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COMMODITY FUTURES TRADING COMMISSION

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COMMENT

April 27, 1998

VIA FACSIMILE, FEDERAL EXPRESS AND ELECTRONIC MAIL

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

Re: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market 63 FR 3708 (January 26, 1998)

Dear Ms. Webb:

The New York Mercantile Exchange ("NYMEX" or the "Exchange") appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc., on the above-referenced Commodity Futures Trading Commission's ("CFTC" or the "Commission") concept release ("Release").

NYMEX is a not-for-profit corporation organized under the laws of the state of New York. It has been designated by the Commission as a contract market for the trading of numerous commodity futures and commodity futures option contracts. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. Public investors in our markets include institutional and commercial producers, processors, marketers and users of energy and metals products.

Principal NYMEX Recommendation and Response to CFTC's General Questions

The Release began with three general questions and then presented a substantial number of more specific questions. This comment letter first will present the central theme of this letter and then will address the three general questions before turning to certain of the more specific questions. NYMEX will respond to those questions of greatest interest to the Exchange and most pertinent for contract markets generally.

Exchanges of futures for physicals ("EFPs") are expressly permitted by Section

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The New York Mercantile Exchange is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, propane, platinum, and palladium. The COMEX Division offers trading in gold, silver, copper, and the Eurotop 100 index.

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4c(a) of the Commodity Exchange Act ("Act") pursuant to the rules of a board of trade that have been approved by the Commission. This statutory structure gives futures exchanges authority in the first instance to fashion rules relating to EFPs as well as other transactions not involving the open outcry auction method of execution, such as office and transfer trades. In turn, such rules must then be approved by the Commission. In addition, the Commission's regulations and procedures provide substantial latitude and discretion to exchanges in their monitoring of EFPs.

There is an inherent logic to this approach. Contract markets vary greatly in many respects. For example, some commodities that are used principally in industry are traded primarily by those involved either in the production or the consumption of such commodities ("industrial traders"). Other commodities are not used in industry to the same extent and are much more likely to be traded by persons and firms who are not involved in the production or consumption of these commodities ("professional investor traders"). In addition, markets can and do evolve over time.

A futures exchange, which has an intimate knowledge of its markets and of its market-users, is in the best position to try to serve the needs of these market-users by tailoring its procedures to recognize the special characteristics of its markets. Hence, it is entirely appropriate that a futures exchange, which serves the public interest by providing open and fair markets that offer legitimate price discovery, should have the initial say in determining the nature of the execution procedures to be permitted at that exchange, including EFP procedures.

NYMEX's principal recommendation to the Commission is that such exchanges should be accorded the greatest possible discretion by the Commission to design procedures that best serve the needs of their market-users. This latitude should apply to procedures for the execution of EFPs.¹ Such latitude also should extend to the execution of less-traditional types of transactions, such as the exchange of futures for swaps ("EFS") transactions, which incorporate into the EFP mechanism a class of commercial transaction that did not exist until several decades after the original EFP statutory language was adopted.

With regard to EFPs, the Commission's first general question asked whether the

¹ Accordingly, it may be appropriate for an exchange to utilize one set of EFP requirements in certain markets that are applicable to one class of participants, such as industrial traders, and another set of EFP requirements that apply to another class of participants, such as professional investor traders; in other markets, such distinctions may not be called for. In addition, as market participants change over time, an exchange might determine at some point to revise EFP procedures that take into account such classes of market participants.

standards articulated in the Division of Trading and Markets' 1987 report on EFPs should be codified in the Commission's regulations and/or refined in any way.² In the Exchange's experience, the guidance provided by the EFP Report has been beneficial, and there do not appear to be any significant problems associated with EFP transactions at NYMEX or at any other exchange that need to be addressed.³ NYMEX questions the necessity of replacing the flexible indicia provided by Commission staff with more detailed, rigid and possibly burdensome regulatory rules, which may well result in the curbing of ongoing innovation in markets regulated by the Commission. Therefore, the Exchange strongly urges the Commission to refrain from codifying the standards in the EFP Report. (Release Question 1).

