VIII. Assessing the Impact of EFPs

A. Responsibilities of the Exchange and Clearinghouse for the Futures Position

Although the futures positions resulting from an EFP are executed off-exchange, and may occur outside of exchange trading hours, they generally are not treated differently from other futures trades. As described above, although all exchanges impose certain recordkeeping and reporting requirements on the parties to an EFP, once the futures trade is reported to the exchange, it is cleared identically with other futures trades and thereafter is subject to the same margin requirements -- both initial and variation -- as other futures contracts. Also, as with other futures positions, the clearinghouse does not assume responsibility for a futures position established by an EFP until it has been cleared.

Because EFPs may be executed after hours, there may be a delay in the reporting and clearing of the resulting futures positions which is longer than that for other futures trades. The Division therefore has considered the possibility that a trader could overextend himself in trading EFPs and be unable to finance the positions when cleared. However, this risk is not materially different from that resulting from trades executed in the pit during trading hours because there is no guarantee in either circumstance that a trader will confine himself to positions he is able to handle financially. In either situation, however, an FCM should evaluate the creditworthiness of a customer in determining whether to accept an order and whether to require an advance payment of margin if there is not already sufficient equity in the customer's account to cover the positions that will result. An FCM particularly should make such a determination for any EFP in which the futures trade is priced away from the market because the resulting margin calls could cause a trader to be unable to meet his obligations. With respect to the evaluation of a customer's creditworthiness, a clearing member presumably could refuse to accept an EFP trade which is presented to it for clearing by a party to the transaction, if that party does not meet the firm's standards.

One interviewee suggested that the clearinghouse may be at increased risk from guaranteeing EFP trades executed when the exchange is closed. The Division does not believe that, as a practical matter, there is any increased risk from this situation. No exchange clearinghouse assumes responsibility for a futures trade until it clears. Thus, the futures obligations arising from an EFP remain solely the responsibility of the parties and their clearing members until they are cleared. Of course, the clearing members remain responsible to the clearinghouse for those positions after clearing. For those reasons, clearing members should have internal controls, in conjunction with their evaluation of their customers' creditworthiness, relating to the size of positions which can be executed by EFP when the exchange is closed.

Variation margin obligations to the clearinghouse likewise will arise only after the futures position has cleared based on the day's settlement price. Since most EFP futures are priced within the day's trading range, there generally is unlikely to be a greater than expected margin obligation. Nevertheless, the exposure of one party to the EFP may increase between the time of the EFP and the time it is cleared due to price movements, just as exposure may increase intra-day or overnight, and the clearinghouse has an interest in assuring that some controls are maintained over that exposure.

In some circumstances EFPs provide a means for traders to exit losing positions or reduce their margin obligations by adjusting the futures price or the size of their positions. Additionally, an exchange might encourage EFPs to permit delivery of commodities of different qualities or at different locations than would be deliverable under the futures contract in order to alleviate tight market situations going into the delivery period. 222/

222/ Traders on NYMEX have employed EFPs for this purpose in the past. For example, demands were made by longs for delivery of heating oil during the first three delivery days on the February 1982 heating oil contract. An oil company with a sizeable short position did not have heating oil available to meet those demands for delivery, some of which were instead offset by EFP with the encouragement of NYMEX staff. Apex Oil Company v. Joseph DiMauro, No. 86-7898 (2d Cir. June 17, 1987). At that time, NYMEX rules permitted EFPs after the termination of trading to offset delivery obligations. Currently, NYMEX does not permit EFPs after the termination of trading but provides the ADP mechanism described at note 85, *supra*.

Although EFPs are executed outside the trading pit, and perhaps outside of trading hours, and thus may not be reported immediately to the exchange, the exchanges are responsible for enforcing their EFP rules, auditing compliance, and investigating customer complaints arising out of those transactions just as they would for competitively executed trades. Thus, if one party fails to report the futures portion of an EFP for clearing, resulting in an outtrade or no reported futures position for either party (since some exchanges require only one party to report an EFP), the exchange would be responsible for taking disciplinary action for the failure to report in violation of exchange rules, and to investigate any complaints filed by the counterparty as a result. 223/

As a result of this responsibility for regulating EFPs, an exchange could choose to limit EFP transactions to protect traders or customers. In particular, as noted in Section IX.B. of this Report, the Division recommends that the exchanges impose explicit requirements that EFPs be reported as soon as possible after execution, or at least within the same time frame as other futures trades. This would enable the exchanges timely to take any remedial action (such as an intra-day margin call or

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223/ The counterparty might also have direct recourse against the violator, including cases where the failure to report the EFP futures position violated a condition precedent to performance of the cash commodity obligation or other contractual obligation between them.

direction to reduce positions) that may be necessary in a particular case.

B. Net Capital Treatment and Segregation of Customer Funds by FCMs Handling EFPs

FCMs are subject to minimum net capital and related reporting requirements, as well as segregation of funds requirements. 224/ The effect of cash commodity inventory, futures positions, and forward contracts established or closed out through EFP transactions on an FCM's net capital and segregation requirements is no different from those established or closed out other than through EFPs. On an FCM's books, an EFP can occur in accounts carried for the FCM's customers or in the FCM's own account.

1. Net Capital Treatment of Proprietary Positions and Margin

As a general rule, all positions in proprietary accounts (futures, forwards, and marketable cash commodity positions) are to be marked to their current market value by the FCM in assessing its net capital position (§1.17(c)(1)(i)-(iv)). The impact of EFPs on an FCM's net capital is based upon changes in the types of positions held (cash commodity and futures) and whether

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224/ Commission Regulation 1.17(a)(1) provides generally that an FCM's adjusted net capital must equal or exceed 4% of the customer funds required by the Act and regulations to be segregated on behalf of customers. Commission Regulation 1.3(gg) defines the term "customer funds" to mean, in essence, the funds deposited by a customer in a commodity trading account plus or minus the unrealized gain or loss on open futures and option contracts.

the positions before and after the EFP are "covered" or "uncovered" within the meaning of Regulation 1.17(j). 225/

Briefly, the FCM must recognize the following effects on net capital when the FCM maintains a futures, forward or cash commodity position, or a combination thereof, for its own account. All positions held (inventory, forward contracts, and futures/options positions) by the FCM for its own account are assessed together. Frequently, an FCM's position will include a combination of these types of contracts:

1. In reporting its net capital position in a financial report filed with the Commission, an FCM must reflect any inventory of readily marketable spot commodities at its current market value (§1.17(c)(2)(iv)(A)). Any change in the reported value of that inventory from that at which the inventory was acquired will directly affect the FCM's net capital. For example, if inventory that was originally acquired at a cost of $150,000 has a current market value of $175,000, the FCM's net capital will have increased by $25,000. The effect of the increase in value, however, may not be fully recognized for purposes of reporting its net capital position because of the charges that may have to be taken against net capital as specified in items 2 - 6 below.

2. Net capital is reduced by 20% of the market value of any inventory that is not covered by a futures, option, or forward contract (§1.17(c)(5)(ii)(C)).

225/ Regulation 1.17(j) defines "cover" as transactions or positions in futures or options "where such positions normally represent a substitute for transactions to be made or positions to be taken at a later time in the physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise" arising from changes in value of assets, liabilities, or services.

3. If the inventory is deliverable against a futures contract and is covered by a futures contract or an option on a physical, or is a foreign currency covered by an open futures contract, the FCM's net capital is not reduced (§1.17(c)(5)(ii)(A)).

4. If the inventory is <u>not</u> deliverable on a futures contract, but is covered by a futures or option contract, net capital is reduced by 5% of the inventory's market value (§1.17(c)(5)(ii)(B)).

5. If the FCM has any forward contracts that are not covered by a futures or option contract, it must reduce net capital by 20% of the market value of the underlying commodity (§1.17(c)(5)(ii)(E)).

6. If the forward contract is covered by a futures or option contract, then net capital is reduced by only 10% of the market value (§1.17(c)(5)(ii)(D)).

Proprietary and customer account futures positions which result from EFPs are margined at the clearinghouse like any other futures positions. Margin funds deposited by a customer for a futures position with an FCM are a liability of the FCM to the customer for financial reporting and net capital, and margins on deposit with the clearinghouse for both customer and proprietary accounts are an asset. Any unrealized gain or loss on an open futures position in a proprietary account results in a dollar-for-dollar adjustment to net capital (§1.17(c)(1)(i)). Likewise, realized gains or losses in futures for proprietary accounts increase or decrease an FCM's net capital, respectively (<u>See</u> §1.17(c)(1)(ii)(C)). Realized or unrealized gains or losses on futures positions for customer accounts will also result in corresponding adjustments to net capital, but there will be offsetting entries to reflect the amount due to or owed by the customer on the position. If the FCM has futures or options contracts that do not represent cover for inventory or forward contracts, its net capital will be reduced by 100 to 150% of the exchange clearing organization's maintenance margin requirement (§1.17(c)(5)(x)(A)-(B)); the actual rate to be applied depends on whether the position is cleared directly or through a carrying broker. 226/

It is evident that when an FCM's position mix changes, whether through EFPs, exchange-traded futures and options, or cash market transactions, corresponding adjustments to its net capital computation may also be necessary. How these principles operate in the context of EFPs can best be understood through an example.

