

COMMENT

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COMMODITY FUTURES
TRADING COMMISSION
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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 Goldman, Sachs & Co. ("GS & Co.") and J. Aron & Company ("J. Aron" and, together with GS & Co. and its affiliates, "Goldman Sachs"), 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 Concept Release"). Goldman Sachs believes that no revision of the existing regulatory structure relating to EFPs is required. Specifically, Goldman Sachs does not believe that there is any need for additional regulation of "basis trading facilities" as that term is used in the EFP Concept Release. Furthermore, Goldman Sachs supports alternative execution procedures, including large order and block trading procedures, pursuant to rules adopted by individual exchanges. In addition, Goldman Sachs believes that exchanges for swaps ("EFS") transactions should be permitted by those contract markets that wish to allow such transactions, and be regulated in a manner parallel to the current regulatory structure for EFPs.

GS & Co. is registered with the Commission as a futures commission merchant ("FCM"), commodity pool operator and commodity trading advisor, and with the Securities and Exchange Commission as a broker-dealer and an investment adviser. In addition, GS & Co. or its affiliates are members of all major securities and futures exchanges worldwide and act as dealers and market makers in a wide range of financial instruments. Among other things, GS & Co. is actively engaged in the execution and clearance of transactions in the full range of financial and commodity futures, options on such futures and other derivative products, including EFPs.

Goldman Sachs offers a wide variety of financial services on a global basis to corporate and governmental issuers and to institutional investors. As a primary dealer it is actively involved with interdealer brokers and the basis trading facilities discussed in the EFP Concept Release. As a broker-dealer and investment advisor, Goldman Sachs is actively engaged in a broad range of equity and fixed income transactions, including derivatives. It provides customized services to its clients in a full range of securities transactions and actively engages in market-making and trading in listed securities, including block trading of listed securities, and fixed-income instruments. In all of these transactions, Goldman Sachs actively uses the futures markets and engages in a complete range of EFP transactions.

Goldman Sachs, primarily through J. Aron and its affiliates, provides a complete range of trading and hedging services for producers, refiners and consumers worldwide in markets for crude oil, petroleum products, natural gas and selected precious and base metals, and develop investment products for investors seeking to invest in commodities. In addition, the firm acts as global market maker in foreign currencies and currency options and provide hedging and other currency-related strategies and services for its clients. In connection with the foregoing activities, J. Aron and its affiliates are major users of the futures, options, forward and cash markets, with extensive experience utilizing exchange-traded futures and options on such commodities, including EFPs, and regularly trade in the over-the-counter forward and swap markets and structure customized swap products for hedging and risk management purposes.

As part of its broker-dealer and FCM businesses, Goldman Sachs regularly executes and clears transactions in EFPs on behalf of investment advisers, commodity trading advisors and major financial institutions that enter into such transactions for multiple accounts under their management. These entities have for many years expressed to Goldman Sachs their interest in using EFPs

to implement their trading strategies, as a means for managing transaction risk, improving liquidity and reducing the impact of volatility in the commodities futures markets. Goldman Sachs also actively engages in EFPs for its own account for hedging and risk management purposes.

The current legal framework governing EFPs, as set forth in § 4c(a) of the Commodity Exchange Act ("CEA"), allows each contract market to determine, subject to the approval of the Commission and in accordance with existing Commission guidance, the manner and procedures pursuant to which EFP transactions will be conducted in contracts traded on such contract market. Based on our own experiences and our discussions with our clients and others, Goldman Sachs recommends allowing the exchanges to continue to retain the flexibility to craft and modify their EFP rules to meet market needs and customer protection requirements subject to the existing level of Commission oversight. This result recognizes that the exchanges are best able to evaluate the benefits of EFP structures for their markets and their participants.

In particular, and as set forth more fully below, Goldman Sachs recommends that the Commission (1) retain the current regulatory framework governing EFPs and (2) adopt the rule proposed by the New York Mercantile Exchange ("NYMEX") permitting market participants to engage in EFS transactions pursuant to a regulatory system similar to that governing EFPs. Goldman Sachs also recommends that the Commission provide a rule structure for the approval of alternative execution procedures, including large order and block trading procedures, in the event such procedures are proposed by an exchange.

