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Cantor Fitzgerald

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COMMENT

April 24, 1998

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

Re: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, 63 Fed. Reg. 3708 (January 26, 1998)

Dear Ms. Webb:

On behalf of Cantor Fitzgerald, L.P. and its group of companies ("Cantor Fitzgerald"), we are pleased to respond to the request of the Commodity Futures Trading Commission ("CFTC" or the "Commission") for comments regarding the regulation of exchange for physicals ("EFP") contracts and other noncompetitive transactions executed on or subject to the rules of a contract market, 63 Fed. Reg. 3708 (January 26, 1998) (the "EFP Request"). Cantor Fitzgerald believes that the existing regulatory structure relating to EFPs should be retained. In addition, Cantor Fitzgerald does not believe that there is any need for additional regulation of what the Commission in its EFP Request described as "basis trading facilities".

Cantor Fitzgerald provides a broad spectrum of institutional brokerage and execution services to global financial markets. It operates the world's largest interdealer electronic marketplace for debt securities and is also one of the largest "third market" equity operations in the United States stock market. Headquartered in New York City, Cantor Fitzgerald currently employs more than 2,300 people in offices throughout the United States, Canada, Europe and Asia, serving the world's largest banks and security houses.

As noted in the Commission's EFP Request, Cantor Fitzgerald is one of the main interdealer brokers in United States treasury securities ("Treasury Securities") and operates a basis trading facility for EFPs, with the futures leg posted at the Chicago Board of Trade ("CBT").* In addition, in an undertaking with the New York Cotton Exchange, Cantor Fitzgerald is developing an electronic futures exchange for Treasury Securities futures and other products. The proposal for the Cantor Financial Futures Exchange ("CFFE") is currently pending approval by the Commission.

As set forth more fully below, Cantor Fitzgerald recommends that the Commission (1) retain the existing regulatory structure governing EFPs, (2) not impose additional regulation on basis trading facilities and(3) provide for a means whereby alternative execution procedures, including large order and block trading procedures, can be approved in the event such procedures are proposed by an exchange.

1. <u>Regulation of EFP Transactions</u>

EFPs have a beneficial impact on the liquidity and efficiency of the cash and futures markets. As the Commission noted in the CFTC Report on Exchanges of Futures for Physicals, dated October 1, 1987 (the "EFP Report"), EFPs, which have been exempt from the CEA's general prohibition of off-exchange futures trading since 1936, reduce the risk of a potential adverse move in market prices. The reduction of such risk enables private parties to enter into contracts that might otherwise not have occurred. The additional contract volume results in increased liquidity in the commodity markets, which in turn serves to narrow the bid-ask spread in the cash markets and to reduce the price differential between the cash and the futures markets.

Pursuant to § 4c(a) of the Commodity Exchange Act (the "CEA") and the regulations of the Commission, the contract markets bear primary responsibility for establishing rules governing EFP

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* See EFP Request, p. 58.

transactions, which rules are subject to approval by the Commission. Each contract market, therefore, has wide discretion to determine the manner in which EFPs will be conducted on such contract market. As market participants have grown more sophisticated, they have sought to utilize EFPs to hedge risk in various ways. The contract markets have been able to respond to this need by devising rules that accommodate their members' interests, while the Commission has retained the ability, through its approval power, to ensure that the contract markets do not promulgate rules that violate the spirit and intent of the CEA. The flexibility and adaptability of the current approach have led to an increase in the number of EFP transactions, as demonstrated by the figures cited in the EFP Request.*

Cantor Fitzgerald and other interdealer brokers engage in EFP transactions as the most efficient means of trading the basis in Treasury Securities. Basis trading requires the simultaneous entering into of contracts in the cash and futures markets. If dealers were to execute such contracts separately, they would be subject to the risk that unanticipated price moves in either market would negatively impact the spread between the two markets. EFPs allow dealers in Treasury Securities to reduce or eliminate such risk, because, subject to the CBT and its clearing house accepting the futures leg for execution, the dealer has agreed to enter into the simultaneous cash and futures market contracts in a single transaction.