Assume an FCM enters into a fixed-price sales commitment for its proprietary account for 250,000 lb. of copper (deliverable against the Comex futures) with a cable manufacturer for September delivery. To protect against a possible increase in price, the FCM buys 10 September copper futures contracts with a market value of $150,000. The FCM marks both of these positions to their current market value and adjusts its net capital accordingly. Because the forward contract is covered by a futures position the FCM must take a charge against its net capital of $15,000 (10% of $150,000 -- item 6, _supra_).

226/ This reduction is a deduction from the full market value of an asset, which is intended to provide a margin of safety against possible adverse market moves.

Subsequently, the FCM agrees to transact an EFP with a merchant in which it will buy 250,000 lb. of copper and sell 10 September futures contracts. The short futures position acquired by the FCM in the EFP will offset its existing long futures position, and any realized profit or loss on that position will increase or decrease its net capital accordingly. The inventory of copper purchased from the merchant in the EFP will be reflected as an asset in the records of the FCM. Both the long inventory and short forward are marked to market and any unrealized profit or loss on both positions are added to or deducted from net capital. 227/ While this change in the FCM's position was effected through an EFP, it could just as well have been effected through a sale of copper futures and a cash market purchase of copper; in such a case, the resulting effect on net capital would be identical.

2. Segregation of Customer Funds

When a customer establishes a futures position, the FCM is required to segregate the funds the customer deposits to margin that position (see Regulation 1.20). If a customer effects an EFP and converts a long futures position into a cash commodity position or otherwise obtains a long cash position, the customer and the FCM must agree between them as to the treatment of the

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227/ A more detailed version of this example with prices and dollar values as well as accounting entries can be found in Appendix 16.

cash commodity. They may agree to treat the cash commodity as margin for the customer's account (if it is permissible for that purpose), in which case the market value of the commodity enters into the calculation of the customer's futures account equity. The FCM will be required to segregate the physical commodity (or the negotiable instrument evidencing the commodity's existence) and its market value will be used as a basis for determining the amount of funds required to be segregated on behalf of the customer when computing the FCM's minimum adjusted net capital under §1.17(a)(1)(i)(B). If, on the other hand, the customer and FCM agree that the commodity will not be used as margin, then the net capital or segregation rules are not applicable. If the FCM takes delivery of the commodity for the customer, it will hold the receipts or other evidence of ownership until the customer directs the FCM as to the disposition of these documents.

C. Changes in Open Interest

1. Commission Action

Part 17 of the Commission's regulations requires FCMs, clearing members, and foreign brokers to report to the Commission each day the quantity of EFPs for all "special accounts" and also to report EFPs in a particular future for such accounts on the first day upon which an account is no longer reportable in that future. 228/ At the time the Commission proposed amending Part

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228/ Commission Regulation 15.00(c) defines the term "special
(Footnote Continued)

17 to require EFP information from FCMs and foreign brokers, the Commission requested comment as to "[w]hether open interest should reflect only those positions which remain to be offset in the pit, upon which delivery notices will be issued or stopped and against which traders will transact EFPs." 229/ The Commission noted that on some exchanges, the proprietary positions of clearing member firms were reported on a net basis, but that the member had the option of "uncovering" long and short positions in the same futures contract either to make and take delivery or to transact an EFP. It was believed that this practice could result in published open interest figures that were misleading to the trade and to the Commission. The Commission sought to resolve this potential problem by clarifying Regulation 16.02 to specify exactly what should be included in published open interest figures and by amending Regulation 1.46. 230/

When the amendments to Part 17 were finalized, the Commission stated that no comments were received on the issue of open interest which indicated that there were any problems with reporting positions on a net basis and uncovering those positions

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(Footnote Continued)

account" to mean any futures or option account in which there is a reportable position. The Commission's EFP reporting requirements are discussed in greater detail in Section IX. of this Report.

229/ 45 Fed. Reg. 57141, 57146 (August 27, 1980).

230/ Id.

to transact EFPs or effect delivery. In addition, commenters had offered several examples of potential benefits. As a result, the Commission determined to take no further action until such time as problems were identified that would warrant reconsideration of the issue. 231/

2. Exchange Rules

Comex rules do not restrict EFPs creating new positions or affecting open interest. 232/ Comex Clearing Association Rule 32, which is typical of other clearing organization rules or requirements, requires that "ex-pit" transactions resulting in an increase in net positions be accompanied by original margin when reported for clearing. CSC, CME, and CBT interpret their rules to permit EFPs to increase or decrease open interest. 233/ Most EFPs taking place at CSC reduce open interest, with the balance leaving it unchanged. CSC staff does not recall that any increase in open interest as a result of EFPs has ever occurred, but nonetheless does not believe that the creation of open interest through EFPs is a problem. CME staff does not consider possible increases in open interest by EFPs to present a problem different from that which might result from increases in open interest resulting from pit trading. All increases in open

231/ 46 Fed. Reg. 18528, 18529 (March 25, 1981).

232/ Comex Notice to Members 83-63 (April 20, 1983).

233/ CME Special Executive Report S-1652 (June 26, 1986). The CBT and CSC rules are silent on this point.

interest are a matter for market surveillance. Both CBT and CME monitor the impact of EFPs on open interest to ensure that a contract expires in an orderly manner and that there is no problem with deliverable supply.

Until 1986 NYMEX interpreted its rules to require that at least one party have a futures position prior to an EFP, even if the futures position was established immediately prior to the EFP (*i.e.*, no increases in open interest through the use of EFPs were permitted). [234/] On December 29, 1986, the Commission approved an Exchange resolution permitting EFPs in platinum to establish futures positions for both parties. On February 13, 1987, the Commission approved an Exchange resolution permitting EFPs in the energy complex (specifically, heating oil, crude oil, and unleaded gasoline) to increase open interest except during the last three business days prior to termination of trading. The Exchange stated in its February 13 submission to the Commission that it was imposing the limitation on EFPs during the last three days of trading in order to ensure the integrity of its market surveillance program and to allow time for any action necessary to assure orderly liquidation and deliveries against the contract.

NYFE is the last of the exchanges to prohibit EFPs that increase open interest. On September 9, 1987, amendments to

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234/ NYMEX Notice to Members (March 7, 1977).

Exchange Rule 432 removing this limitation were approved by the Commission.

3. Practices and Interview Comments

According to a grain trader and a trade house in the coffee, sugar, and cocoa markets, in practice most EFPs in those markets offset existing futures positions of at least one of the parties. Three FCMs handling T-bond, T-note, stock index, and gold EFPs also said that in their experience, or based on their general knowledge, most EFPs are used to offset positions. 235/

Of the sixteen trade or FCM interviewees commenting on this issue, nine specifically stated that a change in open interest as a result of EFPs was not a cause for concern. Three of those nine commented that anyone with a position in the spot contract needed to be prepared to make or take delivery. One FCM, using EFPs in T-bonds and T-notes, emphasized that EFPs creating a new futures position could be important to a trading strategy shifting a hedge position from the cash to the futures market. A commercial trader noted that EFP figures are posted daily, and that any resulting establishment or liquidation of futures positions is reflected in published open interest figures. Two other FCM interviewees believed that a dramatic

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235/ However, as noted elsewhere, gold EFPs are also used extensively to establish an open futures position in connection with a separate transitory cash transfer. None of the interviewees commented on the effect of EFPs on open interest in the currency markets.

increase in open interest during the spot month could distort prices either between the spot and deferred futures or the spread between the cash and futures, but both believe this consequence to be unlikely and stated that dissemination of EFP volume data could alleviate the problem. 236/

Changes in open interest as a result of EFPs do not appear to pose any threat to the market at this time. As noted by CME, there is no difference in increases in open interest as a result of EFPs and those resulting from pit trading. Decreasing open interest can remove pressure from the market. Changes in open interest are not problematic _per se_ and can be viewed basically as a matter of market surveillance. The same observation is true for cash-settled contracts; indeed, because they are cash-settled, changes in open interest would appear to be less likely to result in a market surveillance problem. The Division nonetheless believes that dissemination of information on the number of EFPs is a valuable tool in monitoring market activity both for market surveillance staff and for market participants.

236/ At CME, Comex, CSC, and NYMEX, EFP data are posted in some manner on the exchange floor. At CSC and NYMEX, EFP data also appear on electronic quotation display screens, the floor Quotron, and on those two exchanges, as well as NYCE and Comex, the data are included on the Daily Market Report (Daily Futures Report at NYMEX). For additional discussion of the reporting of EFP data, _see_ Section IX.B. of this Report.

D. Impact on Liquidity

The impact of EFPs on the liquidity of pit trading in the futures markets is difficult to assess because one cannot determine the number or volume of transactions that would be made if the EFP mechanism were not available. Conversely, it is impossible to determine how many additional trades are executed in futures because EFPs are available to offset risk. However, the 18 exchange and commercial interviewees commenting on this issue unanimously agreed that EFPs are not harmful to liquidity at this time, and some stated the view that EFPs may aid liquidity. The interviewees provided a variety of observations.

Nine trade and FCM interviewees believed that EFPs contribute to futures market liquidity because they provide traders with an additional means to enter or exit the market and limit risks from adverse price movements. 237/ In their view, without the availability of EFPs, traders might be less willing to carry positions overnight. In addition, two interviewees stated that foreign customers, whose normal trading hours do not coincide with those of the United States markets, might not use the United States futures markets were it not for EFPs because they are uncomfortable with the method of trading which permits partial executions and executions at different prices. Four

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237/ EFPs are a major factor at NYMEX where commercials use the market and EFPs extensively and have indicated that they would be less likely to trade futures were it not for the availability of EFPs.

other interviewees commented generally that EFPs do not harm liquidity.

