be traded initially: 2-Year Short Term U. S. Treasury Notes; 5-Year Medium Term U.S. Treasury Notes; 6 ½-10 Year Long Term U.S. Treasury Notes; and 15-30 Year U.S. Treasury Bonds.	Acceptable. A review of each of these contracts, including discussion of individual contract terms and conditions, is contained in an attached memorandum. *See* Attachment A.
Core Principle 4 *Monitoring of Trading* – The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.	BTEX Rules 206(b), (c), (d), and (e); BTEX authority to obtain data on large trader positions and other factors from BTEX members; and NFA-BTEX Regulatory Services Agreement, which provides for monitoring of large trader positions, deliverable supplies, and cash and futures prices. See also BTEX Affirmative Representations.	Acceptable. BTEX monitoring of trades on a real-time basis coupled with daily collection of large trader position reports should minimize potential for manipulation, distortion of prices, or disruption of delivery for listed contracts.
Core Principle 5 *Position Limitations or Accountability* – To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for	BTEX Rules 412, 413 and 414 specify: (1) general requirements concerning speculative position limits, including provisions allowing exemptions to such limits for hedgers, spread or arbitrage traders, eligible entities as defined in CFTC Reg. 150.1(d), and eligible swap	Acceptable. The proposed rules are consistent with the provisions of Part 150 of the CFTC Regulations. The proposed speculative limit and position accountability levels for the proposed U.S. Treasury note and

speculators, where necessary and appropriate.	participants; (2) the policy for the aggregation of positions; (3) the procedures for obtaining exemptions from the limits; and (4) position accountability requirements when such procedures are adopted in lieu of speculative position limits.	bond futures contracts are discussed in an attached memorandum. *See* Attachment A.
Core Principle 6 *Emergency Authority* – The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to – (A) liquidate or transfer open positions in any contract; (B) suspend or curtail trading in any contract; and (C) require market participants in any contract to meet special margin requirements.	BTEX Bylaws Sections 5.8 (Emergency Powers), 6.5 (Quorum and Voting). BTEX Rule 709 (Financial or Operational Emergencies).	Acceptable. By a two-thirds vote, BTEX's Board could place into immediate effect temporary rules. Among other actions, the Board could order the liquidation of contracts or liquidation-only trading, suspend or limit trading, change delivery points and/or the means of delivery, and modify trading hours. Generally, no member could knowingly participate in deliberations and voting if such member had an interest in the matter. BTEX could also take various actions in response to physical emergencies, which would include any circumstance that could have a severe or adverse effect upon BTEX's physical functions.
Core Principle 7 *Availability of General Information* – The board of trade shall make available to market authorities, market participants, and the public information concerning – (A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market.	BTEX Application Letter dated May 8, 2000. Statement of Affirmative Representations. November 21, 2000 Responses of BTEX to Questions posed by Commission on October 2, 2000. BTEX Letter dated April 17, 2001.	Acceptable. BTEX has represented that it would participate in the Commission's Exchange Database System project by routinely providing trading information to the Commission. BTEX Bylaws, Rules, and contract specifications, including the terms and conditions of the BTEX contracts and the mechanisms for executing transactions on or through BTEX, would be posted on the Exchange's website.
Core Principle 8 *Daily Publication of Trading Information* – The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.	BTEX Rule 411 (Establishment of Settlement Prices). BTEX Application Letter dated May 8, 2000. November 21, 2000 Responses of BTEX to Questions posed by Commission on October 2, 2000. BTEX Letter dated April 17, 2001.	Acceptable. Daily information on settlement prices, volume, and open interest for actively traded contracts would be posted on the Exchange's website.
Core Principle 9 *Execution of Transactions* – The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.	BTEX Rules Part 4 generally (Trading), Rules 406 (Block Trades), 407 (Exchange of Futures for Physicals), 408 (Exchange of Futures for Swaps). Description of the BTEX Trading System. BTEX	Acceptable. Orders would be executed in accordance with an algorithm that gives first priority to orders at best prices, and then gives priority

	Disaster Recovery Plan. Uniform Electronic Trading Disclosure Statement. BTEX User Manual; Statement of Affirmative Representations.	among orders at the same price based on time of entry into BTEX. Functional demonstration and mock trading conducted for Commission staff on April 20, 2001 verified that the electronic facility provides for open, competitive, and efficient trading and otherwise complies with the IOSCO principles for screen-based trading. BTEX provided ample evidence that it had adequately tested its system's functions, capacity, and security and its interfaces to external systems, including its interface with NFA. *See* Discussion at IV (Block Trading Explanation).
Core Principle 10 *Trade Information* – The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.	BTEX Rules 206 (Duties of Members), 207 (Prohibited Conduct by Members), 403 (Handling of Orders), 903 (Confidentiality of Information). NFA-BTEX Regulatory Services Agreement. Description of BTEX Trading System. BTEX User Manual.	Acceptable. All orders entered into the BTEX Trading System would include, among other things, the identity of the originator of the order, an account number or identifier, and a customer type indicator code. BTEX would automatically capture all required information for each trade, including the time of entry of each bid or offer and the time of execution to the nearest one-thousandth of a second. BTEX would have an electronic analysis capability and could reconstruct trading rapidly and accurately. NFA programs would be run routinely to identify possible trading violations with respect to both market and customer abuse. Members would be required to retain and make available records pursuant to Commission regulations. BTEX computer data would be retained and stored for a period of five years as magnetic media (tape or CD Rom) in a secure storage facility at the Iron Mountain records repository north of New York City.
Core Principle 11 *Financial Integrity of Contracts* – The board of trade shall establish and enforce	BTEX Rules Part 2 generally (Membership Rules), especially 202 (Eligibility), 205 (Grant of	Acceptable. BCC would be responsible for

rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.	Membership or Clearing Membership), 206 (Duties of Members), 207 (Prohibited Conduct by Members); Part 3 generally (Contract Terms and Conditions); Part 4 generally (Trading). BCC Rules 503 (Cash Margin Deposits), 505 (Deposits of Securities, Approved Foreign Currencies, and Letters of Credit as Original Margin). Statement of Affirmative Representations. BCC-BOTCC Processing Services Agreement. NFA-BTEX Regulatory Services Agreement.	clearing and settlement functions for BTEX. BCC would have its own financial resources, market protection mechanisms (as described in its Bylaws and Rules), risk management staff and internal controls in place in order to monitor risk exposure and maintain the financial integrity of BTEX and BCC. BOTCC would provide certain clearing and processing services and process BTEX trades in accordance with standards and systems currently utilized by BOTCC on behalf of other designated contract markets. BCC bylaws and rules are addressed in a separate Trading and Markets memorandum recommending designation of BCC as a DCO.
Core Principle 12 *Protection of Market Participants* – The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.	BTEX Rules 206 (Duties of Members), 207 (Prohibited Conduct by Members), 403 (Handling of Orders). NFA-BTEX Regulatory Services Agreement. Statement of Affirmative Representations.	Acceptable. Members would be required to exercise due diligence in receiving and handling customer orders, entering such orders into BTEX, responding to customer inquiries about orders, and reporting order executions to customers. Except as may be permitted by rule, members are prohibited from executing wash trades, cross trades, accommodation trades, or prearranged trades. Members may not manipulate, or attempt to manipulate, the price of, or to corner, any commodity. NFA would utilize an automated system to perform trade practice surveillance to monitor for, among other trading abuses, direct and indirect trading ahead of customers, direct and indirect crossing of orders, prearranged trading, wash trading, and direct and indirect accommodation trading.
Core Principle 13 *Dispute Resolution* – The board of trade shall establish and enforce rules regarding [sic] and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.	BTEX Rules Part 8 (Arbitration). Statement of Affirmative Representations.	Acceptable. BTEX's Arbitration Committee would settle a claim or grievance submitted to arbitration. A customer's claim against a member or employee could be settled by arbitration if the customer so elects; a member's claim against another

		member or employee would be required to be settled by arbitration. A panel of three or more disinterested members would hear the grievance. If the claimant is a customer who has elected a mixed panel, at least a majority of the Panel could not be members, associated with any member, employees, or otherwise associated with a contract market. Each party would be entitled to be represented by counsel, to present all relevant facts, and to examine other parties, any witnesses, and documents. The Panel's decision would be final and binding upon each of the parties. In response to a request of any party, or on the Arbitration Committee Chairman's own motion, cases involving claims of less than $5,000 could be determined "on the papers" by the Chairman.
Core Principle 14 *Governance Fitness Standards* – The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).	BTEX Bylaws Article V (Directors), Sections 5.2 (Number; Election or Appointment; Tenure), 5.3 (Resignation or Removal), 5.6 (Eligibility for Service on Boards and Committees). Article VII (Committees), Section 7.1 (Designation and Powers). Section 3.4 (Class B Shareholdings). BTEX Rules 202 (Eligibility [for membership]), 205 (Grant of membership or Clearing Membership), 206 (Duties of Members), 207 (Prohibited Conduct by Members).	Acceptable. To become a BTEX member, an applicant must, if an individual, be of the age of majority and be of good character. If an entity, the applicant must be duly organized and in good standing, have good commercial standing and business experience, and have such operational capabilities as BTEX may determine to be appropriate. An applicant must also be a Class B shareholder of BTEX or an affiliate of such a shareholder. To become a Class B shareholder an applicant must, among other things, be an "accredited investor" as defined in Rule 501(a) of Regulation D of the Regulations of the SEC under the Securities Act of 1933. To become a clearing member, the member also must be an entity and either (1) have capital of not less than $50 million, (2) have a guarantee of the applicant's obligations from an affiliate of the applicant which has capital of not less than $50 million, or (3) be either a category 1 Dealer Netting Member

