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COMMENT

April 27, 1998

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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

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments in response to the Commodity Futures Trading Commission (the "Commission")'s request for comments on a broad range of questions concerning the oversight of transactions involving (i) the exchange of futures for, or in connection with, cash commodities; (ii) other noncompetitive transactions, including alternative execution procedures; and (iii) the use of execution facilities for noncompetitive transactions. 63 Fed. Reg. 3708 (January 26, 1998) (hereinafter sometimes referred to as the "Concept Release").

FIA, a not-for-profit corporation, is a principal spokesman for the futures industry. Its members include approximately 70 of the largest futures commission merchants ("FCMs") in the United States. Among its associate

members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 80 percent of all customer transactions executed on United States contract markets.

I. Introduction

We have focused our comments on those aspects of the Concept Release which are most important to FIA members. Thus, this letter does not attempt to respond to all of the questions on which the Commission is requesting comment. Given that the Commission has extended the comment period with respect to its request for comment on alternative execution procedures, this letter does not respond to the questions in the Concept Release relating to such procedures or otherwise address those issues. We have identified by number the particular questions to which our comments are responsive.

In general, FIA supports the existing regulatory framework applicable to exchanges of futures for physical ("EFP") transactions without any modifications; favors expanding the boundaries of permissible noncompetitive trading on designated contract markets; and believes that the use of execution facilities for EFP transactions in Treasury securities or for other types of EFPs or for similar transactions does not present issues that require revisions to the existing regulatory structure or any other form of additional oversight by the Commission under the Commodity Exchange Act, as amended (the "CEA"), 7 U.S.C. § 1 *et seq.* Each of these topics is discussed at greater length below.

II. Standards Governing EFP Transactions

As the Commission observes in the Concept Release, the common element of all EFPs is that the futures transaction has a direct relationship to a transaction in the "cash" or "physicals" market. The exemption permitting EFP transactions in Section 4c(a) of the CEA has existed essentially unchanged since 1936, because they are a "common and necessary practice."¹ Under the current statutory scheme, the regulation of EFPs is delegated to the designated contract markets, with the Commission functioning in an oversight role principally through (i) the Commission's review of contract market rules governing such transactions; (ii) the Commission's reporting and recordkeeping requirements; (iii) the Commission's rule enforcement review program to monitor the contract markets' enforcement of their rules; and (iv) the Commission's own enforcement program.²

¹ H.R. Rep. No. 1551, 72d Cong., 1st Sess. 3 (1932).

² See generally 63 Fed. Reg. at 3711.

For this purpose, the Commission's reporting and recordkeeping requirements for EFPs are designed to enable the applicable contract market and/or the Commission to obtain documents on both the futures and physical legs of the transactions that may be necessary to determine the legitimacy of particular EFPs.³

The numerical data set forth in the Concept Release indicates that EFPs have increased as a percentage of trading volume in certain financial futures contracts during the past decade, but EFPs today continue to serve, as they always have, the historic purpose of these transactions: providing market participants with greater flexibility on matters such as price, timing, quality of the deliverable commodity, and delivery point that cannot be obtained through traditional on-floor exchange transactions.

The historic needs served by EFPs have been magnified by globalization and the need for 24-hour trading in some commodities. For example, for banks and other financial institutions that trade currency on a 24-hour-a-day basis, EFPs may be the only viable means available to enter or exit futures positions in response to events that have occurred overseas, or to arbitrage or hedge positions that have been taken in related markets on a real-time basis. Indeed, without the flexibility provided by EFP transactions, market participants might reduce their use of the futures markets.

As we have noted, all EFPs are routinely monitored by the contract markets for compliance with their rules, subject to comprehensive Commission oversight. In the absence of any systemic abuses or irregularities, none of which are identified in the Concept Release, FIA does not perceive a need for commencement of a rulemaking process by the Commission. In this regard, FIA does not believe that the standards articulated in the Division of Trading and Markets' EFP Report should be codified in the Commission's regulations or refined⁴ (Concept Release Questions 1, 4). We note that, in providing guidance on EFP transactions to the contract markets and other interested parties, the Division endorsed the current flexible approach to the oversight of these transactions, which recognizes the contract markets' need "to adapt [the Division's guidance] . . . to the particular circumstances of their markets."⁵ To codify by Commission rulemaking particular standards or guidelines, whether those contained in the EFP Report or other criteria,

³ See, e.g., Commodity Futures Trading Commission Rules 1.35(a), (e); 1.35(a-2); 1.38(b); 16.00(a)(4); 16.01(a)(2); 17.00(a); 17.01; 18.05; 21.03(e)(1)(iii).