In addition, several CME and CBT members observed that EFPs add liquidity if the futures positions of the parties are not both established and liquidated via EFPs. In those circumstances a position established initially through an EFP may be offset later in the conventional manner in the pit, adding liquidity. One other trade house/FCM stated that EFPs promote the orderly liquidation of positions. Finally, CSC and Comex staff and two commercial interviewees believe that EFPs keep transactions in the United States markets, and that business would be taken overseas if EFPs were eliminated or limited sharply. 238/

Only the CME believed that EFPs have the potential to harm liquidity if a substantial percentage of transactions come to be

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238/ In this regard, it should be noted that EFPs may not be available on foreign markets. For example, the criteria for exchanges set by the Securities and Investments Board ("SIB") in London, England provide that exchanges may have rules permitting exchange of futures for physicals to either initiate or offset futures or cash positions. Not all exchanges, however, have such rules. Moreover, the criteria established by the SIB with respect to EFPs note that although there may be commercial reasons to support many EFPs, such transactions are subject to abuse and should be limited to those with a genuine cash transaction taking place. Finally, the criteria lists certain items which exchange rules governing EFPs should address. Those items include the circumstances under which EFPs may occur, price range limits, reporting and recordkeeping requirements, and provisions relating to the cash component. The SIB does not itself directly impose limits on the use of EFPs.

executed by EFP instead of in the futures market. However, the Exchange representatives interviewed by the Division stated that, on balance, EFPs presently aid the market.

The Division is persuaded that EFPs do not presently threaten the liquidity of the futures markets. Moreover, the availability of EFPs may in fact promote the use of the futures markets because traders are assured of a vehicle to exit the market in the event of adverse price changes while the futures market is closed or a price limit is in effect. While EFPs could theoretically remove a high percentage of trades from the trading pits and thereby compromise the pricing efficiency of the markets, this presently appears to be unlikely and, thus far, has not occurred. This is particularly true where there is a highly liquid futures market, because, as some interviewees observed, the bid/ask spread is likely to be more advantageous in the pit than would be quoted for an EFP.

IX. Recordkeeping and Reporting Requirements

A. Commission Regulations

Commission Regulation 1.38(b) requires that "every person handling, executing, clearing, or carrying trades, transactions or positions . . . involving the exchange of futures for cash commodities or the exchange of futures in connection with cash commodity transactions, shall identify and mark . . . all such transactions or contracts and all orders, records and memoranda pertaining thereto." 239/ Commission Regulation 1.35(a) requires each FCM, introducing broker, and member of a contract market to "keep full, complete, and systematic records, together with all pertinent data and memoranda, of all transactions relating to its business of dealing in commodity futures, commodity options, and cash commodities," [emphasis added] and to retain such records and produce them upon a request by the Commission. 240/ In addition, Regulation 1.35(e) requires that a contract market's

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239/ There have been three Commission enforcement actions taken against FCMs concerning, in part, failure properly to designate certain trades as EFPs, pursuant to Section 4g of the Act and Regulation 1.38(b). All arose out of the silver market events of 1980-81, and all were settled without any findings by the Commission. In re Paine Webber, Jackson & Curtis, Inc. (CFTC Docket No. 86-10); In re Merrill Lynch, Pierce, Fenner and Smith, Inc. (CFTC Docket No. 86-8); and In re E.F. Hutton (CFTC Docket No. 86-4).

240/ Among the records to be maintained are trading cards, orders, trade registers, journals, ledgers, copies of confirmations, purchase-and-sale statements, and all other records prepared in the course of its business of dealing in commodity futures, commodity options, and cash commodities.

trade registers "show, by appropriate and uniform symbols, any transaction which is made noncompetitively in accordance with written rules of the contract market which have been submitted to and approved by the Commission in accordance with the provisions of [Regulation] 1.38."

Thus, the Commission's regulations require that FCMs, introducing brokers, and members of contract markets keep extensive documentation of their futures, options, and cash commodity transactions, retain those documents, and produce them upon the request of the Commission, and identify and mark all such documents pertaining to EFP transactions. 241/ This includes records of cash commodity transactions underlying an EFP to which the FCM, introducing broker, or member of a contract market is a party. Examples of the types of records which might be required would be cash confirmations, telexes, cash contracts, or any

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241/ The Commission imposes other requirements that must be satisfied in reporting EFPs. Part 16 of the Commission's regulations requires each contract market to supply the Commission with the total number of EFP transactions by clearing member [Regulation 16.00(a)(4)] and, additionally, requires each contract market to publish "the total quantity of futures for cash transactions which are included in the total volume of trading." Regulation 16.01(a)(2). Part 17 requires FCMs, members of contract markets, and foreign brokers, to report to the Commission the quantity of EFPs in each special account which has a reportable position and on the first day the account is no longer reportable. Regulation 17.00(a)(1), (2)(ii). In addition, the Commission may issue a special call under Part 21 that requires information about EFPs to be submitted for the commodity, contract market, and delivery months named in the call. Regulation 21.03(e)(1)(iii).

other records documenting the transaction. These records are essential to the success of the self-regulatory programs of the exchanges in monitoring EFP activity (most exchanges already impose similar requirements on their members). These records are equally important to the Commission's rule enforcement program which must be able to confirm whether a given EFP is _bona fide_ and properly executed.

The requirements of Regulation 1.35(a) may not, however, extend to records of cash transactions underlying EFPs involving the customer(s) of an FCM since those transactions arguably do not relate either to the FCM's business of dealing in commodity futures (for itself or customers) or to "its business" of dealing in cash commodities. Assessment of the _bona fides_ of a cash transfer as part of an EFP requires that cash documentation be readily available to the exchanges and the Commission for surveillance purposes. The Division, therefore, recommends that the Commission's regulations be amended expressly to require FCMs to obtain from their customers documents evidencing the underlying cash transactions associated with EFPs in response to exchange or Commission requests. The Division also recommends that the amended regulations require customers to provide the requested information to their FCM or directly to the Commission or exchange upon request. Finally, the Division recommends that exchanges be required to adopt rules, if such rules are not already in effect, expressly requiring that their members provide such documents to the exchange upon request.

The Division's recommendations with respect to recordkeeping regulations are intended to assure that the documentation necessary to the meaningful investigation of EFPs is available to the exchanges and the Commission, without imposing any additional recordkeeping requirements directly on FCMs or members of contract markets. The proposed regulatory amendments would further serve to provide exchanges with an enforceable right to such documents.

It is important to note that FCMs or members of a contract market are frequently parties to one or both sides of an EFP transaction. The proposed regulations would not impose any recordkeeping obligations on those entities as to those transactions which are not already required by Regulation 1.35(a), and the documents already will be available for them to provide. Further, as discussed below, several -- but not all -- of the exchanges already require that their members maintain full and complete records of EFP transactions, including cash documentation, and that they provide those records to the exchange upon request. Thus the proposed amendments would impose the minimum requirements necessary to assure effective monitoring of EFPs by the exchanges and the Commission

B. Exchange Reporting Requirements

All of the exchanges impose certain recordkeeping, record submission, and documentation requirements on members transacting EFPs. Although specific reporting procedures vary among the exchanges, because the futures component of an EFP is cleared in the same manner as any other futures contract, in all cases the commodity, contract month, quantity, price, and identity of the clearing member must be provided to the exchange for clearing.

1. CBT

CBT Regulation 444.01 governs EFPs on that exchange. Under this rule, EFPs are a type of "transfer trade," done for the purpose of "exchanging futures for cash commodities or in connection with cash commodities transactions." Neither this Regulation nor any other exchange rule, regulation or interpretation provides a definition or list of specific elements or conditions defining an EFP. The rule, however, does specify that EFPs "shall be designated by proper symbol as transfer or office trades and must be cleared through the Clearing House in the regular manner." In addition, Regulation 444.01 states that each party to an EFP must file with the Board of Trade Clearing Corporation "memoranda" stating the nature of the transaction, whether there has been a change in ownership, the kind and quantity of the cash commodity, the kind, quantity, and price of the futures, the name of the opposite clearing member (if any), and such other information as the Clearing Corporation may require. 242/ EFP data are not posted on the floor of the Exchange.

242/ Such memoranda are not prepared and submitted to the Clearing Corporation at this time; instead, EFPs, like other futures trades, are submitted for clearing "on-line" with

(Footnote Continued)

The documentation of the cash transaction may consist of an invoice, Federal Reserve confirmation, or forward contract, as appropriate. In the case of EFPs involving financial instruments, the documentation usually consists of wire transfers and confirmations. The CBT Department of Market Surveillance of the Office of Investigations and Audits is responsible for reviewing EFPs and examines these documents to establish that there was in fact a change in ownership of the cash commodity.

