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COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

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April 27, 1998

Ms. Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1115 21st Street N.W.
Washington, D.C. 20581

Re: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of A Contract Market ("Concept Release")

Dear Ms. Webb:

Thank you for the opportunity to comment on the Commission's efforts to reevaluate its regulation of noncompetitive transactions executed or subject to the rules of a contract market. The main conclusion of this letter is that the current EFP regulatory structure works well and should not be modified. The New York Cotton Exchange ("The Exchange"), however, does encourage the Commission to consider, develop, and present to the industry for discussion regulatory schemes for other off exchange transactions.

I. Introduction

The Commission in its 1987 "Report on Exchanges of Futures for Physicals"[1] emphasized a flexible regulatory approach.

> "This flexible approach, which recognizes the variety of uses for EFPs across the different markets, will enable the exchanges to adapt the Division's analysis to the particular circumstances of their markets, either by rule or through their affirmative surveillance programs. The division recognizes that EFP practices continue to evolve to accomplish a variety of trading strategies and industry needs as the nature of the futures market changes." P. 260

In the Concept Release, the Commission's approach is first to see if the guidelines should be codified and then to see if the regulatory structure should be expanded for other types of off-exchange transactions, executions and trading platforms. Significant changes in one part of the regulatory structure may have unintended effects in the other. In other to minimize any unintended ill effects, the Commission should set out the proposed regulatory structure to be considered. This should be done before proposing changes in the existing regulatory structure, especially when the current regulatory environment is effective. EFP markets are able to perform the traditional hedging and price basing functions as well as to adapt to new uses.

[1] Report on Exchanges of Futures for Physicals, Commodity Futures Trading Commission, Division of Trading and Markets. October 1987

It is true that we have grown beyond the original model used for the EFP regulation and it is also true that Exchanges face increasing competitive pressures from OTC trading and from futures exchanges abroad. The regulatory structure must be flexible enough to adapt to new uses and to allow the Exchanges to compete. The existing guidelines have worked. Codification is a tightening of the existing regulatory structure that limits the Exchanges ability to react or protect their existing markets. It is not clear what problems are being resolved.

Over the counter ("OTC") markets continue to grow and are gaining ground from the exchange traded futures. Bank of International Settlements[2] data show that the OTC and Exchange markets were equal in size as measured by daily turnover in 1993. In 1996—three years later—the OTC market was 2.5 times the size of exchange traded derivative market. Seventy two percent (72%) of the total derivative traded in 1996 was OTC trading. In the currencies markets, less than 1% of the market turnover occurs on exchanges. For customers OTC markets offer flexibility and innovation. Netting and collateral arrangements have allowed the OTC markets to manage the credit risk and extend their products to all sorts of customers. What are the prospects for futures markets in the OTC trading of similar instruments? The futures markets must have a regulatory environment that allows the Exchanges to compete.

In this letter, the Exchange does not answer all fifty-seven questions of the Concept Release. Instead the Exchange has chosen to comment on selective portions of the release.

II. Standards Governing EFP Transactions

There are diverse products and many different reasons for doing EFPs. The guidelines of the 1987 study have been useful in establishing Exchange EFP policy and are helpful to end users and market makers in understanding EFPs and determining what parameters to consider. The guidelines allow the Exchanges the flexibility to create a structure taking into consideration the product, the cash market practices and the impact of EFPs on the liquidity of the marketplace. Guidelines are appropriate and have worked. Codification may create a regulatory structure that is more burdensome than it need be and without the flexibility to respond to changing market needs. Restrictions in accepting EFPs should be decided upon by the Exchange. One standard can rarely be applied uniformly to all products.

A. Elements of a Bona Fide EFP: Relationship of the Parties.

Strong correlation is a good guideline but does not make for good codification. The Commission should not adopt minimum statistical correlation to be used in assessing the acceptability of a particular cash commodity for use as the cash leg of an EFP. In many markets it is not necessary because the underlying cash is deliverable onto the futures contract. Although everyone can agree that the underlying cash should have strong price correlation with the futures not everyone can agree what the minimum level of correlation should be. Do you use daily, weekly, monthly data? How do you evaluate the quality of the data being used? Are there other ways to hedge that may be liquid and with less basis risk. Exchanges currently have the flexibility to specify the required characteristics of the cash leg to limit the use of EFPs. Exchanges want EFPs to be useful to some market participants who cross hedge. EFPs used in cross hedging should be and are monitored by the Exchanges.

[2] Central Bank Survey of Foreign Exchange and Derivatives Market Activity. Bank of International Settlements. Basle, Switzerland. May 1996

Futures and Cash Legs Requirements. Transitory EFPs have helped low volume futures markets to be liquid especially when derivative to a highly liquid underlying cash market such as currencies. This has had a positive impact on price discovery and liquidity. In most cases, this is business that would not have come to the futures markets if EFPs had not been available or has been used to overcome deficiencies of futures contracts such as entering or exiting a position when futures markets are closed. As long as the cash leg is bona fide, transitory EFPs should continue to be accepted.

Regulation to halt contingent ABA trades sometimes run contrary to cash market conventions that have been designed to reduce risk as well as the costs of doing business. Cash transactions are net out or paired off between dealers for a given day. EFP market makers may incur increased costs because they are required to distinguish between outright cash transactions and those cash transactions resulting from EFP. The Commission must make sure that the new regulations do not place significant costs in order to prevent abuses that may not have been occurring in the first place.