1. EFP Transactions

The benefits of EFPs are well-recognized. Moreover, EFPs have not been a source of any abuse or harm to private parties or the futures and physical commodity markets in general. 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 recognized in the CEA since 1936, reduce the transaction risk of an adverse move in futures prices reducing or eliminating the expected profits from a cash commodities trade. EFPs thus preserve for transacting parties the basis relationship of the cash and futures legs of the transaction. EFPs also enable market participants to reduce the risk of price changes in positions after domestic markets are closed. EFPs, therefore, permit market participants to engage in worthwhile and efficient transactions that might otherwise not be consummated. Such transactions, in

turn, benefit the markets, since increased market participation in EFPs serves to narrow the bid-ask spread, thereby increasing market liquidity. Furthermore, EFP activity better aligns the prices in the cash and futures markets.

Goldman Sachs believes that the benefits of EFPs are substantial and that such transactions should be encouraged. To date, the Commission has left to the various contract markets the responsibility for establishing rules governing EFP transactions. Each contract market, therefore, has had the discretion to adopt those rules that it believes best accomplish its members' and participants' objectives. For example, contract markets have developed different rules relating to the commodities acceptable for use in the cash leg of an EFP transaction and the degree of price correlation required between the futures and the cash commodities. In the process, the use of EFPs has increased, with such transactions increasingly being carried out in the currency, energy and precious metals commodities markets.

Recent market studies confirm the growth in EFP transactions.* Such growth, however, has not been accompanied by either a decrease in market liquidity or an increase in market volatility. Rather, increased activity in EFPs has resulted in a decrease in bid-ask spreads in certain markets, such as the cash bond market, thereby increasing market liquidity. Studies also show that EFPs have not increased market volatility.** In addition, we are not aware of any regulatory problems or other concerns that have arisen as a result of EFP transactions. In sum, we are not aware of any need for change in the Commission's current approach and guidelines for the approval of EFP transactions.

Goldman Sachs believes that the significant benefits of EFP transactions are attributable to the current regulatory structure and that any change would be unwarranted and potentially harmful. As pointed out above, EFPs have grown in scope and application because of the ability of contract markets to devise rules that accommodate their respective members' and participants' interests. Such growth would be endangered if the Commission were to depart from its current regulatory approach. Although the Commission states in the EFP Concept Release that, "if the

* See The Role of EFPs in Futures Markets, dated January 1, 1997, by Sharon Brown-Hruska and Paul A. Laux (the "Catalyst Report").

** Id. at pp. 42 - 49.

Commission were to revise its regulatory structure relating to noncompetitive transactions, the choice of whether to permit these types of transactions on a particular contract market would remain, in the first instance, with that contract market", any such revision could reduce or eliminate the discretion of a contract market to regulate those transactions it intends to permit. If contract markets are unduly restricted in deciding the manner in which EFP transactions are to be conducted, it is foreseeable that members of contract markets will no longer be able to adapt EFPs to their specific needs, and that certain otherwise beneficial transactions will no longer be consummated. Nor would the loss be confined to market participants. The contract markets would lose some of the market discipline EFPs impose, with a deleterious effect on bid-ask spreads in the physical commodity markets and the spread between cash and futures market prices.

Goldman Sachs further notes that the Commission's current system and guidelines address the concerns that ostensibly would be addressed by a change in the Commission's regulatory approach. As the Commission notes in the EFP Concept Release, FCMs and the contract markets are already subject to substantial record-keeping and disclosure requirements. As mentioned above, the Commission requires that contract market rules be submitted for approval. In addition, the Commission requires that contract markets identify and mark all non-competitive transactions and all related orders, records and memoranda; and that they maintain records showing all non-competitive transactions, and report daily the total quantity of executed EFPs. With respect to FCMs, the Commission requires FCMs to keep full, complete and systematic records of all EFP transactions and to retain them for five years and to produce such records upon the request of the Commission or the Department of Justice; to ask their customers for documentation of the cash leg upon the request of the contract market, the Commission or the Department of Justice; to create, retain and produce such documentation directly to the requesting body; to report to the Commission the quantity of EFPs executed in each special account; and to keep records of all futures and cash commodity positions and transactions. Goldman Sachs believes these measures are sufficient to deter sham transactions designed to circumvent the Commission's general prohibition against off-exchange futures trading. Indeed, EFPs have been part of the regulatory scheme in futures trading since 1936 and we are not aware of any abuse.