2. CME

CME Rule 538 requires EFPs to be reported to the Department of Compliance and requires the clearing members and brokers to the transaction to maintain a full and clear record of the transaction, along with all pertinent memoranda. Documentation of the cash transaction for currency EFPs usually is in the form of an invoice or contract; for other EFPs the documentation may be a letter of confirmation. CME Rule 719, which pertains to EFPs after termination of trading (but before delivery notices are assigned) provides that the transaction must be approved by the President and is to be cleared through the clearinghouse in

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(Footnote Continued)

all of the Commission Regulation 1.35(e) information. KCBT and MGE require the submission of separate trading cards for EFPs which contain the quantity, price, clearing member, contract month, and designated symbol for an EFP but provide that EFPs are to be cleared in the same manner as other futures trades.

accordance with normal procedures. 243/ In addition, Rule 719 requires that the transaction be designated clearly as an EFP, recorded by the Exchange and clearing members, and reported to the membership. Finally, Rule 719 requires each party to file with the clearinghouse all memoranda detailing the terms of the transaction. Rule 719's requirement that EFPs after the termination of trading be approved is designed to avoid unexplained changes in open interest and to ensure that the clearinghouse does not assign delivery notices for those contracts.

The CME requires that every EFP be documented with an acceptable trading card or order prepared by one of the parties. 244/ The documentation must be submitted to an Exchange official for posting on the trading floor. The trading card or order ticket must contain the following: the buying and selling firms, the contract and contract month, the quantity, the futures price, and the date executed. The card or ticket is time-stamped

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243/ According to the structure of the Exchange's rule book, Rule 719 would only apply to agricultural contracts, but the Exchange interprets this rule to apply to all contracts. It is, however, invoked only infrequently, and the only instances recalled by Exchange staff occurred in lumber.

244/ These trading cards and orders are the same as other trading cards and orders except for the designation of the transaction as an EFP. The Exchange does not specify which party (buyer or seller) is responsible for reporting the EFP. This is usually established by the prior dealings and practices of EFP participants. Sample copies of Exchange EFP documentation can be found in Appendix 17, along with sample documents and contracts for other markets.

and identified as recording an EFP. The Exchange official posts the EFP clearing member, quantity, and futures price on a bulletin board on the Exchange floor. Exchange staff also noted that EFP information is made available to all of the commodity news services. 245/

If an EFP is transacted after trading hours, one of the brokers must prepare an EFP trading card and the following morning submit it to an Exchange official. Normally, EFP cards can be submitted up to one-half hour after the close of the day's trading in the contract. After that time, it will be identified as an "as of" EFP. If an EFP card is not submitted on the actual trade date, it is to be submitted as early as possible on the following trading day. The CME has no specific rules, however, governing the timely submission of EFP trading cards. The EFP trading cards are sent to the CME's Market Surveillance Department, which is responsible for retaining them. 246/

3. NYMEX

NYMEX Rule 6.21, governing EFPs generally, and the EFP rules for each of its energy contracts -- crude oil (200.20), heating oil (150.14) and gasoline (190.14) -- together impose certain recordkeeping requirements on members transacting EFPs.

245/ EFP information is made available to the news services by all exchanges. It is, however, not routinely disseminated by those services. Some services make the information available to their customers for an additional charge.

246/ CME Special Executive Report S-1652 (June 26, 1986).

The EFP must be reported during hours of trading (EFPs taking place overnight are reported at the open) and may take place until 2:00 p.m. of the first business day following the last trading day of a futures contract. Initially, EFPs are reported on a "pit card." 247/ After the pit card data are entered, a transfer form is generated which is filled out identifying the clearing members involved. After the transfer form is processed, a report must be submitted which contains information showing that the transaction resulted in a change of ownership and the date thereof, the kind and quantity of cash commodity and futures, the price at which the future is to be cleared, the names of clearing members, and such other information as the Exchange may require.

The required report must be made by the party selling futures in the EFP. Notice is posted on the floor of the Exchange on the day that the EFP is made or, if after the close, the next business day. The contract, contract month, and quantity of the EFP are posted on the wallboard. 248/ The EFP also appears on the Exchange's trade register (the "Street

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247/ The "pit card" is a trading record prepared by the selling party to each trade which shows the member's name, commodity, delivery month, quantity, price, and opposite trading member, which must be turned in promptly to an Exchange employee in the pit, and which is time-stamped and used for entering trades into the Exchange's computer system.

248/ The "wallboard" at NYMEX, Comex, CSC, and NYCE is the electronic display board.

Book"), and the daily volume of EFPs is shown separately on the Daily Futures Report. 249/

All of the Exchange's records then will identify the trade as an EFP, but the trade will be handled as any other futures position. The EFP is cleared in accordance with normal procedures and identified and recorded as an EFP by the Exchange and clearing members involved. NYMEX rules require that each seller and buyer satisfy the Exchange that the EFP is _bona fide_, and provide that the clearing members shall obtain all documentary evidence and make that evidence available at the Exchange's request. NYMEX requires that a clearing member submit a Form EFP-1, which documents the EFP and certifies the EFP is _bona fide_, to the Clearing Department by 12:00 noon on the business day following an EFP. A Form EFP-2, which documents the actual transfer of possession of the cash commodity, must be submitted to the Exchange's Compliance Department within five business days after physical delivery has occurred. NYMEX is the only exchange with an affirmative requirement that the clearing member routinely submit documentation of the cash transfer for every EFP. 250/

249/ The Daily Futures Report is a daily report of volume, open interest, and high, low, and settlement prices for each futures contract.

250/ It should also be noted that the NYMEX Market Surveillance Department recently has begun to implement an on-line computerized review of EFPs.

4. Comex

Comex Rule 4.36 requires that EFPs be reported to a designated Exchange employee. The report must specify the seller of the future and the number of contracts and generally is submitted by the selling floor broker. Thereafter, a "ring slip" is prepared which shows the quantity, month, reporter, and seller. Exchange rules impose no time limit on the reporting of EFPs. EFPs are posted on the wallboard on the Exchange floor showing contract, contract month, and volume. EFP information also appears on the Exchange's Price Change Register, Daily Brokerage Recap, 251/ Cleared Trades Register 252/ and Daily Market Report 253/ (contract month and EFP totals).

Members and clearing members involved in an EFP must maintain full and complete records of EFPs and identify and mark by appropriate symbol or designation all transactions or contracts and all orders, records and memoranda of such transactions. For these purposes, Comex defines complete records as

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251/ The Daily Brokerage Recap is Comex's official record of trading under Commission Regulation 1.35(e).

252/ The Cleared Trades Register shows for each clearing member the trade date, bracket, commodity, month, price, broker, opposite broker and clearing member, trade type, customer type indicator, and time of submission for all cleared trades.

253/ The Daily Market Report at Comex and CSC is a daily report of volume, open interest, and the high, low, and settlement prices for each futures contract. It corresponds to the Daily Futures Report at NYMEX.

sales invoices, delivery instructions to a depository or dealer, confirmations from a depository or dealer showing delivery and receipt of payment, and, if necessary, physical inventory records. 254/

5. CSC

CSC Rule 3.06(e) requires the member or members who are parties to an EFP to report orally the trade to a member of the Floor Committee immediately following execution (EFP trades must be made during trading hours). 255/ That report must include the contract involved, the number of contracts, and the delivery month, and identify the carrying members and clearing members through whom the transactions will be cleared. The selling broker thereafter shall promptly deliver a written copy of the report (a ring slip) to the Exchange. As noted earlier, such report may, at the election of the members involved, also include the futures price at which a coffee or sugar EFP was effected; for cocoa, the report must include the price at which the transaction was effected. EFP volume and contract months are publicly disseminated on a wallboard on the Exchange floor, and total EFP volume by month is also included on the Daily Market

254/ Comex Notice to Members 83-63 (April 20, 1983). Sample copies of cash documentation can be found in Appendix 17.

255/ Although the language of Rule 3.06(c) requires EFPs to be "made during the trading hours," Exchange staff is uncertain whether the transaction must take place during trading hours or simply must be reported during trading hours.

Report. In addition, EFPs appear on the Time and Sales record and on the Exchange's trade register, including the customer type indicator. The EFP is then cleared in the usual manner, and at that time the price of the futures must be included, if not previously indicated. Members doing an EFP must, at the request of the Exchange, provide, without limitation, copies of documents evidencing title to, or contracts to buy or sell, the cash commodity involved.

The Division believes that these five exchanges impose generally adequate recordkeeping requirements for EFPs. Each exchange, either by written rule or in practice, requires an EFP to be reported to the exchange for clearing on some type of trading card or order ticket including, at a minimum, the quantity, contract and contract month, and clearing member or selling broker or both. CME, CBT, and Comex also require that the futures price be reported. Only NYMEX routinely requires that any information regarding the cash transfer be supplied (Forms EFP-1 and EFP-2 and the EFP report submitted at the time of the trade). CBT does not presently require submission of such information, notwithstanding the literal language of Regulation 444.01. The Division notes that a general requirement of such a submission to clearing would be impractical. Furthermore, although NYMEX's requirement is consistent with its trade recordation system, cash documentation can be effectively available for surveillance without being submitted to clearing. Thus, the various approaches employed by the exchanges to secure the cash documentation are not problematic so long as the information is available for surveillance purposes.

In this regard, the exchanges make clear, for the most part, that the clearing members and brokers must maintain full and clear records of all EFP transactions, including documentation regarding the cash transaction. The rules of NYMEX, Comex, and CSC are very specific as to the documentation required. CME's rule requires members to maintain a "full and clear record" but does not specify the types of documents which are necessary. CBT is even less explicit, but staff routinely examines documentation of the cash transfer in monitoring EFPs. Nevertheless, the Division believes it is clear that the exchanges require documentation of EFPs by their members. It is not clear, however, that the members must obtain documentation of the cash transaction from their customers. The Division, as detailed above, therefore recommends that the Commission amend its regulations to require FCMs to obtain such documentation of the underlying cash transaction.