B. Elements of a Bona Fide EFP: Nature of the Transaction

Price of a Transaction. There are at least two reasons not to require the futures or the cash leg to be within the daily price range. The Commission, in its 1987 provides the first reason.

> "EFPs that priced away from the prevailing market provide participants with flexibility. This flexibility is often needed since the EFP integrates both cash and futures markets. Further, this flexibility may be important in cross-hedges where basis movements may not always correspond to the expected price movements or may be erratic. Restrictions on EFP pricing should, therefore, be carefully considered so that they do not unduly inhibit commercially appropriate transactions." (Page 174, EFP Report)

At least one leg of an EFP should reflect the actual price in that market. This approach will permit the desired flexibility and still impose a limitation related to the commercial aspects of a transaction. If the EFP is away from the market the Exchange determines whether the pricing is supported by a business purpose. The Commission goes on to say although the absence of a business purpose for the prices selected will not in and of itself be required for a finding that the EFP is not bona fide. The second reason that the futures leg may not be within the daily price range is the underlying cash markets maybe more liquid than the futures markets and the futures range may not be consistent with the market range.

Business Purposes. The Commission should not require EFP users to state the business purposes of each EFP that is done. For most EFPs the purpose is well known and the requirement would be burdensome for the whole market. As long as the technical and legal requirements of the regulation are currently being fulfilled, why should the Commission care or keep track of the business purposes of EFPs. The Commission's 1987 study was done to understand the motivations behind EFP trading. Surveying participants is different from requiring all users to keep track of their motivation.

C. Other Regulatory Requirements.

The current reporting requirements seem to be adequate and the Exchange does not understand why the Commission wishes to impose any disclosure or consent requirements on EFPs.

Price Transparency. Currently, the price of the futures leg of an EFP is reported and disseminated. Requiring more i.e. that the basis or the price leg of the cash transaction be reported seems to be unnecessary for most markets. For example, what does the basis quote or the cash quote mean? With agricultural commodities, location and grade variation determine the basis and the ultimate cash quote. Without knowing those factors that specify the type of cash transaction, basis information is meaningless. In many markets, EFPs are privately negotiated transactions done by phone. Requiring that bids and offers as well as consummated EFP transactions to be reported seems burdensome.

We hope that the Commission does not regulate in such a way as to take away the flexibility of using EFPS. Exchanges need flexibility to survive and be relevant in the long run because there are OTC alternatives that offer flexibility and innovation without the regulatory burden. EFPs have enhanced the ability of futures markets to work in concert with the underlying cash market, thereby creating a liquid market with the guarantees of an exchange based clearing association and the integrity of a Commodity Futures Trading Commission regulated marketplace.

III. Other Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market

The Commission wants to explore whether there are other types of noncompetitive transactions such as the Exchange of Futures for Swaps; the Exchange of Options for Physicals or block trading that could be useful without compromising the existing regulatory safeguards.

A. Exchanges of Futures for Swaps ("EFS"). The New York Mercantile Exchange has applied to the Commission for approval of a rule that would establish EFS provisions that are separate but parallel to existing regulations for EFPs. The growth of swaps has been fostered by the existence of liquid exchange markets for futures and options in which the risks of the customized swap can be transferred to broader marketplace.

Swap intermediaries typically match counter-parties to eliminate the price risk involved in a swap. Quite often when there is no immediate offsetting swap available; commodity futures are used to hedge the swap temporarily. EFS would bundle a swap and futures position into one so that dealers could initiate trades in one transaction. The swap component must comply with the requirements of Part 35 of the Commission's regulations.

The Commission should create the regulatory structure to allow EFSs. The Commission should not limit EFS to particular markets but allow each Exchange to decide to implement EFS for what products. If an Exchange believes that EFS detract from the overall liquidity and price discovery in its futures then it should have the right to prevent EFSs.

B. Exchanges of Options for Physicals. The Exchange believes that EOPs are and do offer genuine risk management benefits. As the Commission points out, EOPs may be appropriate for a grantor of an option who has a delivery commitment upon exercise or the holder of a deep-in-the money option. EOPs may be useful to a farmer, for example, who has purchased puts to hedge a crop and wants to liquidate the options hedge and sell the crop to a merchant at the same time. If the Commission allows EOPs, the Exchange will work with the industry to discuss the appropriate limitations on these transactions.

C. Alternative Execution. The New York Cotton Exchange has recognized the need for large order execution system and has pioneered the execution of large order blocks on the trading floor. Centralized trading has long been the cornerstone of futures markets because it promotes transparency and competitive price determining. Futures markets exist to facilitate risk shifting and price discovery while the purpose of equities markets is to foster capital formation. Unlike the stock markets with its specialist system, futures markets operate with a multiple market-maker system. The advantage of futures is that there is a level playing field: everyone competes on equal footing in an auction-style, open outcry market. Competitive prices and liquidity of exchange traded futures foster their use. Competitive determination of price is key. The Concept Release suggests that such procedures could be designed to allow execution off the floor and merely reported to the exchange.

The Commodity Exchange Act and Commission Regulations provide that exchanges may establish rules and procedures governing the conduct of EFPs. The authority to regulated EFPs is with the exchanges and should continue to be with the exchanges. The commission has raised numerous issues in the Concept Release. We look forward to further comment on the specific regulatory proposals that may result from this Concept Release.

Respectfully Submitted,

Joseph J. O'Neill
President