		(net worth of at least $50 million and excess net [or liquid] capital of at least $10 million) or a category 1 FCM Netting Member ($50 million in net worth and $10 million in excess adjusted net capital) of the Government Securities Clearing Corporation. The applicant also must be approved for membership in the BCC. A non-clearing member would be required to deliver an agreement whereby a clearing member agreed to accept all transactions effected by that member that are not accepted for clearance by any other clearing member and to deposit with BTEX either $100,000 in cash or $105,000 in U.S. Treasury Bills as security. Members would be required to make and file reports and to notify BTEX of events which would impact their capability to meet minimum standards of fitness and of any material change in any information contained in the membership application. Members would be required to diligently supervise the activities of their employees. No natural person would directly or indirectly have a greater than 10 percent interest in BTEX. BTEX's Bylaws regarding eligibility for service on boards and committees are consistent with Commission Regulation 1.63.
Core Principle 15 *Conflicts of Interest* – The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.	BTEX Bylaws Article V (Directors), Section 5.7 (Improper Use or Disclosure of Material Non-Public Information); Article VI (Meetings of the Board), Section 6.5 (Quorum and Voting); Article IX (Officers), Section 9.11 (Restrictions on Trading and Disclosure by Employees).	Acceptable. No member of the Board or any Disciplinary Committee or Oversight Panel could knowingly participate in deliberations and voting if such member had a specified relationship with respect to a named party in the matter or an interest therein. BTEX Bylaws require that each Board, Committee, or Panel member disclose such relationships or interests to the President prior to consideration of the matter.

		No Board or committee member may inappropriately use or disclose any material non-public information obtained as a result of participation on the Board or committee. No employee may trade in any commodity interest if the employee has access to material non-public information concerning such commodity interest.
Core Principle 16 *Composition of Boards of Mutually Owned Contract Markets* – In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.	BTEX Bylaws Article V (Directors), Sections 5.2 (Number; Election or Appointment; Tenure), 5.3 (Resignation and Removal) 5.4 (Vacancies).	Acceptable. BTEX Bylaws require that the Board include a diversity of Exchange membership interests. Of the regular voting members of the Board, twenty percent must be knowledgeable individuals who are not members or employees ("Public Directors") and ten percent must represent entities engaged in the business of trading underlying commodities.
Core Principle 17 *Recordkeeping* – The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.	BTEX Rules 206 (Duties of Members), 406 (Block Trades), 407 Exchange of Futures for Physicals), 408 (Exchange of Futures for Swaps), 410 (Transfer of Positions). Statement of Affirmative Representations.	Acceptable. Data would be safely stored and retained pursuant to Commission Regulation 1.31. The BTEX Trading System would automatically record and time to the nearest one-thousandth of a second all information required for each trade. BTEX Rules provide for the documentation of cash transactions underlying an exchange of futures for physicals. It would not be possible for members or authorized traders to fabricate or alter trading records on BTEX without leaving a permanent record of the change and of the original data that was replaced.
Core Principle 18 *Antitrust Considerations* – Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid – "(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anticompetitive burden on trading on the contract market.	BTEX Bylaws Articles I - XII and BTEX Rules Parts 1 - 9.	Acceptable. Staff did not identify any antitrust issues in reviewing the application.

IV. Novel or Unusual Issues

A. Market Maker Program

In addition to its proposed Bylaws and Rules, BTEX has submitted for Commission approval a proposed Market Maker Program. Pursuant to this provision, members and/or their affiliates who were designated as Market Makers would receive certain privileges for undertaking market making responsibilities and obligations. For each contract for which he or she agreed to make a market ("covered contract"), the Market Maker would be required to quote continuously both a bid and an offer price for a specified minimum lot size during at least seventy-five percent of the time from 8:00 a.m. to 5:00 p.m., and to use best efforts to quote continuously both the bid and offer price for a specified minimum lot size during the remaining trading session hours.[3] The Market Maker would be required to quote a bid/ask spread equal to or within certain specifications established by BTEX.

For assuming these obligations, a Market Maker would be granted certain specified benefits. First, Market Makers could, if the Board so determines, receive an annual rebate of a specified percentage of any BTEX transaction fees incurred with respect to each transaction in a covered contract. Second, the Market Makers would be entitled to pay the lowest available transaction fee for a transaction entered into for their proprietary account in the covered contract. Third, Market Makers would be granted special privileges under the Exchange's block trading rule, which is discussed below. In this context, only Market Makers in each particular covered contract would be entitled to effect block trades in that contract, subject to the following exception: a member that is not a Market Maker for a covered contract may, as agent for a customer, effect a block trade with a Market Maker for that covered contract.

Staff recommends that the Commission approve BTEX's proposed Market Maker Program pursuant to Section 5c(c)(2)(A) of the Act, since it does not violate any provision of the Act or the Commission's regulations.

