



Coffee, Sugar & Cocoa Exchange, Inc.

James J. Bowe
President

April 23, 1998

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COMMENT

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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Dear Ms. Webb:

The Coffee, Sugar & Cocoa Exchange, Inc. ("CSCE" or "Exchange") is pleased to submit comments in response to the Concept Release published by the Commodity Futures Trading Commission ("CFTC" or "Commission") on January 26, 1998, concerning the Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market (the "Concept Release").¹

The ambitious breadth of each of these subjects, coupled with the limited response time given to the industry, precludes the Exchange from providing specific answers to the 57 questions posed by the CFTC. Based on the preliminary meetings held among CSCE's trade committee representatives, floor and FCM community members, CSCE can respond to the Concept Release at this time only from a broad viewpoint. Accordingly, CSCE's comments could change, or be supplemented substantially, if specific regulatory proposals are published for comment at a future date. In that regard, to the extent that the Concept Release is a precursor to CFTC rulemaking, CSCE believes it is important that the Commission recognize in such rulemaking the differences among exchanges in terms of their products, market participants, end users, trading systems and size. Any proposed rulemaking should be flexible enough to allow each exchange to determine how best to implement such rules in its own markets, and, in appropriate cases, whether to adopt such rules at all.

The following summarizes CSCE's views on several of the issues covered by the Concept Release.

1. Standards Governing EFP Transactions

EFPs are an integral part of the business of many Exchange members because CSCE's contracts call for physical delivery of the agricultural product underlying the contract -- coffee, sugar or cocoa. Thus, unlike cash settled financial futures, the large traders in CSCE's markets are involved in the production and/or merchandising of these products, and use CSCE's markets to hedge the risks associated with their business. Because this characteristic distinguishes CSCE's markets from many others, the views expressed by the Exchange are limited to its markets. Based

¹ 63 F.R. 3708 (1998)

on the input of our market users, CSCE does not believe there is a need to change the existing standards regarding the elements of a *bona fide* EFP, or to impose any other regulatory requirements governing EFPs, such as disclosure. It has been CSCE's experience that its membership is well versed in the elements of a *bona fide* EFP and that the CFTC's standards, as implemented by the Exchange, have worked effectively. Therefore, codifying these standards (or imposing new ones) in a CFTC Regulation is likely to do nothing except unintentionally constrain the Exchange's ability to apply the standards in a way that makes sense in its markets. For example, the Concept Release asks whether the Commission should require both the futures and cash legs of a EFP, only one leg or neither leg to be priced within the daily range of their current respective markets. This aspect of EFPs, like so many others, is presently governed by Exchange rules -- rules that account for the different practices that have evolved in each of its markets and recognize the business reasons underlying those differences (i.e. the price at which a cocoa EFP is transacted must be reported to the Exchange and must be at the current market price at the time of report, whereas the price of coffee and sugar EFPs need not be so reported and may be priced as the parties choose). To have one standard apply to all exchanges, for all products, in a CFTC regulation will blend away these differences into the lowest common denominator for the sake of having a single rule. CSCE believes that to do so would be detrimental to the commercial users of its markets, and could undermine the legitimate use of EFPs. While the foregoing example deals with only one of the CFTC's questions, many of the proposals covered by other questions raised in this section of the Concept Release would pose the same concerns for the Exchange if implemented by the Commission.

It is noteworthy that the Commission does not predicate the Concept Release on any real or perceived abuses in the use of EFPs. This is consistent with CSCE's experience in surveilling the use of EFPs by its members. It is extremely rare that the Exchange finds an EFP not to be in conformity with CSCE rules. Given this environment, it is difficult to comprehend why the Commission would even consider imposing disclosure or customer consent requirements on EFP transactions where none have ever existed. In the absence of compelling evidence that EFPs are the subject of abuse, CSCE believes that the Commission should not take action to codify or change the current standards, and, if faced with evidence of abuse on a particular exchange, the CFTC should require that exchange to rigorously enforce its existing rules.