The Division also recommends that the exchanges impose a time limit on the submission of EFP reports. At present, of these five exchanges, only CSC requires that EFPs be reported immediately; NYMEX and CME require that the EFP be submitted on the day it is executed (or the next trading day if executed after the close), and Comex and CBT impose no such time limits. The Division believes that allowing this degree of latitude in the submission of trades for clearing is subject to abuse and falsification of trade data, and that the exchanges should require that EFPs be reported within the same time frame as other futures trades. These standards would vary from one exchange to another depending on how futures trades are required to be reported for clearing. Thus, at NYMEX, for example, EFPs executed during trading hours would have to be reported immediately since other futures trades must be submitted on pit cards at the time of execution. Alternatively, at CBT trades are required to be submitted once intra-day and then at the end of the trading day (except during the CBT's evening trading session when trades are submitted throughout the session). Further, these requirements may be modified as the exchanges implement their enhanced audit trail systems. In any event, EFPs executed after hours should be submitted before the opening of trading the following day.

X. Options on Futures and Options on Physicals as the "Futures" Component of an EFP

The Division's study has failed to reveal any instance in which an option on a futures contract was exchanged for a cash commodity. Apparently this is at least partially because market participants have not yet been able to design a plan to effect such transactions, possibly because of difficulty in establishing an appropriate basis relationship between the option and the cash commodity. However, there is some interest in the concept among market participants, and the Division believes it appropriate to address whether such transactions would be permissible under the Act.

A. Exchange Rules and Viewpoints Expressed

Only CME expressly prohibits EFPs in options under its Rules 538 and 719. The other exchanges' rules are silent on this point, although CSC would view the exchange of options for physicals as permissible under its rules. The Commission previously had approved ACC's rule permitting an exchange of actual commodities and options on physicals traded on the Exchange. However, at the request of Commission staff in expectation of this Report, ACC recently withdrew that rule.

One NYMEX staff member objected to the idea of options EFPs because in his view options do not involve a commitment to deliver. Actually, as noted above, the seller of an option is irrevocably obligated to perform in the event of a buyer's exercise unless it offsets that obligation through the purchase of an option. Staff at CSC expressed the opinion that a deep-in-the-money option is the equivalent of a futures position presumably because of the likelihood of exercise or automatic exercise under some exchange rules.

Four trade house or FCM interviewees believe EFPs in options to be possible although none has executed any. One views EFPs in options as another arbitrage opportunity, while another has considered EFPs in T-bond options but has not yet devised a plan to carry out such transactions.

The Division interviewed a trader who had previously developed the concept of exchanging an exercised futures option for a cash position. 256/ For instance, a trader who purchased a futures call option and then exercises it will receive a long futures position through book entry after the close of trading in the option. However, since the futures position is not assigned until the next morning, the trader could elect to trade out of the futures position by using an EFP. In such a case the trader will buy the cash commodity from a dealer via an EFP, thereby liquidating his futures position before assignment and obtaining the cash commodity.

This individual also believes the concept of EFPs in options on futures to be viable but explained that the instability of option deltas (and, therefore, the value of an option)

256/ Tompkins, Robert G., "Midnight Cowboys: How EFPs are Bridging Cash and Futures Markets," 1 Intermarket, No. 6, 34-35 (November 1984).

could create great risk for the person who accepted an option position in exchange for the cash commodity. If that risk were passed on to the customer, such an EFP would be very expensive.

B. Section 4c and Commission Regulations

The trading on exchanges of commodity options is governed by Sections 4c(b) and (c) of the Act and Part 33 of the Commission's Regulations. At the time of the 1936 Act, when the EFP exemption was adopted, options trading was prohibited in all agricultural commodities then regulated. In 1978, Congress amended Section 4c to prohibit all options trading except in accordance with a regulatory scheme established by the Commission. 257/ This led to the adoption of Part 33 of the Commission's Regulations in 1981 [46 Fed. Reg. 54500 (November 3, 1981)] which established a pilot program for the trading on domestic exchanges of options on non-agricultural futures contracts. Over the years, the pilot program was expanded to options on physicals and options on agricultural futures, and on February 9, 1987 was made permanent for all categories. 258/

257/ The Congressional action codified the Commission's suspension of option trading effective June 1, 1978 as a result of persistent and pervasive fraudulent practices.

258/ Option trading on non-agricultural futures was made permanent effective August 1, 1986 [51 Fed. Reg. 17464 (May 13, 1986); 51 Fed. Reg. 27529 (August 1, 1986)]. Options on agricultural futures and options on physicals were made permanent effective February 9, 1987 [52 Fed. Reg. 777 (January 9, 1987)].

Neither Section 4c(b) nor Section 4c(c), which pertain to options trading, explicitly provides for the extension of 4c(a) exceptions to options. Likewise, in adopting Part 33 the Commission did not explicitly provide for EFPs in options, although Regulation 33.2(a)(2) incorporates Section 4c(a) by reference in order to eliminate the need for repetition of those provisions which the Commission intended to apply to options and which otherwise might be read to apply only to futures transactions [46 Fed. Reg. 54500, 54504]. Given the previous prohibition on options trading, the pervasive nature of the options regulatory scheme, the absence of an explicit statutory provision allowing EFPs in options, and the Commission's desire to maintain strict control over exchange-traded options, the Division does not believe the reference in Regulation 33.2(a)(2) to Section 4c(a) should be interpreted to permit options EFPs. On the contrary, the most logical interpretation of that provision is that the prohibitions in Section 4c(a) against wash trades, accommodation trades and fictitious sales also apply to options trading. 259/

The other ambiguity with respect to EFPs in options arises from amendments to Regulation 1.38(a). Regulation 1.38 was last amended in connection with the adoption of regulations

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259/ By comparison, the prohibitions contained in Section 4b of the Act, which is not incorporated by reference in Regulation 33.2, are separately provided for in Regulation 33.10.

implementing a pilot program for the trading of options on domestic exchanges. At that time the requirement of competitive execution was extended to purchases and sales of commodity options [46 Fed. Reg. 54500 (November 3, 1981)]. There were no changes in the proviso for EFPs, which could imply that EFPs in options fall within the exception for noncompetitive trades executed in accordance with Exchange rules.

As discussed in Section IV.A., supra, the EFP exception should be narrowly construed. Therefore, any ambiguity with respect to the legality of EFPs in options should be resolved against expansion of the exception to these types of instruments. This is particularly true in light of the pervasive nature of the options regulatory scheme and the absence of any explicit provision allowing EFPs. Notwithstanding the Division's belief that EFPs on options are not permissible under the Act and regulations in their present form, the Division recommends that the Commission amend Part 33 of the regulations (and other regulations as appropriate) expressly to prohibit EFPs in options.

In addition to the legal and regulatory bases for a determination that EFPs in options are not permissible, the Division notes other obvious differences between futures and options on futures or options on physicals. An option on a future conveys the right, but not the obligation, to buy or sell a futures contract at a given price. The grantor of the option is obligated to deliver a futures contract in the event of a buyer's exercise, unless he offsets that obligation through the purchase of an option. However, the buyer of the option is not obligated to exercise the option and will not always receive a futures position. Indeed, the purchaser of the option often abandons the option if the position is not profitable and at other times will offset the option by taking an opposite position. Thus, an option on a future is not the equivalent of a futures position. For similar reasons, an option on a physical is not the equivalent of a futures position. Indeed, an option on a physical is removed even further from the concept of a futures position because upon exercise the buyer will receive the physical commodity rather than a futures position. On the other hand, the exchange of an exercised futures option for a cash position in an EFP, as proposed by the interviewee mentioned above, would be acceptable because the trader is exchanging a futures position through the EFP.

XI. Other Approaches to Trading

According to many interviewees, EFPs have become an increasingly common means to limit risk as a result of, or to participate in, price changes when domestic futures exchanges are closed. In the interest rate, currency, and gold markets the cash market is active after the futures markets close, and EFPs provide flexibility in the timing of execution. Another advantage of EFPs is that a price is assured, and an entire order can be filled at one price, an important consideration to fiduciaries who manage the accounts of third parties. If those orders were required to be executed in the market, the result could be several different prices, particularly if a large number of contracts are involved. There are other mechanisms which have been suggested as a means of meeting these particular trading needs without the use of EFPs -- extended trading hours and market linkages, and block trading, respectively.

A. Globalization of Futures Trading

There currently are two domestic approaches to meeting the needs of traders for access to futures trading on a 24-hour basis -- extension of trading hours on domestic futures exchanges and linkages between domestic and foreign futures exchanges.

1. Extended Trading Hours

On April 15, 1987, the Commission approved amendments to CBT rules providing for an evening trading session in the T-bond and T-note futures and option contracts. A major factor in the CBT's decision to extend its trading day beginning April 30, 1987 is the international market for United States Treasury securities, and in particular, long-term securities. The CBT noted that there has been significant growth of business in cash United States securities by Far Eastern participants in recent years. 260/ Until mid-May 1987, however, Japanese law prohibited Japanese firms from trading futures on foreign (including United States) markets. CBT rules provide for evening hours of 5:00 p.m. to 9:00 p.m. Sunday through Thursday. The current evening trading session hours are 6:00 p.m. to 9:00 p.m. Sunday through Thursday to correspond to the active morning session in Japan (Tuesday through Friday); in winter, the hours will be 5:00 p.m. to 8:30 p.m. 261/

The evening trading session provides an opportunity for United States traders to access the futures market during a period of significant international trading in the cash market. It is not clear, however, whether the availability of evening trading will affect the number of EFPs executed in T-bonds. The Division reviewed EFP and volume figures in T-bonds for the

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260/ Statistics cited by the CBT from the Treasury Bulletin showed that trading by Japanese investors in T-bonds expanded ten-fold from 1983 to 1985. (T-bond futures volume at the CBT increased 100% over the same period.)