B. Block Trading

BTEX's proposed block trading rule, Rule 406, differs from block trading rules previously approved or allowed into effect by the Commission. Unlike other block trading provisions, which require that all block transactions be reported to an exchange within five minutes of execution, BTEX's required reporting time would be longer, would be based on trading session minutes, and would be scaled based upon the size of the trade, i.e., the

[3] There is no restriction on there being multiple Market Makers for a single covered contract. In fact, BTEX would allow Market Makers to opt out of the program on an expedited basis in instances where their covered contract had three or fewer Market Makers.

larger the trade, the longer the time period before reporting is required ("tiered reporting").[4] BTEX proposes to have the following schedule of reporting times for block transactions based upon the number of contracts in the block:

Number of Contracts[5]	Reporting Time in Trading Session Minutes
250 – 999	15 Minutes
1000 – 2499	30 Minutes
2500 – 4999	60 Minutes
5000 – 9999	120 Minutes
10,000+	240 Minutes[6]

For the reasons discussed below, Commission staff recommends that BTEX's block trading rule be approved.[7]

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[4] Notably, the two comments that the Commission received on BTEX's proposed application commented on the Exchange's block trading proposal. The Futures Industry Association supported the proposal. The Chicago Mercantile Exchange ("CME") commented that the BTEX proposal's tiered reporting requirements for block trades were not consistent with preserving a considerable degree of meaningful price discovery for block transactions. (The CME also contrasted the BTEX proposal with CME block trading rules that had been approved by the Commission and voiced reservations about the Commission's "case-by-case" approach in the rule approval process, commenting that it would not be fair to approve a BTEX rule that would permit BTEX to avoid obligations imposed on competing exchanges until those competitors had been provided an opportunity to amend their rules accordingly).

[5] The nominal value of a 2-Year Short Term U.S. Treasury Note futures contract would be $200,000. The nominal value of one contract in each of the other three futures contracts would be $100,000. Thus, a block trade of 5000 contracts in the 2-Year Short Term U.S. Treasury Note futures contract would have a nominal value of $1 billion and a similar block trade in any of the other three futures contracts would have a nominal value of $500 million.

[6] Notably, BTEX's original proposal had the following reporting time schedule:

Number of Contracts	Reporting Time in Trading Session Minutes
250 – 499	15 Minutes
500 – 999	30 Minutes
1000 – 2499	60 Minutes
2500 – 4999	120 Minutes
5000 – 9999	240 Minutes
10,000+	500 Minutes

Commission staff believed that these original reporting periods were excessive and could have had an adverse impact on price transparency and discovery. (As indicated in footnote 3, CME also commented that the originally-proposed reporting periods were not consistent with preserving a considerable degree of meaningful price discovery for block transactions).

[7] The CFMA has provided the Commission with broad authority to approve Exchange rules that permit the noncompetitive execution of transactions on designated contract markets. Revised Section 5(b)(3) of the Act, which addresses just and equitable trading, unambiguously provides that the Commission may designate as a contract

BTEX contends that the success of its block trading facility would depend, to a large extent, on the willingness of block facilitators (Market Makers under BTEX's Market Maker Program) to offer liquidity to potential block trade participants and their ability to offer competitive prices, which largely depends on the facilitators' ability to offset, without undue risk and market impact, the position acquired through their execution of a block trade. BTEX contends that the facilitator of the block must be able to establish its hedging position, over time, in efficiently-sized lots, without revealing to the marketplace the ultimate size of the position to be hedged, thus permitting the facilitator of the block to avoid disadvantageous prices in its related hedging activity. Thus, BTEX contends that the block trade reporting time criterion is important in determining whether, and at what price, to execute the trade. If block facilitators are not satisfied that they can effectively lay off or hedge a position resulting from a block trade in the futures market within the stipulated reporting period, it is unlikely that the pricing would be competitive or that the transaction would be executed. Further, like larger orders generally, larger block trades would require a longer period to hedge and, thus, a longer reporting period.

The staff believes that the BTEX proposal concerning delayed reporting of block trades is acceptable. In general, the price discovery process is optimized if all information about transactions is revealed to the marketplace in a timely manner. However, information associated with certain block trades may be revealed to the marketplace in other ways, which would suggest that a delay in the reporting of details about such block trades should not undermine the price discovery process. For example, if a block trader hedges or offsets the position acquired via the block trade by establishing futures positions in the regular (non-block) exchange market after executing the block trade, then the price and size information contained in the block will be revealed to the marketplace as futures transactions associated with the block trade are executed in the marketplace. Recognizing this, a short delay in the reporting of information about a block trade, where the extent of the delay is a function of the size of the block, would not appear to impair the price discovery process in the futures market.

In view of the foregoing considerations, a modest delay in reporting information about a block trade appears reasonable for those block trades representing transaction sizes that are larger than the typical transaction sizes of trades in the relevant market. As noted above, BTEX contends that such a delay in reporting would

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market a board of trade that has rules which authorize the execution of various noncompetitive transactions, including exchanges of futures for physicals or swaps and certain transactions involving a futures commission merchant acting as a principal or agent.

facilitate traders' ability to hedge or offset positions associated with block trades by executing transactions in the futures market before exposing their entire positions to the market.

