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NATIONAL GRAIN TRADE COUNCIL
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April 24, 1998

Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
1155 - 21st Street, N.W.
Washington, D.C. 20581

Dear Ms. Webb:

The National Grain Trade Council submits these comments on the Commission's concept release titled "Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market." The concept release was published in the January 26, 1998, ***Federal Register***.

The Council is a national trade association whose voting members are grain exchanges, boards of trade, and national grain marketing organizations. Council associate members include grain companies and related businesses. The Council's diverse membership provides the organization with a unique perspective on issues facing the grain industry. Even though Council members often have divergent views, they unequivocally support the Council's mission which is: *"to advocate and defend, consistent with the public interest, the principles and merits of open and competitive markets for the production and distribution of agricultural commodities."* We believe that some of the issues raised by the Commission go to these very fundamental beliefs.

The Commission is asking for comments on the regulatory approach for "non-competitive transactions" that take place on an exchange floor or under the rules of an exchange. The Commodity Exchange Act generally prohibits non-competitive transactions, but does provide careful exceptions for such items as transfer trades, office trades, and the exchange of futures for physicals that are traded in accordance with exchange rules.[1] Given changes in the marketplace over the last 10 years, the Commission asks whether the regulatory structure governing non-competitive transactions should be modified. The Commission says, in general, it is asking for comments on the following questions:

1. Should the standards articulated in the EFP Report[2] be codified in the Commission's regulations and/or refined in any way?

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1. 63 Fed. Reg. 3709 (1998).
2. THE COMMODITY FUTURES TRADING COMMISSION DIVISION OF TRADING AND MARKETS, REPORT ON EXCHANGES OF FUTURES FOR PHYSICALS (1987). EFP transactions are the exchange of futures for, or in connection with, physicals.

2. Should other types of non-competitive transactions, such as EFS and EOP transactions[3] or block trades, be permitted to be executed on or subject to the rules of a contract market and, if so, what standards should apply to these transactions?

3. What standards should be applicable to execution facilities for non-competitive transactions executed on or subject to the rules of a contract market?

The Council has carefully reviewed the questions raised by the Commission. We are profoundly concerned by the notion of allowing the block trading of futures positions off the floor at privately negotiated prices. In addition, we are opposed to regulations that would impede the natural evolution of the exchange of futures for physicals (EFP), exchange of futures for swaps (EFS), or exchange of options for physicals (EOP). Lastly, we oppose a new regulatory structure for execution facilities. We will address each of these concerns in more detail.

Block Trading

The Council opposes the concept of block trading as outlined in the Commission's release. We believe block trading is fundamentally different from the exception granted by Congress for EFPs, office trades, and transfer trades and, therefore, beyond the scope of the non-competitive transaction exception. Block trading is also anti-competitive and contradicts the Commission's role, as specified by Congress, "'to ensure that all trades are executed at competitive prices and . . . focused into the centralized marketplace to participate in the competitive determination of the price of futures contracts.'"[4]

Block transactions discover and create futures prices outside the centralized marketplace. This discovery process clearly distinguishes block transactions from EFPs, office trades, or transfer trades. By comparison, the exchange of futures for physicals simultaneously fixes the components of a basis transaction in a cash commodity contract. Since the basis level is in fact the "price discovered,"[5] the price at which the futures are exchanged is rarely negotiated. Time and price of the futures exchange are customarily determined by the buyer.[6] The pricing of basis transactions is conceptually similar to the pricing of futures spreads in which the prices assigned to each "leg" are essentially bookkeeping entries reflecting the differential traded. The convention of the buyer and the seller "exchanging" futures resulted from the desire on the part of cash merchants to limit price risks to simple basis risks and from the need to establish an identical contract price between purchase and sale.

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3. EFS transactions are the exchange of futures for, or in connection with, swap agreements. EOP transactions are the exchange of options for, or in connection with, physicals.
4. 63 Fed. Reg. 3709 (1998) (quoting REPORT OF THE SENATE COMMITTEE ON AGRICULTURE AND FORESTRY, S. Rep. No. 1131, 93rd Cong., 2d Sess. 16 (1974)).
5. For example, the discovered price of a sale of 100,000 bushels of corn delivered CIF NOLA, June shipment, +30 CN (July corn futures), futures in exchange, is +30 CN.
6. NATIONAL GRAIN AND FEED ASSOCIATION, BYLAWS, TRADE RULES AND ARBITRATION RULES, 349 (1994) (referencing rule 30).