In the eleven years since the staff issued its EFP Report, the markets have changed and the developments in the use of EFPs have transcended even the indicia of a bona fide transaction that the staff promulgated. Certain financial markets, including precious metals, have adopted customs, policies and/or rules explicitly permitting contingent, or back-to-back (or ABA) cash transactions as the basis for the EFP. Pricing mechanisms have not only remained stable and preserved their integrity, but customers have been drawn into the regulated exchange markets because an exchange has recognized and addressed their market-driven needs. NYMEX would not advise undertaking a new regulatory regime by codifying standards which may, in many instances, no longer be relevant, and, in other instances, may be appropriate as indicia but not as bright-line tests.

The Commission's next general question asked whether other types of "noncompetitive" transactions, such as EFS transactions or "block trades," should be permitted to be executed on or subject to the rules of a contract market and, if so, what standards should apply to these transactions. Consistent with the central theme expressed above, NYMEX continues to support strongly its proposal to permit the use of EFS transactions for NYMEX Division futures contracts, which would be conducted pursuant to appropriate surveillance and monitoring programs that would be analagous to those employed for EFP transactions.

NYMEX also is generally supportive of other innovative procedures, such as the use of "block trades" that, in appropriate markets and circumstances, may provide

²Division of Trading and Markets ("Division"), Report on Exchanges of Futures for Physicals (October 1, 1987) ("EFP Report").

³As noted in the Release, "EFP transactions are currently subject to oversight through a variety of sources, including: (i) the Commission's review of contract market rules governing such transactions; (ii) the Commission's reporting and recordkeeping requirements; (iii) contract markets' enforcement of their own rules; (iv) the Commission's rule enforcement review program; and (v) the Commission's own enforcement program." Release, at 3711.

additional liquidity and utility to a market. However, it is important to emphasize that such initiatives should be left in the first instance to the business judgment of the individual exchanges, and that any such proposal submitted to the Commission for review and approval should properly address the need for customer disclosure and demonstrate that the proposal inherently did not involve harm to customers or to the market. (Release Question 2).

Finally, the Commission's third general question asked for comment regarding the standards that should be applicable to so-called "execution" facilities for noncompetitive transactions executed on or subject to the rules of a contract market. Again, the Exchange believes that individual futures exchanges should make the initial business judgment as to whether and how such facilities might effectively serve the needs of their market-users, and that the Commission should be receptive to such innovative proposals following appropriate review through the Commission's rule review process.⁴ (Release Question 3).

Exchanges of Futures for Physicals as Privately Negotiated Transactions

Before turning to address the specific questions posed in the Release, NYMEX believes that it is important to identify the appropriate terminology that will provide the greatest degree of clarity to analysis of these questions. Section 4c(a) of the Act begins with prohibitions against transactions that are "of the character of" wash sales, cross trades, accommodation trades, or fictitious sales. Section 4c(a) further proscribes transactions used to cause any price to be reported that is not a true and bona fide price. As developed in the Commission's case law, these types of trades are violations of the Act because they give the appearance of submitting trades to the open market while negating the risk or price competition incident to such a market. Thus, the Commission generally refers to these types of trades as noncompetitive trades. In Commission Regulation § 1.38 and again in the Release, the Commission also applies this term when referring to EFPs.

Notwithstanding the phraseology in Regulation § 1.38, the Exchange believes that it is not useful to rely upon the term "noncompetitive trade" as a characterization of EFPs in a discussion of regulatory policy, such as that generated by the Release.

⁴ Under Section 4(a) of the Act, transactions for contracts for purchase or sale of a commodity for future delivery generally must be conducted on or subject to the rules of a board of trade that has been designated by the Commission as a contract market for that commodity. Thus, if any proposed facility would involve transactions in products that are most appropriately characterized as futures contracts or as futures option contracts, such products would need to be designated as contract markets by the Commission. In addition, if the transactions were not conducted pursuant to the rules of an entity that was already registered as a board of trade, the facility would need to register as a board of trade.