Commission staff reviewed transaction data in an existing U.S. Treasury securities futures markets in evaluating the BTEX proposal. These data indicate that trades representing 250 to 2,500 contracts are somewhat larger than the typical sizes of trades transacted in those markets. Staff further found that in the 10-year U.S. Treasury note contract, over 93 percent of trades in the 250- to 1000-contract range were executed in less than 15 minutes. The maximum15-minute delay proposed by BTEX for block trades in the 250- to 1,000-contract range corresponds to observations about the time required to execute comparably sized transactions in the existing U.S. Treasury futures markets. Similarly, the maximum 30-minute delay proposed by BTEX for block trades in the 1,000- to 2,500-contract range also corresponds to the observed time required to execute transactions in the existing U.S. Treasury futures markets.[8]

Accordingly, BTEX's proposed delay in the reporting block trades representing transaction sizes greater than 250 but less than 2,500 contracts comports with the length of time observed for executing a comparable number of contracts in the existing U.S. Treasury futures market. Moreover, the proposed reporting timeframes appear reasonable to meet the business objectives identified by BTEX. In addition, the staff notes that the 15- and 30-minute reporting periods proposed by BTEX for these larger-size block trades would allow for the reporting of information about the block trade within a period of time where the information may be useful for price discovery on the futures markets.

With regard to block trades involving more than 2,500 contracts, an analysis of trades in the existing U.S. Treasury futures markets indicates that such transactions are rarely observed. The limited frequency of such very large transactions relative to transactions sizes commonly observed in the U.S. Treasury futures markets suggests that these trades are not, and would not normally be, relied upon to provide price information and, therefore, would not likely constitute a meaningful component of the price discovery process in the futures market. Accordingly, allowing longer delays in the reporting of such large block trades, of up to four hours for the largest block trades as proposed by BTEX, should not have an appreciable adverse affect on the ability of the futures markets to carry out their price discovery function and, thus, the proposal would not appear to be inconsistent with the Commission's

[8] In this regard, a review of transaction data in the active 10-year U.S. Treasury note futures contract indicated that over 90 percent of all trades representing 1,000 to 2,500 contracts were executed in less than 30 minutes.

guidance for block trading.[9] Nevertheless, Commission staff will monitor the impact of the BTEX block trading rule on price discovery in the relevant markets.

C. NFA-BTEX Regulatory Services Agreement

Schedule A to the NFA-BTEX Agreement, Scope of Regulatory Services, provides, in paragraph III.D., that if an inquiry reveals conduct that might violate both BTEX's and NFA's rules, NFA will defer to BTEX staff to determine whether prosecution is warranted and will not prosecute the matter under NFA's rules. In its review, Commission staff evaluated whether this provision might prevent NFA from fulfilling its obligations as a registered futures association in circumstances where a member may have violated both BTEX and NFA rules, but BTEX elected not to prosecute the member for the potential violation of the BTEX rule and, thus, foreclosed NFA from prosecuting the member for violation of NFA's rule.

Commission staff concluded that the provision was acceptable for a number of reasons. First, as the designated contract market, BTEX remains responsible for any function contracted to the NFA. As such, BTEX has the responsibility to make the ultimate decision with respect to whether to prosecute a member for any potential rule violation. Second, this provision provides for disciplinary procedures that are consistent with existing procedures at other contract markets: the compliance department (NFA under contract at BTEX) presents an investigation of potential rule violations to a disciplinary committee (BTEX members) which, after review of the investigation report, makes a determination as to whether to prosecute (issue a notice of charges). Third, NFA rules would generally not be implicated in this context because NFA rules normally do not duplicate those implemented and enforced by contract markets. Fourth, where the rules of NFA and BTEX are both applicable to suspect conduct, the same paragraph III.D. of the BTEX-NFA Agreement permits BTEX to request that NFA investigate and litigate the matter under NFA's rules. And fifth, the Commission could take action on its own initiative if it believed the situation required it. For these reasons, staff believes this outsourcing of the compliance function to NFA will not prevent BTEX from complying with the core principles.

V. Attachments:

[9] This conclusion is based upon information provided to Commission staff by BTEX and independent sources with respect to the Exchange's four proposed U.S. Treasury securities futures contracts. Accordingly, any further proposals in this regard would have to be evaluated in light of the circumstances of the particular market(s) involved.

A. Division of Economic Analysis Memorandum Regarding BTEX Request for Approval of its U.S. Treasury Bond, Long-Term U.S. Treasury Note, Medium-Term U.S. Treasury Note, and Short-Term U.S. Treasury Note Futures Contracts
B. May 8, 2000 Application letter from BTEX to Commission
C. BTEX Limited Liability Company Agreement and Bylaws
D. BTEX Rules
E. Description of BTEX Trading System (Exhibit F to BTEX Application)
F. NFA-BTEX Regulatory Services Agreement and Schedule A thereto
G. BCC-BOTCC Processing Services Agreement
H. Disaster Recovery Plan
I. BTEX User Manual
J. Statement of Affirmative Representations
K. September 15, 2000 letter from BTEX to Commission re: Responses to Commission Staff Questions
L. November 21, 2000 BTEX Response to Commission Staff Questions of October 2, 2000
M. April 17, 2001 letter from BTEX to Commission
N. April 27, 2001 letter from BTEX to Commission
O. Market Maker Program
P. June 8, 2001 letter from BTEX to Commission

June 11, 2001

Memorandum

To: **The Commission**

From: **The Division of Economic Analysis**

Subject: BrokerTec Futures Exchange, L.L.C. (BrokerTec) Request for Approval of its U.S. Treasury Bond, Long-Term U.S. Treasury Note, Medium-Term U.S. Treasury Note, and Short-Term U.S. Treasury Note Futures Contracts.