⁴ See Report of the Division of Trading and Markets: Exchange of Futures for Physicals (October 1, 1987) ("EFP Report").

⁵ Id. at 260.

would impose unduly rigid criteria on these transactions and stifle market innovation, without advancing any policy or purpose under the CEA.

In a similar vein, FIA opposes requiring contract markets to adopt particular minimum statistical correlation coefficients for evaluating the relationship of the futures and cash legs of EFP transactions (Concept Release Questions 5, 6); does not believe that the Commission should address the separate parties requirement or string trades (Concept Release Questions 8, 9); and believes that it is appropriate for contract markets to apply their own criteria for judging whether the futures or cash leg of an EFP transaction is bona fide, including with respect to whether a transitory EFP is bona fide and whether an EFP is contingent (Concept Release Questions 7, 10-13). Also, FIA believes that the issue of restrictions on the pricing of one or both legs of EFP transactions should be left to the contract markets (Concept Release Question 14). In the latter regard, we note that the contract markets already have the ability to obtain documentation from their members concerning the business purpose underlying the pricing of an EFP pursuant to Commission and contract market reporting and recordkeeping requirements and frequently do so in connection with their monitoring of these transactions (Concept Release Question 15). The contract markets publish written guidance regarding such matters as the acceptability of particular cash commodities for the cash leg of EFP transactions, which they periodically revise and update.⁶

In sum, FIA believes that these matters should be left to the contract markets' discretion, as the contract markets are best positioned to address them, taking into consideration differences among the various futures markets and the underlying commodities. This approach is consistent with the statutory framework and provides the benefit of permitting EFP practices to evolve over time in response to changing market conditions, subject to monitoring by the contract markets, with the Commission playing an oversight role. The Commission has ample authority to address situations in which a contract market fails to monitor these transactions in a manner consistent with the CEA and the rules and regulations thereunder.

In line with our general thinking on these issues, FIA finds that the current reporting and recordkeeping requirements relating to EFPs, as summarized in the Concept Release, are adequate, and we are not aware of any evidence to indicate otherwise. Indeed, the experience of FIA's clearing member FCMs

⁶ See, e.g., Chicago Board of Trade Notice to Members (October 1, 1997); Chicago Mercantile Exchange Regulatory Memorandum RG Notice No. 96-0001 (January 11, 1996); New York Mercantile Exchange Letter re: Amendment to NYMEX Rule 6.21 -- Exchange of Futures for, or in Connection with, Product (October 16, 1991); Commodity Exchange, Inc. Notice No. 90-27 (March 23, 1990).

demonstrates that contract markets frequently request them to produce documentation relating to both the futures and cash legs of EFP transactions and that the contract markets have been diligent in monitoring these transactions to assure compliance with the requirements of their rules (Concept Release Question 16).

FIA believes that the Commission should refrain from regulating the form or content of disclosure concerning EFPs, given that the customers engaging in EFP transactions are commercial, institutional, or otherwise sophisticated market participants and the Commission has not identified any perceived abuses or other problems in the Concept Release that might justify such regulation (Concept Release Questions 17, 18). On this basis the Commission recently determined to provide FCMs and introducing brokers ("IBs") with relief from various mandatory disclosure requirements with respect to specified categories of customers that meet certain sophistication criteria.⁷ Since EFP transactions are individually negotiated, principal-to-principal transactions, they are undertaken by an FCM or an IB only upon request of the customers or their duly authorized agents such as investment managers (Concept Release Questions 19, 20).