With respect to the Commission's concern with price transparency in the EFP market, Goldman Sachs notes that because of the sophistication of market participants and the rules established by the various contract markets there is already a high degree of

price correlation between privately negotiated transactions and the prices established on the exchange. Thus, market participants are able to determine, by reference to published futures prices, the price to be paid in an EFP transaction. Finally, to the extent that a contract market determines that additional price transparency is required, nothing under the current regulatory system precludes the contract market from establishing rules for such purpose.

For the foregoing reasons, Goldman Sachs recommends that the Commission not depart from the current regulatory structure. Contract markets should retain the flexibility to adopt rules governing EFP transactions that both preserve the benefits of such transactions for market participants and the markets in general and address any regulatory concerns.

2. Alternative Execution Procedures.

Goldman Sachs recommends that the Commission provide a rule structure for the approval of alternative execution procedures, including large order and block trading procedures, in the event such procedures are proposed by an exchange. Goldman Sachs notes that such procedures exist for block trading in the securities exchange and over-the-counter markets, where block trading is permitted subject to certain restrictions intended to promote price discovery and other objectives. Goldman Sachs believes that, if an exchange were to permit block trading subject to similar safeguards, it would address a specific need of market participants without adversely affecting the price discovery function of the contract markets. Indeed, the hedging of any block trade or similar large order likely will find its way back to the exchange as an executed transaction.

As the Commission recognized in its recent proposed "bunched order" rulemaking to amend Rule 1.35(a-1), 63 Fed. Reg. 695 (January 7, 1998), futures trading is increasingly interrelated with trading in the underlying securities markets. Block trading or large order execution procedures are additional ways to bring efficiencies to the trading of futures and the underlying securities. Customers seeking to execute large blocks of securities and, at the same time, establish corresponding future positions in stock indices or government securities will benefit from being able to utilize large order or block trading procedures that futures exchanges should be encouraged to establish. The certainty of being able to price these transactions and deliver executed positions to customers should be the goal of an effective futures market.

In addition, Goldman Sachs does not believe that there is any need for additional regulation of basis trading facilities. As an active user of interdealer brokers and their basis trading facilities, Goldman Sachs sees no need for additional Commission regulation of their activities. The government securities markets are actively overseen by the Securities and Exchange Commission and the Department of the Treasury. Basis trading facilities provide valuable liquidity and efficiency to both the cash and the futures markets. Basis trading activities, like any other EFP transaction, operate subject to exchange rules. In the absence of any abuses and given their obvious benefits, Goldman Sachs sees no need for any changes.

3. EFS Transactions.

Goldman Sachs supports the request by NYMEX for a rule permitting EFS transactions. Many, if not all, of the reasons for permitting EFPs apply to EFS transactions. EFS transactions would permit sophisticated and creditworthy market participants (all of whom must be "eligible swap participants") to reduce transaction risks in much the same way as do EFPs, and would similarly enhance competition among futures and swaps markets and reduce the bid-ask spreads in the swaps markets. Swaps have become an integral part of the physical energy markets and are executed by market participants in many situations as alternatives to physical transactions. As with EFPs, swap participants often have a need to move their positions onto the futures markets. EFS transactions provide an efficient means to facilitate such transactions with the related efficiencies and liquidity exhibited by EFPs.

EFS transactions should be permitted pursuant to the same guidelines the Commission has adopted for EFPs. Goldman Sachs notes that EFS transactions are currently allowed on the International Petroleum Exchange (the "IPE"), and that delays in adopting a rule permitting such transactions on NYMEX could lead to a loss in the stature of NYMEX as the leading international energy futures market. Goldman Sachs therefore recommends that the Commission approve NYMEX' rule proposal permitting EFS transactions.

Goldman Sachs appreciates the opportunity to respond to the EFP Concept Release. We of course stand ready to provide any further assistance which may be helpful to the Commission in its consideration of these matters.

Sincerely,



A. Carver Wickman
Managing Director