Block trading is also anti-competitive because it violates the purpose of an open and focused centralized marketplace to provide "ready access to the market for all orders [which] results in a continuous flow of price information."[7] We recognize that block trading is a practice common in securities markets. However, notwithstanding the recent development of hybrid securities/commodities products, at the basic level, securities and futures instruments and markets remain differentiated.[8] The instruments serve different functions--securities facilitate investment and represent equity ownership in a corporation, whereas commodity futures transfer price risk and enable price discovery. The structure of the two marketplaces is dissimilar--fragmentation characterizes securities markets while centralization describes commodities markets. Each market also has a unique set of laws designed to protect the public interest. By establishing a separate regulatory structure for securities and futures markets, Congress has recognized that what is appropriate for one market may be inappropriate for the other. In sum, the Council believes the existence of block trading in securities markets does not support the adoption of block trading in commodities markets.

The Council deems block trading an unacceptable practice which would concentrate trading into a few large institutional corporations. The outcome would drain liquidity, prevent equal access, curtail information, foster "bucketing,"[9] and, in short, destroy 150 years of public confidence in our markets. The greatest harm would befall the producer. We can think of no better example of harm wrought by allowing prearranged block trading than the damage to a farmer using the futures market to hedge five thousand bushels of grain production. To a large integrated company, a single contract to sell in the futures market, opposite the company's large buying order, may represent only one of thousands or tens of thousands of contracts purchased in a single transaction or during a trading day. However, to the farmer, that single contract represents an important percentage of production, and the price received for it becomes an important element in his profit margin for the year. The farmer is clearly harmed when the prospective counter party to his futures hedge can legally locate another large institution and contract with that party at a higher price.

EFP, EFS & EOP Transactions

The Commission's concept release has asked whether the agency should codify the EFP standards set forth in the Commission's 1987 report. We believe the current regulatory framework is adequate. Exchange auditors have successfully monitored EFP transactions for decades. Imposing static regulatory standards will only limit the evolution of valid EFP transactions and decrease the competitiveness of U.S. futures markets. A statistical correlation requirement would also limit the development of exchange of futures for swaps (EFS) and exchange of options for physicals (EOP), transactions, which we believe, will become increasingly necessary and common.

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7. 63 Fed. Reg. 3709.
8. Sanford J. Grossman, *An Analysis of the Role of "Insider Trading" on Futures Markets*, 59 J. BUS. S144-45 (1986).
9. Bucketing is defined as "[d]irectly or indirectly taking the opposite side of a customer's order into the broker's own account or into an account in which the broker has an interest, without open and competitive execution of the order on an exchange." THE COMMODITY FUTURES TRADING COMMISSION, THE CFTC GLOSSARY: A LAYMAN'S GUIDE TO THE LANGUAGE OF THE FUTURES INDUSTRY 6 (1990).

EFS and EOP transactions fall within the noncompetitive transaction exception because they, like EFP transactions, are integrally-linked to a cash commodity transaction or swap. Because of this linkage, the Council views EFS and EOP transactions as hybrids of EFPs which do not displace price discovery from the centralized marketplace.

Exchanges should retain their authority to determine the validity of EFP, EFS, and EOP transactions without additional regulatory restrictions. Exchanges are most closely connected with the evolution of the marketplace and best positioned to monitor these transactions. Imposing new regulatory standards in this area would significantly limit the use and development of valid, exchange regulated transactions without providing additional public interest protections.

Execution Facilities

Turning to the issue of execution facilities, we strongly oppose any new regulatory structure in this area. As with EFP transactions, the current system functions well. By expanding its authority over execution facilities, particularly in the absence of block trading execution facilities, the Commission would move into the business of regulating the cash side of the grain trade and well beyond the scope of its authority.

Summary

The Council appreciates the Commission's re-evaluation of the regulatory structure for non-competitive transactions. A fresh look at the structure and how it is adapting to an evolving market place can be constructive. Our comments focused on those areas where we disagree with key elements of the concept release.

While we welcome the CFTC's attempts to improve the efficiency of futures markets, we are alarmed by several proposals that we view as dangerous and contradictory to the CFTC's mission to protect the public interest. Proposals to authorize block trades, limit the natural evolution of EFP, EFS, and EOP transactions, and regulate execution facilities are of deep concern.

Respectfully,

Robert Petersen

Robert R. Petersen
President