The Commission is requesting comment on the types of internal controls that are appropriate for Commission registrants to assure compliance with regulatory requirements concerning the essential elements of bona fide EFPs, reporting and recordkeeping, and disclosure (Concept Release Question 21). As the Commission points out, in accordance with Rule 166.3, Commission registrants are already required to supervise the handling of these transactions for their customers. For this reason EFP transactions typically are addressed as a matter of internal control. To date the Commission has declined to publish an all-inclusive list of essential elements of acceptable compliance programs or internal controls⁸ (Concept Release Question 43). If the Commission revisits its position on this point, it is not clear as to why EFP transactions merit special consideration.

Lastly, the Commission is soliciting comments relating to the transparency of EFPs and whether improved price transparency is necessary or appropriate for these transactions (Concept Release Questions 22, 23). The commercial and institutional participants engaging in these transactions recognize that, because EFPs are not pit traded and not executed in open outcry, they do not have the same degree of price transparency as futures trading. However, because EFPs fulfill particularized needs which traditional execution methods associated with futures trading do not, the lack of price transparency is acceptable as a necessary tradeoff and has not presented any difficulties. Indeed, price is not always the

⁷ See 63 Fed. Reg. 8566 (February 20, 1998).

⁸ See 43 Fed. Reg. 31886, 31889 (July 24, 1978).

paramount consideration behind an EFP transaction and publicizing information about bids and offers for EFPs (which would be problematic in that EFPs are transacted on a spread basis and the spreads reflect the particular details of each EFP) could defeat the purpose of such transactions by informing market participants of the needs of large institutions to enter or exit particular futures contracts or to hedge or unwind hedge positions. Accordingly, FIA believes that existing price reporting standards provide adequate transparency to the marketplace and that the Commission should not require contract markets to publicize information about bids and offers for EFPs in addition to consummated EFP transactions (Concept Release Questions 22, 23, 44).

In any event, if the Commission determines to proceed further with any of these concepts, FIA believes that they should be published in proposed form with notice and an opportunity for public comment.

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

The Commission is requesting comment on three other types of noncompetitive transactions: (i) Exchanges of Futures for Swap ("EFS") Transactions; (ii) Exchanges of Options for Physicals ("EOPs"); and (iii) alternative execution procedures. As previously noted, this letter does not respond to the questions in the Concept Release relating to alternative execution procedures or otherwise address those issues.

A. EFS Transactions

FIA supports the New York Mercantile Exchange ("NYMEX") proposal for EFS transactions and urges the Commission to approve its rule proposal that would permit the execution of EFS transactions (Concept Release Questions 2, 26). These transactions are no different in concept than traditional EFP transactions, except that the cash leg of the transaction is a swap agreement. FIA believes that the Commission has ample authority under Rule 1.38 and also Section 4(c) of the CEA to permit EFS transactions.

FIA finds that the benefits that NYMEX has projected to occur from these transactions, including improvements in liquidity and reductions in basis and credit risks, are compelling. For example, by making it easier to exit and enter energy futures positions, NYMEX is likely to enhance the volume and liquidity in its energy futures markets (Concept Release Question 24). We do not anticipate that EFS transactions will create any potential costs or risks that are unique to these transactions, including with respect to any effect on price discovery, risk transfer, or the competitive conditions of the on-exchange market. Rather, as NYMEX has concluded, they should assist in integrating the exchange and over-the-counter

markets in energy commodities to the benefit of the marketplace and market participants (Concept Release Question 25). EFS transactions should be limited to commercial or institutional participants, in view of the eligible swap participant criterion in the Commission's Part 35 rules or the line of business and the prohibition on marketing to the public criteria in the Commission's Policy Statement Concerning Swap Transactions.⁹ However, we find no regulatory reason to limit these transactions to particular markets or types of transactions (Concept Release Questions 27, 28, 37).

B. Exchanges of Options for Physicals ("EOPs")

As with EFS transactions, FIA finds ample authority under Rule 1.38 and also Section 4(c) of the CEA for the Commission to permit EOP transactions. FIA also believes that the contract markets and marketplace should be permitted to determine whether these transactions are viable and offer genuine risk management benefits (Concept Release Question 29). FIA does not believe that the Commission should impose limitations in advance on EOPs that may reflect the particular risk characteristics of options, but that such issues ought to be addressed in the context of the Commission's rule review process (Concept Release Questions 2, 30).