Cantor Fitzgerald believes that the existing regulatory structure satisfactorily addresses any concerns of the Commission raised by the recent growth in EFP transactions. Indeed, we are not aware of any problems or abuses that have been identified in the trading of EFPs of any kind. As noted above, the current regulatory structure gives the various contract markets wide discretion to establish rules governing off-exchanges transactions, subject to approval of such rules by the Commission. The various exchanges have used the broad authority granted them to craft procedures that balance the interests of their members in responding to a fast-evolving financial marketplace against the potential harms of off-exchange trading identified by the Commission. Chief among these harms is the possible effect of off-exchange futures transactions on price transparency and market manipulation. As a safeguard against such abuses, the Commission

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* See EFP Request, p.14.

exercises regulatory oversight of the contract markets and their members and participants through several sources, such as: (i) the Commission's review of contract market rules governing such transactions; (ii) the Commission's reporting and recordkeeping requirements; (iii) the contract markets' enforcement of their own rules; (iv) the Commission's rule enforcement review program; and (v) the Commission's own enforcement program.* Cantor Fitzgerald believes that these measures are sufficient to deter any potential violations.

In sum, Cantor Fitzgerald believes that there is no reason to change the current regulatory structure governing EFPs. Contract markets are perfectly capable, with the additional level of oversight provided by the Commission, of establishing procedures governing such transactions that accommodate the concerns of the Commission and the interests of their members and participants.

2. Regulation of Basis Trading Facilities

Cantor Fitzgerald further believes that added regulation of EFPs entered into via a basis trading facility is unwarranted particularly since one of the Commission's major concerns - the possible adverse effect of off-exchange futures transactions on price transparency - is largely inapplicable to EFPs entered into via a basis trading facility. Indeed, since several interdealer brokers, including Cantor Fitzgerald, list bond basis quotations on publicly available screens, EFPs entered into via a basis trading facility benefit from price transparency that is lacking in most other EFP transactions. The basis of a trade entered into via a basis trading facility is determined by reference to a formula, which is in turn based on a conversion factor and a futures price determined and published by CBT. Studies have shown that EFPs are rarely priced outside of the trading range for futures on the date of the transaction.**

Furthermore, studies have found that this reduction in risk and increase in price transparency of the bond basis market

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* See the EFP Request, p. 15.

** See Exchange for Physicals in the Chicago Board of Trade U.S. Treasury Bond Futures Contract, dated July 1990, by Nancy L. Redheffer, Division of Economic Analysis, Commodity Futures Trading Commission (the "Redheffer Report").

have had the combined effect of narrowing the bid/ask spread in the cash bond market, thereby enhancing the liquidity and efficiency of the cash market. This is particularly critical in times of market stress where traders need both markets to operate at peak capacity. These same studies have observed that such EFP transactions also benefit the futures markets by attracting institutional participants who otherwise may have been reluctant to use futures for fear of execution risk or exchange floor practices.*

Cantor Fitzgerald respectfully disagrees with the position taken by the Commission in the EFP Request that basis trading facilities "may be beyond the operational and regulatory purview of contracts markets to some extent". We also believe the Commission erred in suggesting that EFPs entered into via a basis trading facility are substantively different from other EFPs, and that basis trading facilities constitute the functional equivalent of contract markets. From the standpoint of a contract market, a futures contract entered into via a basis trading facility is no different from other EFPs. In both types of transactions, the futures component of the EFP is not "executed" off-exchange but is entered into subject to acceptance by the contract market and its clearinghouse. The contract market has the same power to regulate EFP transactions entered into via a basis trading facility as it has with respect to other EFPs. In both cases, it is the sole decision of the contract market as to whether a futures position has been created.

Accordingly, Cantor Fitzgerald believes that EFPs entered into via a basis trading facility do not warrant more extensive regulation than other EFP transactions. In particular, we are of the opinion that the current regulatory system governing basis trading facilities, which includes the important oversight by the Securities and Exchange Commission and the U.S. Treasury's of the government securities markets, is fully adequate and that no further regulatory action need be taken.

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* See the Redheffer Report.

3. Alternative Execution Procedures

Cantor Fitzgerald also recommends that the Commission provide a means whereby alternative execution procedures, including large order and block trading procedures, can be approved in the event similar procedures are proposed by an exchange. Cantor Fitzgerald notes that such procedures exist for the securities exchange markets, where block trading is permitted subject to restrictions intended to ensure that all members of an exchange have access to the same price information. Cantor Fitzgerald believes that, if a futures exchange were to adopt similar rules, it would address a specific need of market participants without adversely affecting the price discovery function of the contract markets.

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Cantor Fitzgerald appreciates the opportunity to respond to the EFP Request. We of course stand ready to provide any further assistance which may be helpful to the Commission in its consideration of these matters.

Sincerely,

Stephen M. Merkel /ec

Stephen M. Merkel
Senior Vice President,
General Counsel and Secretary