261/ The trading day in T-bond and T-note futures and options begins with the start of the evening session and ends at the close of trading on the next business day. The daily settlement price is established at the close of the day session.

period May 1 to June 15, 1987 and found that for those 30 trading days, EFPs comprised from .3% to 1.7% of the total trading volume. (EFPs were over 1% of volume on only eight days.) These percentages are consistent with the number of EFPs as a percentage of volume prior to the commencement of evening trading.

2. International Futures Market Linkages

There are presently futures trading links between the CME and SIMEX, and between Comex and SFE. 262/ These links provide a means for participants to trade identical futures contracts over an extended trading day.

The link between CME and SIMEX, initially approved by the Commission on August 28, 1984, provides for the trading of identical futures contracts on Eurodollars, yen, D-marks, pounds, and Swiss francs through a mutual offset system. The mutual offset system links two independent clearing organizations to permit clearing members of each exchange to establish or liquidate a position on one exchange through the execution of a trade on the other exchange.

262/ On February 9, 1987, the CBT and LIFFE signed a memorandum of understanding to develop a trading link between the two exchanges. T-bonds may be the first contract to be traded through the link. Currently, LIFFE and SFE have a linkage agreement for the trading of a United States T-bond contract, but that contract is not identical to the CBT contract.

The link between Comex and SFE, approved by the Commission on August 12, 1986, provides a link for trading of gold futures. All trades executed in the gold contract are cleared by a common clearinghouse, the Comex Clearing Association, Inc. Trading pursuant to the link commenced on November 20, 1986. A linked trading day commences in Sydney as early as 6:00 p.m. New York time and continues for six hours and then resumes at 9:00 a.m. when Comex opens and concludes at 2:30 p.m. with the Comex close.

Although it is not possible to determine the effect of the availability of EFPs on these linkages, or of linkages on EFPs, the Division has reviewed some trading volume and EFP statistics for the linked markets. Thus far, gold futures trading volume through the link at the SFE has been very small -- too low to expect any impact on EFP volume. 263/

With respect to the the CME-SIMEX link, the Division notes that the period following the commencement of trading pursuant to the link also was a period of dramatic growth in the number and percentage of volume of EFPs transacted on CME in the D-mark and yen contracts. Futures trading volume on SIMEX from July 1986 to March 1987 averaged 18,204/month in D-marks (ranging from a low

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263/ The monthly volume figures for December 1986 through March 1987 were 1,003, 698, 919, and 519 contracts, respectively. In comparison, there was total volume of 579,569, 130,078, 140,016, 156,832 for the same four months on Comex. EFP volume in December 1986 was 38,689 contracts (6.68% of futures volume) and was 626,865 contracts for all of 1986 (7.46% of futures volume).

volume of 8,749 contracts to a high of 28,410) and averaged 6,688/month in yen (from 2,528 to 13,020). The monthly average volume in D-marks and yen at SIMEX was 1/30 and 1/49 of the monthly average volume for 1986 at the CME. The number of EFPs alone in each currency during 1986 exceeded the average volume of trading on SIMEX. The number of EFPs each month in D-marks ranged from 26,000 to 44,000 contracts, and for yen ranged from 16,000 to 40,000 contracts. By comparison, Eurodollar EFP activity has been insignificant in relation to futures volume and cash market activity. Eurodollar trading volume on SIMEX, on the other hand, ranged from 30,884 to 78,546 contracts monthly from July 1986 to March 1987.

Again, it is not possible to determine whether there is a correlation between EFP activity and trading volume pursuant to international exchange linkages. As a general rule, however, traders may be expected to favor more liquid markets because of a narrower bid/ask spread, assuming the products offered meet their needs, the desired trade size can be accommodated, and other costs are comparable to or lower than those in the less liquid market. Interviewees told the Division that at present the bid/ask spread is more favorable for EFPs in currency than it is on SIMEX because of the degree of competition among firms quoting EFPs as compared to SIMEX activity. Trading volume on the Comex/SFE link appears thus far to have been insufficient to provide the liquidity necessary to offer an alternative to EFPs. Likewise, the size of the SIMEX market relative to that of CME and to the interbank market 264/ would appear to limit the use of SIMEX as an alternative to EFPs at this time.

There are two reasons why a trader may favor EFPs over linked markets without regard to liquidity and the bid/ask spread: first, the trader may need to acquire the physical commodity and simultaneously hedge that position in the futures market or unwind a hedge; and second, a trader may need to execute a trade at a time when there is no futures market open since linkages and evening trading sessions still cover only a portion of the trading day. As noted earlier, many EFPs in currency take place when trading is active in Europe and CME is closed; during much of that time, SIMEX is also closed.

B. Block Trading

Because of the use of EFPs to obtain a one-price fill on large orders, commentators have drawn parallels between securities block trading and EFPs. 265/ Although they are similar in some respects, fundamental differences exist between the

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264/ The entire currency futures market (CME and others) itself accounts for less than 15% of all foreign currency exchange, and options on currencies less than 8%. Survey of Foreign Exchange conducted by the Federal Reserve Bank of New York as cited by the Bank of England on August 20, 1986 in a press release. Charts reflecting this information can be found in Appendix 14.

265/ See, e.g., S. Smidt, "Trading Floor Practices on Futures and Securities Exchanges: Economics, Regulation, and Policy Issues," Futures Markets: Regulatory Issues 124 (A. Peck, ed., 1985) [hereinafter cited as S. Smidt]. For additional information on block trading and securities trading practices, see Appendix 11.

practices. A comparison of the similarities and differences between block trading and EFPs, however, does provide useful insight into EFPs.

1. Negotiating the Block Trade

Block trading is commonly defined as a securities transaction that involves 10,000 or more shares or a quantity of stock having a market value of $200,000 or more. Block trades became an increasing factor in the securities markets, from the 1960s to the 1980s, as large institutional investors became more active in the securities markets and preferred to manage their portfolios through the use of block trades, rather than through a number of smaller transactions. 266/

The most common method for the execution of block trades in exchange-listed securities involves arrangement of the trades off-exchange, followed by a cross of these orders on the floor. Traders who arrange block transactions are "upstairs" marketmakers, meaning that they arrange the trades off-exchange. Most arranged block trades involve the sale by customers of stock

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266/ In its Institutional Investor Study, the SEC found that the dollar volume of NYSE block trades increased almost elevenfold from the fourth quarter of 1964 to the third quarter of 1970. Institutional Investor Study: Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Congress, 1st Sess. 1540 (March 10, 1971). In 1985, the NYSE reported a record share volume of block trades, equalling approximately 14 billion shares. Block trades accounted for 51.7 percent of NYSE reported volume and amounted to 539,039 transactions for that year. NYSE Fact Book 1986 at 5, 12.

rather than the purchase of stock, so the following description refers to block sales.

A block transaction that involves a cross of orders on an exchange floor begins when a block customer contacts a trader, called a block trader, and places an order for the purchase or sale of 10,000 or more shares. After receiving the customer's order, a block trader must decide whether or not to contact the exchange specialist. By contacting the specialist, the block trader could determine the price of the stock and discover the number of orders in the specialist's limit order "book" and orders in the crowd.

After deciding whether to contact the specialist, a block trader must decide whether to "position" the entire block by purchasing it for his house account, or "shop the block" by contacting potential customers to take the opposite side of the trade. Block traders may also combine these strategies by positioning part of the block and seeking customers for the remaining shares. To position a block, block traders quote a tentative price for the stock to the block customer and the customer may tentatively accept this price. Barring an extreme and unexpected movement in the price of the stock, the customer may be reasonably assured of execution at the quoted price. If the block customer agrees to a sale at the price quoted by the block trader and the trader has positioned the entire order, the trader generally must relay the block order to the exchange floor, in accordance with exchange rules explained below. There, his broker crosses the order with the house account.

When a block trader "shops a block," the trader contacts one or more potential customers to take the opposite side of the block. Block traders continue to "shop the block" until they have a sufficient quantity of orders for the opposite side at a single price. At this point, the trader returns to the block customer and confirms the customer's interest in the transaction at the negotiated price. This final negotiated price is known as the "clean up" price. If the block customer agrees to the trade at that price, then the block trader relays the orders to the floor for a cross trade by a broker, as explained below.

2. Block Cross Trades

Once negotiated, block trades may be completed on or off an exchange. Under exchange rules, however, many blocks must be executed on an exchange floor. For example, NYSE Rule 390 provides that member firms must complete trades in most listed issues on the floor of the Exchange when the firm participates in a trade as a principal or as an agent for both sides of the transaction. This rule would govern most block trades executed by NYSE members because block traders frequently participate in blocks as principals by positioning shares in their own accounts and frequently act as agent for both the buyer and seller in a block transaction. 267/

The execution of a block trade on the floor of an exchange generally involves a cross trade, where brokers match the order of the block customer with orders on the opposite side of the block and with purchases for their house account. A review of rules established by the NYSE provides an example of the steps involved in block trades on the securities exchanges.