IV. Execution Facilities for Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market

The Commission is requesting comment as to the appropriate form of oversight for certain execution facilities identified in the Concept Release for EFP transactions in Treasury securities or for other types of EFPs or similar transactions. Because these facilities merely facilitate or assist in arranging potential EFP transactions and do not provide a means for consummating or executing them, we believe that they are more appropriately viewed as facilitation services. FIA believes that the current regulatory approach concerning these facilitation services is adequate because they do not function any differently than individual dealers that assist in assembling EFP transactions, and FIA is not aware of any rationale that would support additional oversight by the Commission (Concept Release Questions 3, 48). We note, among other things, the following: (i) the futures leg of these EFP transactions must be reported to and accepted for clearance by a clearing organization; (ii) the Commission's reporting and recordkeeping requirements are applicable to EFP transactions; and (iii) the antifraud and antimanipulation provisions of the CEA and the rules and regulations thereunder also are applicable. Thus, the existing regulatory framework for EFP transactions provides the

⁹ See 17 C.F.R. Part 35 (1997) and 54 Fed. Reg. 30694 (July 21, 1989), respectively.

Commission with the tools to monitor for any potentially abusive practices and should preclude any perceived need for the Commission to impose additional oversight on such facilitation services. In addition, with respect to EFP transactions in Treasury securities, interdealer brokers and the cash leg of these transactions are subject to regulation under the Securities Exchange Act of 1934 and the rules and regulations thereunder and oversight by the Securities and Exchange Commission and the National Association of Securities Dealers, Inc., the Treasury Department, the Office of the Comptroller of the Currency, and the Federal Reserve Board.

With respect to EFP transactions in Treasury securities and foreign currency, any additional oversight by the Commission over the cash leg of these transactions would be inconsistent with the Treasury Amendment, which provides that over-the-counter transactions in U.S. government securities, foreign currency, and other specified financial instruments are not subject to the CEA and Commission jurisdiction¹⁰ (Concept Release Question 51). FIA recognizes that there may be disagreement over the scope of the Treasury Amendment exclusion, in particular relating to the meaning of the phrase "board of trade", but we believe that the cash leg of EFP transactions involving such instruments are within the purview of the Treasury Amendment under any reasonable interpretation of that provision.¹¹ (Concept Release Question 52). In Tauber the Fourth Circuit noted that the United States, advising the court as an amicus curiae, predicted that significant disruption of the when-issued market for Treasury securities would result if the court adopted a narrower view of the Treasury Amendment.¹²

V. Conclusion

FIA appreciates the opportunity to submit these comments in response to the Commission's publication of the Concept Release. If the Commission or any

¹⁰ 7 U.S.C. § 2(a)(1)(A)(ii), which provides:

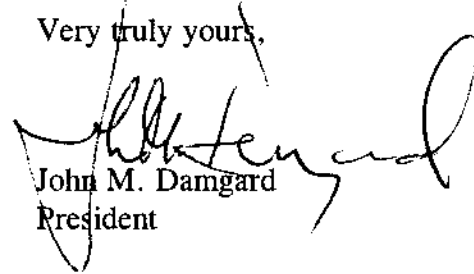
Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages or mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

¹¹ See, e.g., Commodity Futures Trading Commission v. Frankwell Bullion Limited, 99 F.3d 229 (9th Cir. 1996); Salomon Forex, Inc. v. Tauber, 8 F.3d 966 (4th Cir. 1993), cert. denied, 511 U.S. 1031 (1994).

¹² Tauber, 8 F.3d at 976.

of its staff has any questions regarding this letter, please contact the undersigned at (202) 466-5460, or Barbara Wierzynski, Executive Vice President & General Counsel, at the same telephone number.

Very truly yours,



John M. Damgard
President

cc: The Honorable Brooksley E. Born, Esq.
The Honorable John E. Tull, Jr.
The Honorable Barbara Petersen Holum
The Honorable David D. Spears
Daniel R. Waldman, Esq.
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