Conclusion: **The subject futures contracts appear to comply with the requirements for approval of contracts as set forth in Commission Guideline No. 1.**

Staff Contacts: **Michael Penick x5279**
Thomas Leahy x5278

Introduction and Background

In correspondence dated May 8, 2000, BrokerTec Futures Exchange, L.L.C. (BrokerTec), an affiliate of BrokerTec Global, L.L.C.[13], applied for designation as a contract market and for Commission approval of its U.S. Treasury Bond (15-30 Year), Long-Term U.S. Treasury Note (6½-10 Year), Medium-Term U.S. Treasury Note (5 Year), and Short-Term U.S. Treasury Note (2 Year) Futures Contracts.[14] The review period for the subject contracts was deemed to begin on March 29, 2001, when the Commission first received unredacted versions of the two-party agreements related to the application for designation as a contract market. However, BrokerTec

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[13] **The shares in BrokerTec Global are held by 12 large debt and capital market dealers active in the U.S. Treasury cash market.**

[14] **BrokerTec initially applied for contract market designation in the subject proposed contracts. However, under the Commodity Exchange Act as amended by the Commodity Futures Modernization Act of 2000, the Commission now is asked to designate BrokerTec as a contract market and separately to approve the subject contracts. The request for designation as a contract market is being considered in a separate memorandum. BrokerTec did not submit or request approval of options on the subject proposed futures contracts.**

requested that the Commission not take final action on the designation application prior to June 14, 2001.

The proposed contracts would be the first contracts approved by the Commission for trading on BrokerTec. The terms and conditions of the proposed contracts, as discussed below, are substantially identical to those of existing futures contracts in those Treasury securities actively traded at the Chicago Board of Trade (CBOT).[15]

BrokerTec plans to list the proposed contracts for trading on an electronic trading platform. The Division of Economic Analysis and the Division of Trading and Markets (collectively the Divisions) have prepared a separate memorandum regarding the approval of specific BrokerTec rules, including a recommendation regarding designation of BrokerTec as a contract market. That memorandum contains additional details regarding the proposed trading platform, and it includes a discussion of comments received in connection with BrokerTec's designation application.[16]

The Division of Trading and Markets, on behalf of the Commission, published a notice of availability of the terms and conditions of the proposed contract in the Federal Register on June 9, 2000 (65 Fed. Reg. 36667). No comments regarding the contracts' terms and conditions were received in response to that notice. Comment also was requested of the Department of the Treasury, and the Board of Governors of the Federal Reserve System. No written comments were received from those agencies.

15 **The CBOT was designated as a futures contract market in long-term U.S. Treasury bonds on August 2, 1977, in long-term (10-year) U.S. Treasury notes on September 23, 1981, in medium-term (5-year) U.S. Treasury bonds on June 19, 1979, and in short-term (2-year) U.S. Treasury bonds on September 30, 1981.**

16 **Comments were received from the Chicago Mercantile Exchange and the Futures Industry Association regarding the block trading provisions. Those letters are addressed in the Divisions' memorandum to the Commission regarding contract market designation.**

Terms and Conditions of Proposed Futures Contracts

Futures Term	*Exchange Proposal*	*Comment/Analysis*
Deliverable Commodities	• U.S. Treasury Bond**: A U.S. Treasury Bond with an original principal of $100,000, a semi-annual coupon, and a time remaining to maturity of at least 15 years (given Treasury issuance patterns, the maturity window is 15 to 30 years) and must not be callable for at least 15 years. Time to maturity calculated in years and complete quarter-years as of first day of contract month (*e.g.*, a 15 year, 5 month bond will be considered 15 1/4 years).** • Long Term U.S. Treasury Note**: A U.S. Treasury Note with an original principal of $100,000, a semi-annual coupon and a time remaining to maturity of at least 6½ years and no more than 10 years. Time to maturity calculated in years and complete quarter-years as of first day of contract month.** • Medium U.S. Treasury Note**: A U.S. Treasury Note with an original principal of $100,000, a semi-annual coupon, an original maturity of at most 5 years 3 months, and a time remaining to maturity of at least 4 years 2 months. Time to maturity calculated in years and complete months as of first day of contract month.** • Short-Term U.S. Treasury Note**: A U.S. Treasury Note with an original principal of $200,000, a semi-annual coupon, an original maturity of at most 5 years 3 months, and a time remaining to maturity of at least 1 years 9 months and no more than 2 years. Time to maturity calculated in years and complete months as of first day of contract month.**	**Acceptable for hedging U.S. Treasury securities in the specified maturities. Maturity windows should result in adequate deliverable supplies, as discussed below.**