When brokers have orders to buy and sell the same stock on the NYSE for prices that are within the current market quotations, they must follow NYSE Rule 76, which governs all cross trades. Under Rule 76, the broker must "publicly offer the security at a price which is higher than his bid by the minimum variation permitted in such security before making a transaction with himself." Members of the crowd, including the specialist, may participate in the block at the price publicly offered.

When a broker receives orders for the purchase or sale of a block on the NYSE which must be crossed outside the current quotation, the broker is bound by NYSE Rule 127. Rule 127

267/ Under SEC Regulation 19c-1, a block trade by members of an exchange can be completed off-exchange if each side of the block was represented by a different block trader and these traders were acting only as agents for the block orders. In addition, under Regulation 19c-3, block trades can be executed off-exchange by exchange members if the stock is one of those excepted from exchange restrictions. Regulation 19c-3 excepts securities listed after April 26, 1979 and those temporarily delisted after that date.

consists of a chronological list of four basic steps that are to be taken: (1) the block trader must inform the specialist of his intention to perform the trade; (2) his broker must probe the market to determine whether or not he would lose more stock than is reasonable to orders in the crowd; (3) the broker next must fill at least a portion of the limit orders at the post from the block orders; and (4) the broker must then cross the remaining orders at the negotiated clean up price. These steps are described in detail below.

Specifically, when a broker arrives on the floor with block orders that he intends to cross outside the current market quotation, he first "should inform the specialist of his intention to cross a block at a specific price." Next, the broker should probe the market to determine whether or not the block trader will lose more stock to members of the crowd and the specialist than is expected or reasonable under the circumstances. The broker must fill at least some orders at the post during the block cross trade, as explained below.

If the broker decides that he would <u>not</u> lose more stock than expected, then he should announce the clean up price to the crowd and fill at such price all agency limit orders at the post for the clean up price or better. The broker then must cross the remaining block orders. If the broker decides that he <u>would</u> lose more stock than expected, then the block trader either may return to his customers to negotiate a new clean up price or may limit participation in the block by members at the post. He limits participation merely by announcing to the crowd that they cannot participate freely in the block. Once he makes this announcement, the broker must wait, to allow the crowd time to trade on this information. After waiting a "reasonable" time, unspecified in the Rule, the broker fills the minimum number of limit orders required, then crosses the remaining block orders at the clean up price.

As noted above, whether or not the broker allows the specialist and crowd to participate freely in the block, the broker <u>must</u> accept at least a percentage of the limit orders at the post. If all or part of the block is to be purchased for the block trader's account, the broker must fill limit orders at the clean up price before any amount may be purchased by the block trader. On the other hand, if all of the block is for the block trader's customers' accounts, the broker must fill a minimum amount of limit orders at the clean up price on the specialist's book equal to 1,000 shares or five percent of the total amount crossed, whichever is greater.

In addition to completion of block trades on the NYSE, block traders also may execute them on other exchanges or OTC, in either the United States or foreign markets. The mechanics of these transactions are simpler than the mechanics of a NYSE block trade. Traders generally do not have to accommodate limit orders, and for OTC trades, do not have to consider the needs of specialists. In the case of trades executed on regional exchanges, the block trader would negotiate the entire trade off the exchange, then cross the orders on the floor, in accordance with exchange rules. In the case of an OTC trade, block traders would arrange the entire trade and cross the resulting orders. Block customers also may choose to execute the trade themselves off-exchange and without assistance of a broker.

3. Comparisons Between Block Trading and EFPs

As noted above, EFPs and block trades have been compared because both may be used to preserve a price and achieve an immediate transaction for a large order. On the other hand, although EFPs are employed in part to execute a transaction without the risk of an adverse price movement and/or to preserve the basis between the futures price and the cash commodity, EFPS are transacted for a number of other purposes as well.

EFPs allow for delivery at locations and of different qualities of product than those specified in the applicable futures contracts; facilitate hedge transactions; allow the parties to reduce credit risk associated with delivery; enable traders to avoid multiple deliveries; allow trading when the exchanges are not open; and facilitate arbitrage opportunities. Any of these reasons for transacting EFPs could be compromised by subjecting them to regulations similar to those governing block trades in the securities markets. For example, if the parties arrange an EFP in order to reduce credit risk on the cash transaction by selecting the counterparty, it would defeat the purpose of the transaction to allow any trader in the pit, whose ability to perform on the cash market transaction may be unknown, to participate in the transaction. Accordingly, it is not feasible to expose EFPs to the exchange floor and maintain their function.

Despite these differences between block trades and EFPs, commentators have drawn parallels between the two trading techniques. One such commentator concluded that certain methods used for block trades should be adopted for EFPs. 268/ Specifically, he stated that the exposure of securities block trades to the exchange floor "legitimizes" the transaction by ensuring that block prices reflect current market prices. 269/ He criticized EFPs because the prices lack this exposure to the exchange floor. Accordingly, he proposed that EFPs be completed on the exchange floor in a manner similar to that used for block trades. Other commentators have noted that other exchange members cannot participate in the transaction without such exposure and reason that lack of participation in EFPs by other traders could have an adverse effect on market liquidity and growth. 270/

268/ S. Smidt, supra note 263, at 81. As noted above, however, not all block trades are in fact exposed to the exchange floor in that, for example, they may be executed OTC.

269/ Id.

270/ The joint venture between CBT and CBOE (approved in principle by the memberships) for the trading of stock index derivative products requires EFPs during market hours to be subject to the auction market but permits the crossing of EFPs in the pit. Ex-pit EFPs are permitted only outside of market hours.

The requirement of "exposure" for block trades is predicated in part upon the fact that there is no disadvantage to the block customer if its offered securities are bought by several persons rather than by the block trader alone as long as the resulting price is the same or better than that offered by the block trader. In contrast, an EFP trader may be disadvantaged by outside participation because the EFP involves an exchange of actual commodities, which may vary in quality or location, and the need for delivery of a specific commodity which may be compromised by such participation. For these reasons, permitting transactions structured as block trades in the futures markets would not be a satisfactory alternative to EFPs.

Because EFPs involve combined cash and futures trades and are executed to preserve a basis and/or to obtain a particular grade or quality of product in a particular location, it is necessary that they be priced noncompetitively. Further, as described in Section VI. of this Report, most EFPs are executed at current market prices, at least with respect to one leg of the transaction. Moreover, where EFPs are not priced at the current market there may be a commercially appropriate reason, not inconsistent with the scope of the EFP exception, for that practice. The Exchanges may, however, impose limitations on the price of the futures portion of an EFP as CSC and NYFE have done. With respect to impact on liquidity, as noted in Section VIII.D. above, the individuals interviewed by the Division unanimously agreed that EFPs, which constitute no more than 25% of the volume of any market, and more commonly comprise 8% or less of volume, are not harming liquidity at this time. Moreover, in some respects EFPs may actually aid liquidity because they may bring an additional trade to the market and provide traders with an additional means to manage risk. Further, EFPs may be used to reduce congestion or bring additional supply into a market and as such may aid liquidity.

Another difference between EFPs and block trades is that there are no regulations in the securities industry that forbid arrangement of a trade off-exchange. Block trades fit into the well-accepted securities practice of off-exchange negotiations. Indeed, where not restricted by exchange rules such as NYSE Rule 390, block trades can be executed entirely off-exchange. In contrast, EFPs are a limited exception to the Commodity Exchange Act's prohibition on the noncompetitive execution of futures transactions.

Although EFPs are different from block trades, traders may execute an EFP in part for reasons similar to those for block traders. For example, in an historically illiquid market, traders may arrange an EFP as a way of ensuring that they could execute a large transaction. Provided that the EFP is otherwise *bona fide*, that purpose would not affect that conclusion. Thus, notwithstanding the important differences between EFPs and block trades detailed above, EFPs sometimes can be done for purposes similar to those underlying securities block trades.

XII. Conclusions and Recommendations

The Division's study revealed that EFPs have assumed a significant role in many markets. In particular, in the grain, sugar, cocoa, and energy markets, EFPs provide an efficient mechanism for commercial participants to integrate their cash and futures trading activity. In the financial, currency, and gold markets EFPs provide an additional method to manage portfolios, take advantage of profit opportunities, and participate in markets on a 24-hour basis. Further, the use of EFPs increased significantly between 1983 and 1986, with EFP volume increasing as much as ten-fold over that period in some markets, and a variety of trading strategies have been developed to make use of the EFP practice.

The Division began its study of EFPs in part because of concerns about potential abuses of the EFP mechanism for noncompetitive futures trading without a corresponding *bona fide* cash transfer. Although the potential for abuse is clearly present, most notably with EFPs involving transitory ownership of the cash commodity (such as those which take place in the gold and currency markets), the Division's study did not indicate that widespread abuses of the EFP exception are currently taking place. 271/ Moreover, most of the EFPs now used to facilitate

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271/ On the other hand, the Division's study did not include an examination of particular EFP transactions and is based on the information provided by exchanges and market participants.

trading strategies, for instance arbitrage trading, appear to involve both cash and futures transactions and to be appropriate to the business purpose to be achieved. Finally, gold and currency EFPs do not appear to be confined to those designed to establish a futures position noncompetitively through transitory ownership of the cash commodity.