2. Exchange of Future for Swap and Exchange of Option for Physical

The Concept Release seeks comment on two types of transactions that are similar to EFPs -- exchange of future from swap (EFS) and exchange of option for physical (EOP). The EFS transaction is the subject of a NYMEX rule currently pending before the Commission. As described in the Concept Release, the EFS rules submitted by NYMEX establish provisions that are parallel to, but separate from, those governing EFPs, so that the structural form would be the same as for EFPs but a swap agreement would be substituted for the physical component. Because the swap component of the EFS must comply with Part 35 of the CFTC's Regulations,

only institutional traders and high net worth individuals would be eligible to effectuate EFS transactions. The Exchange believes that EFS transactions are a logical outgrowth of the swap market and that permitting them to be effected under exchange rules may increase market efficiency and enhance the use of exchanges as a risk transfer medium. We agree with NYMEX's conclusion that EFS transactions should not harm existing liquidity -- indeed they may bring to the exchange environment business that currently is transacted entirely in the OTC market. Accordingly, the Exchange supports the NYMEX proposal.

Likewise, CSCE believes that EOP transactions are an obvious adjunct to the use of EFPs. As the Commission correctly notes in the Concept Release, an in-the-money option is, as a practical matter, no different than a futures contract. Similarly, viewed from the standpoint of the grantor of an option who has a delivery commitment upon exercise, the grantor's obligation to deliver makes the position akin to having a futures contract. While it may be the case that the multitude of strike prices and the costs associated with EOPs makes their occurrence few and far apart, conceptually there is no reason not to permit their use if an exchange seeks to introduce them. Accordingly, CSCE supports the non-competitive execution of EOP transactions.

3. Other Types of Non-Competitive Transactions

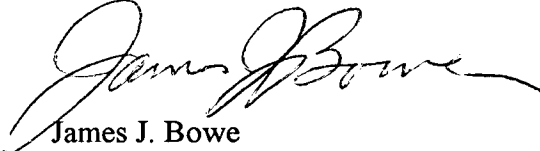
The Concept Release also seeks comment on alternative execution procedures, such as pre-trade negotiation and/or off-exchange execution of block trades. In this regard the Commission suggests that such procedures could be designed in a multitude of ways ranging from pre-trade negotiation with open outcry execution to transactions which are effected entirely off the floor and merely reported to the relevant exchange. CSCE believes there has been no demonstrated need justifying the circumvention of floor execution for large orders, no matter how "large" is defined for this purpose. Indeed, if such a need existed, the large order execution procedures developed by futures exchanges to date -- LOX, All-or-None and Block Order Execution -- albeit imperfect from the standpoint of those seeking non-competitive execution of such trades, would have been used regularly by their proponents. Instead, they have been scarcely, if ever, used in a limited number of markets, thus signaling that large orders can be efficiently filled in a competitive fashion. That block orders of stock are regularly executed away from the floor of the stock exchanges does not mean that the futures markets should follow suit, or that the CFTC should permit exchanges to do so. The capital formation purposes served by the securities markets and the existence of specialists controlling customer order books may justify the transaction of large orders to the exclusion of smaller traders. However, the role of the futures markets is to serve as a place for price discovery and risk shifting. If "large" orders are removed from the mix of elements which determines the true market price of a commodity underlying a futures contract, how can the market fulfill these functions? The price discovery and hedging functions of futures exchanges lie at the core of the policies and purposes underlying the Commodity Exchange Act. The Commission should not allow those purposes to be sacrificed for the sake of expediency or lower transaction costs. Therefore, the Exchange does not believe that

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the Commission should countenance any large order execution procedure which does not subject an order to the trading ring.

CSCE is pleased to have been able to submit these preliminary comments to the Commission and hopes that they are useful to the staff in dealing with the many issues covered by the Concept Release. While the futures industry may be growing at a record pace, it is important that the CFTC proceed cautiously and not disturb those practices which continue to serve the futures markets and their users well.

Respectfully submitted,



James J. Bowe

cc: Chairperson Born
Commissioner Holum
Commissioner Spears
Commissioner Tull

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