Futures Term	Exchange Proposal	Comment/Analysis
Delivery Terms & Procedures	• **Physical delivery through book-entry wire transfer.** • **Conversion factor is used to price deliverable securities with a coupon rate other than 6% and to adjust for the actual term to maturity of the delivered security, calculated as described above.** • **Accrued interest charged to long.**	**Acceptable. Use of book entry wire transfer is consistent with cash market practice and it has worked satisfactorily for futures deliveries on CBOT. Procedures for calculating the invoice price, including the conversion factors, are identical to those specified for the corresponding CBOT U.S. Treasury bond and note futures contracts and are appropriate for proposed futures contracts.**
Trading Months	**March quarterly cycle months.**	**No seasonality in issuance or cash-market trading. Thus, any months are acceptable from an economic standpoint.**
Delivery Period	**Any business day during the contract month for bonds, 10-year notes, and 5-year notes. Delivery period extends to third business day following last trading day of delivery month for 2-year notes.**	**Acceptable. Same as CBOT Treasury instrument futures contracts.**
Contract Size	**$100,000 original principal for bond, 10-year note and 5-year note contracts. $200,000 original principal for 2-year note contract.**	**Acceptable. Smaller than most Treasury instrument cash market transactions (which generally are in increments of $1,000,000 face value) but not an impediment to delivery given that delivery is through book entry transfer.**
Trading Hours	**Several trading sessions during business day. Specific trading hours to be determined.**	**Any hours are acceptable.**
Last Trading Day	**Last trading day for bonds, long-term notes, and medium-term notes is the eighth last business day of the contract month. Last trading day for short-term notes is either last business day of contract month or 2 business days prior to issuance of 2-year notes auctioned in the current month, whichever is earlier. Trading terminates at 1:00 p.m. on the last trading day.**	**Acceptable. Same as specified for CBOT Treasury instrument futures contracts.**

Futures Term	*Exchange Proposal*	*Comment/Analysis*
Pricing Basis and Minimum Ticks	**In points and 32nds of 100 points with the following minimum ticks for outright transactions:** U.S. Treasury Bond: **1/32 point ($31.25 per contract).** Long-Term U.S. Treasury Note: ½ **of 1/32 point ($15.625 per contract).** Medium-Term U.S. Treasury Note: ½ **of 1/32 point ($15.625 per contract).** Short-Term U.S. Treasury Note: ¼ **of 1/32 point ($7.8125 per contract).** **Inter-month spread transactions can be executed at ¼ of 1/32 point for Bonds and Long-Term Notes ($7.8125 per contract) and 1/8 of 1/32 for Medium-Term and Short-Term Notes ($3.90625 and $7.8125 per contract, respectively). Inter-commodity spread transactions can be executed at lowest available minimum tick for outright transactions.** **In the event that the U.S. Treasury cash market adopts decimal pricing, BrokerTec proposes a minimum tick for outright transactions of $10.00 per contract for each subject contract. This is equal to 0.005 point for the 2-Year T-Note contracts and 0.01 point for the other subject contracts. BrokerTec also proposes a minimum tick for inter-month spread transaction of $5.00 per contract for each subject contract.**	**Acceptable. Pricing convention the same as used in the cash market. The minimum ticks are not inconsistent with the cash market minimum ticks and are equivalent to those for the corresponding CBOT Treasury instrument futures contracts.** **Smaller minimum ticks for inter-month spreads are equivalent to those of the corresponding CBOT Treasury Bond and Long-Term Treasury Note contracts, and are half the size of the corresponding CBOT Medium-Term and Short-Term Treasury Note contracts.**
Daily Price Limit	**None.**	**Acceptable. Meets Guideline No. 1 standard.**
Position Accountability and Speculative Position Limit Provisions	• U.S. Treasury Bond**: Category 3 position accountability with a trigger at 10,000 contracts.** • Long-Term U.S. Treasury Note**: Category 3 position accountability with a trigger at 7,500 contracts.** • Medium-Term U.S. Treasury Note**: Category 3 position accountability with a trigger at 7,500 contracts.** • Short-Term U.S. Treasury Note**: Speculative position limit of 5,000 contracts in all months combined and 5,000 contracts in the spot month.**	• **Position accountability trigger levels are identical to those on the CBOT and are acceptable for BrokerTec contracts. Category 3 position accountability is more conservative than the CBOT for the Treasury bond contract (the CBOT has Category 2) and the same as the CBOT for the Medium-Term and Long-Term Treasury note contracts. Category 3 is acceptable for these BrokerTec contracts.** • **Short-Term note all-months-combined and spot month speculative position limits are identical to those on the CBOT and are acceptable for the BrokerTec contract.**

Futures Term	*Exchange Proposal*	*Comment/Analysis*
Reportable Level	• U.S. Treasury Bond**: 500 contracts.** • Long-Term U.S. Treasury Note**: 500 contracts.** • Medium-Term U.S. Treasury Note**: 300 contracts.** • Short-Term U.S. Treasury Note**: 200 contracts.**	**Acceptable. Same as levels specified in Commission Regulation 15.03.**

Deliverable Supply for the Proposed Futures Contracts

As noted, the delivery windows and, thus, the economically deliverable supply, for each of the proposed contracts are identical to those of the CBOT's corresponding U.S. Treasury bond and note futures contracts. The cash market for US Treasury instruments has exhibited the highest degree of breadth and liquidity and is characterized by tight bid-ask spreads. There are very large supplies of Treasury bonds and notes available for purchase or sale. The CBOT contracts are highly liquid and provide for very large economically deliverable supplies. There have been no significant problems related to deliverable supplies in the CBOT contracts.