The Division believes that as an exception to the competitive execution requirements that generally apply to futures trading, the scope of transactions conducted under the aegis of the EFP exception should be limited. In this regard, the language in Section 4c(a) that nothing in the "section is to be construed to prevent [EFPs]" is intended to prevent the named transactions from being defined to include EFPs. Without the specific exception such transactions might have been interpreted to include, and hence to prohibit, EFPs. Further, the language of the statute itself does not indicate whether <u>all</u> transactions structured as EFPs are excepted, or whether some transactions which may be structured as EFPs but which may not be <u>bona fide</u> may still be prohibited by Section 4c(a). Considering the general purposes of the Act, the history of EFP practices at the time, and the specific statutory language, the Division has concluded that in order to qualify for the EFP exception a transaction must comply strictly with the provisions of Section 4c(a) and applicable exchange rules. Further, the EFP transactions must not be designed to accomplish some otherwise illegal purpose. To conclude otherwise would provide a ready means for traders to engage in the types of detrimental practices prohibited by Section 4c(a) or other abuses proscribed by provisions of the Act, without regard to the benefits of EFPs which Congress intended to preserve.

As provided in Section 4c(a) and Regulation 1.38, EFPs are limited to transactions that have been executed in accordance with exchange rules approved by the Commission. Thus, the responsibility for regulating EFPs lies in the first instance with the exchanges. The existing exchange rules, however, generally provide little guidance as to the permissible scope of EFPs. The Division has endeavored, therefore, to define the scope of the EFP exception by enumerating the essential elements of an EFP as required by the language of Section 4c(a). Further, the Division has sought to provide guidance for exchange evaluation of the <u>bona fides</u> of an EFP, and to the users of EFPs, by setting forth additional indicia which the Division believes should be examined in evaluating particular EFP transactions.

The essential elements of an EFP described in this Report -- that the cash commodity and futures trades be integrally related, that an "exchange" of cash for futures take place, and that there be separate parties to the EFP -- are derived directly from the statutory language. Exchange EFP rules cannot, of course, confer an exception to competitive trading which is broader than that provided for by Section 4c(a). The Division has set forth indicia to provide the exchanges with additional means of assessing whether the essential elements are present in a particular EFP. The failure of a given EFP to meet any of the individual indicia will not alone require a finding by an exchange that the EFP is not bona fide, rather, the indicia are factors which should be applied in evaluating the underlying bases for an EFP. Evaluation of EFPs pursuant to the indicia should provide a basis for an exchange to determine whether an EFP complies with exchange rules.

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. The frequent references in this Report to standard cash market practices and commercial appropriateness are designed to address those evolving needs.

Notwithstanding the Division's view that the exchanges should be free to adopt rules and approaches to EFPs which are appropriate to their markets, the Division has identified certain areas in which additional regulatory clarification and authority or additional exchange rules are desirable. The most important of these is the need for adequate records of cash transactions associated with EFPs to be available to the exchanges in order that they may effectively carry out their self-regulatory responsibilities.

At present, the Commission's regulations do not explicitly require that FCMs and other persons handling, executing, clearing, or carrying EFP transactions obtain data from their customers with respect to a cash transfer in an EFP. Further, the exchanges do not uniformly impose such a duty on their members. Moreover, the duty of a customer to provide such documentation is not expressed in the Commission's regulations or exchange rules. This information is essential to the ability of exchanges to conduct a meaningful review of EFP activity on their markets and assess the _bona fides_ of particular EFP transactions. The information is equally necessary to the Commission's general oversight and enforcement program which must be able to confirm whether exchanges have adequate programs to detect EFP abuses and whether particular EFPs are _bona fide_.

For the foregoing reasons, the Division is recommending that the Commission's regulations be amended as follows:

1. That FCMs and members of contract markets be required to obtain from their customers documents evidencing the underlying cash transactions associated with EFPs in response to exchange or Commission requests.

2. That customers be required to furnish the requested information to their FCMs or members, or directly to the exchanges or Commission upon request.

3. That the exchanges be required to adopt rules, if such rules are not already in effect, requiring that their members provide such documents upon request by the exchange or the Commission.

The Division has made this recommendation to assure that the documentation necessary to the meaningful investigation of EFPs is available. The proposed amendments would achieve this result without imposing any additional recordkeeping requirements directly on FCMs or members of contract markets. In this regard, the proposed amendments address only documentation of cash transfers associated with EFPs executed for customers, since Regulation 1.35(a) clearly requires FCMs and members of contract markets to maintain such records for their own business and to provide those records to the Commission on request.

One of the indicia identified by the Division for assessing the *bona fides* of an EFP is whether there is a reasonable correlation between the cash commodity being exchanged and the futures contract involved in the EFP. The exchanges have applied slightly differing standards and have made determinations in individual cases with respect to the acceptability of the cash component. In the interest of providing some guidance to the users of EFPs, the Division recommends that:

> The exchanges make public their determinations with respect to the acceptability of particular commodities as the cash component in an EFP. When these determinations are of general applicability, the provisions of Section 5a(12) of the Act and Commission Regulation 1.41 will be applicable.

With respect to additional exchange rules, the Division notes that although EFPs are executed outside the trading pit and sometimes outside of trading hours and thus may not be reported immediately to the exchange, the exchanges are responsible for enforcing their EFP rules, which includes monitoring compliance and investigating customer complaints arising out of those transactions, in the same manner as they do for competitively executed trades. So that the exchanges can adequately carry out these responsibilities, the Division is recommending the following:

> That exchanges require their members to report EFPs as soon as possible after execution, or at least within the same time frame as other futures trades on their markets. EFPs executed after exchange trading hours should be reported before the open of trading on the following trading day.

This would enable the exchanges to take timely remedial action (such as the issuance of an intra-day margin call or a direction to reduce the size of a position) that may be necessary in a particular case. This recommended approach will permit the exchanges to set their own timely reporting requirements and does not require more prompt submission of EFP data than is required for other trades. The exchanges could, of course, impose stricter limitations on EFPs if they desire.

The futures positions resulting from an EFP are executed off-exchange and may occur outside of exchange trading hours, but once the futures trade is reported to the exchange, it is cleared identically with other futures trades and thereafter is subject to the same margin requirements as other futures contracts. Also, as with other futures positions, the clearinghouse does not assume responsibility for a futures position established by an EFP until it has been cleared. Because EFPs may be executed after hours, however, there may be a delay in the reporting and clearing of the resulting futures trades. As with other futures trades, it is possible that a trader could overextend himself in trading EFPs and be unable to finance the positions when cleared. Further, the exposure of one party to the EFP may increase between the time the transaction occurs and the time it is cleared due to price movements, just as exposure may increase intra-day or overnight. The risk that a party may be unable to finance a position resulting from an EFP may be greater than for other trades if the futures component of the EFP is priced away from the market. The clearing member will remain responsible for the futures obligations arising from an EFP until they are cleared and will remain responsible to the clearinghouse for those positions after clearing. For those reasons, the Division suggests that:

1. Clearing members evaluate the creditworthiness of a customer in deciding whether to accept an EFP order and whether to require advance payment of margin if there is not already sufficient equity in the customer's account to cover the positions which will result, particularly if the futures trade is priced away from the market.

2. Clearing members, as part of their evaluation of a customer's creditworthiness, have internal controls relating to the size of positions which can be executed for a particular account by EFP when the exchange is closed.

Variation margin obligations to the clearinghouse likewise will arise only after the futures position has cleared based on the day's settlement price. Since most EFP futures are priced within the day's trading range, there generally is unlikely to be a greater than expected margin obligation. Nevertheless, because of the possibility that the exposure of one party may increase during the time passing before the EFP clears, as described above, the clearinghouse has an interest in assuring that some controls are maintained over that exposure. For that reason, the oversight programs of the exchanges and clearinghouses with respect to market and financial risk should extend to EFP transactions conducted during and after trading hours.

Finally, it is the Division's opinion that EFPs on options are not permissible under the Act and Commission regulations as they presently are written. Some ambiguity exists, however, because Regulation 33.2(a)(2) incorporates by reference Section 4c(a) of the Act. In addition, Commission Regulation 1.38(a), which requires competitive execution, extends that requirement to options and could be read to permit EFPs in options. Given the previous prohibition on options trading, the pervasive nature of the options regulatory scheme, the absence of an explicit statutory provision allowing EFPs in options, and the Commission's desire to maintain strict control over exchange-traded options, the Division does not believe the language of Regulations 33.2(a)(2) and 1.38(a) should be interpreted to permit options EFPs. Instead, those provisions should be read to extend both the prohibitions of Section 4c(a) against wash trades, accommodation trades, and fictitious sales and the requirement in Regulation 1.38 of competitive execution to options trading. To eliminate any such ambiguity the Division recommends that:

> Part 33 of the Commission's regulations (and other regulations as appropriate) be amended expressly to prohibit EFPs in options.

The Division notes that no interviewee could identify a method by which an EFP in an option could be effected, citing some difficulty in pricing such a transaction. Further, none of these entities is presently executing such EFPs. The Division's proposed clarification will not, therefore, result in limitations on transactions presently being employed by market participants.

In summary, the Division believes that the approach to EFPs set forth in this Report recognizes the importance of EFPs to the marketplace, provides needed guidance to exchanges and market participants with respect to appropriate limits on the scope of EFPs, and provides flexibility for the exchanges to address the needs of their markets and carry out their self-regulatory responsibilities.