Due to actual and expected budget surpluses, the funding needs of the Treasury have declined in recent years, and may continue to decline in the future. As a result, the Treasury adopted changes that affected the pattern of issuance of five-year notes and the economically deliverable supplies of both five-year notes and two-year notes. In addition, the Treasury has adopted a redemption program through which the Treasury periodically buys and retires certain outstanding marketable securities.

With respect to the Medium-Term Treasury Note contract, in 1998, the Treasury reduced the frequency of five-year note auctions to a quarterly basis[17] from a monthly basis while increasing the size of such auctions. Recent five-year note auctions have averaged about $13 billion as compared to an average size of about $11 billion for the last several monthly auctions. This change in the Treasury's auction schedule affected the economically deliverable supply of the medium-term note futures contracts both at BrokerTec and at the CBOT. However, since the Treasury increased the size of each five-year note issuance and since the most recently issued five-year note comprises a disproportionate part of the economically deliverable supply, the effect of the reduction in auction frequency on the economically deliverable supply of the medium-term Treasury note futures contracts was modest. Accordingly, the Division believes that BrokerTec's proposed position accountability provisions (as well as the CBOT's existing substantially identical provisions) remain appropriate for the Medium-Term Treasury Note futures contract. However, the Division will continue to monitor economically deliverable supplies, and the appropriateness of the position accountability provisions, for the medium-term note contracts.

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[17] **The final issuance of five-year notes in the monthly cycle occurred in June 1998. The first quarterly issuance of five-year notes occurred in August 1998. Treasury also had issued five-year notes on a quarterly basis prior to 1991.**

With respect to the Short-Term Treasury Note contract, the Treasury's recent changes did not affect the two-year note auction schedule. The Division notes, however, that five-year Treasury notes issued three years prior to the delivery month are deliverable against the Short-Term Treasury Note contract if the remaining maturity of those notes falls within that contract's delivery window (that is, if they have a time remaining to maturity of at least 1 years 9 months and no more than 2 years). Thus, the economically deliverable supply of two-year notes at BrokerTec, and at the CBOT, will be affected by the recent changes in the auction schedule for five-year notes, as discussed above. Since two-year notes will continue to be issued on a monthly basis, and since old five-year notes comprise a relatively small part of economically deliverable supplies for the short-term note futures contracts, the Division believes that deliverable supplies will remain adequate and that the proposed speculative position limit provisions (as well as the CBOT's existing substantially identical provisions) remain appropriate. However, the Division will continue to monitor economically deliverable supplies, and the appropriateness of the speculative position limit provisions, for the short-term note contracts.

Under the Treasury's redemption program, the Treasury announces a buyback, including the maximum amount that may be redeemed, and solicits offers by persons wishing to sell Treasury securities covered by the buyback. Recent redemptions have been for off-the-run Treasury bonds, which typically would not account for a significant portion of the economically deliverable supply under the Treasury bond contract. Thus, the Division concludes that the Treasury's redemption program should not adversely affect economically deliverable supplies. Nevertheless, the Division will continue to monitor economically deliverable supplies of the subject contracts, and the appropriateness of the speculative position limit standards or position accountability standards, for the subject contracts.

Proposed Minimum Tick in the Event of Decimalization

The proposed rules include provisions for pricing in decimals rather than in thirty-seconds in the event that the cash market adopts decimal pricing. The Division notes that it is difficult to predict what the minimum ticks in the cash market would be under decimalization. However, the minimum ticks that BrokerTec proposes to make effective under decimalization would be smaller than the current minimum ticks stated in terms of thirty-seconds. Therefore, the contingent minimum ticks under decimalization appear to be acceptable.

Conclusions

The Division of Economic Analysis has completed its economic analysis of BrokerTec's proposed U.S. Treasury Bond (15 - 30 Year), Long-Term U.S. Treasury Note (6½ - 10 Year), Medium-Term U.S. Treasury Note (5 Year), and Short-Term U.S. Treasury Note (2 Year) futures contracts. The Division believes that the terms and conditions of the proposed futures contracts meet the requirements of the Commodity Exchange Act (Act), the Commission's Guideline No. 1, and Commission Regulation 150.5 concerning speculative position limits. Also, the Division, based on its analysis, is of the opinion that the proposed futures contracts reasonably can be expected to be used for hedging on more than an occasional basis. Finally, the Division is of the opinion that the terms and conditions of the subject futures contracts do not appear to make those contracts readily susceptible to price manipulation or other distortions.