Because the term noncompetitive trade is used to refer to the categories of abusive trades identified above, this term is pejorative in tone and the application of the same term to EFPs unfairly associates EFPs with such abusive trades.⁵ In this regard, use of EFPs has long been recognized as a necessary and acceptable commercial practice; indeed, EFPs were provided for by the rules of futures exchanges that predated the passage of the Commodity Exchange Act of 1936.⁶ Accordingly, this comment letter instead will characterize EFPs more appropriately as privately negotiated transactions.

Elements of a Bona Fide EFP: Relationship of the Instruments

The NYMEX Division rules require that the physical commodity be a by-product, derivative or related product to the futures commodity. The COMEX Division rules require that the physical commodity be substantially the economic equivalent of the futures commodity. These requirements in and of themselves ensure a close correlation between the futures price and the price of the cash commodity. The Exchange agrees that in general the futures and cash commodities should exhibit a reasonably consistent price correlation.

Nevertheless, NYMEX does not believe that it is appropriate for the "strong price correlation" standard to be more narrowly defined at this time because of the many potential basis differentials such as time, location, delivery grade, quality, and other particulars to the transaction. (Release Question 4). Also, in view of the requirements that already exist, at least for NYMEX Division and COMEX Division products, the Exchange does not believe that it is necessary for the Commission to require contract markets to adopt a minimum statistical correlation coefficient (to be used in assessing the acceptability of a particular cash commodity for use as the cash leg of an EFP). (Release Question 5).

Elements of a Bona Fide EFP: Relationship of the Parties

In the EFP Report, the Division indicated that a bona fide EFP must be executed between separate parties. Furthermore, the Division suggested that the determination as to whether separate parties were involved in a particular transaction in turn depends

⁵Use of the term noncompetitive trade to characterize EFPs is also a misnomer. A significant number of entities compete to make a market by providing quotes on EFPs, and such transactions are legitimately negotiated at arm's length between competitive counterparties in a free and open market. In this regard, cash market physical transactions and over-the-counter ("OTC") forward transactions, which are also executed in arm's-length transactions between the counterparties, are not referred to as noncompetitive trades.

⁶G. Wright Hoffman, Hedging by Dealing in Grain Futures, 55, note 2 (1925), cited in the EFP Report, at 1.

upon whether the accounts have different beneficial owners or are under separate control. The EFP Report standard permits separate profit centers of a futures commission merchant to engage in EFPs with each other in order to accomplish their trading strategies and to fulfill their business needs. In the Release, the Commission sought comment on the appropriate scope of the separate parties requirement.

NYMEX does not object to the current guideline articulated in the EFP Report. Beyond that general comment, though, it may be useful to point out, on an informational level, that NYMEX has chosen to implement a requirement that is a somewhat more strict position than that articulated by the Division. At present, the Exchange's view is that separate divisions of a corporate entity cannot be counterparties to an EFP. Instead, it has been the Exchange's position that separate divisions of a corporate entity cannot satisfy the "change of ownership" or "transfer of ownership" requirements of the respective NYMEX and COMEX Division rules. However, the Exchange does permit parent corporations and their subsidiaries, as well as affiliated entities, to be counterparties to EFPs. NYMEX requires written documentation explaining the relationship, and Exchange staff assesses and requires an "arms-length" relationship. (Release Question 8).⁷

Elements of a Bona Fide EFP: Nature of the Transaction

The Commission sought comment on the criteria appropriate for judging whether the futures leg of an EFP is bona fide. NYMEX requires that the quantity of futures contracts approximate the quantity of the physicals and that the physicals be a by-product, derivative or related product. This second requirement, as noted above, should ensure a strong price correlation between the futures and physicals. These two requirements of the NYMEX Division EFP rules together serve to ensure that the futures leg is bona fide. (Release Question 10).

The Commission also sought comment on the criteria appropriate for judging whether the cash leg of an EFP is bona fide. In the EFP Report, the Division discussed several factors to be considered in analyzing the parties' intent with respect to the transfer of cash commodity, including: (i) the ability of the cash seller to make delivery and of the cash buyer to take delivery of the cash commodity; (ii) the level of creditworthiness required of the cash seller and buyer; (iii) the form and terms of the cash commodity contract; (iv) the documentation underlying the transfer of cash commodity from the cash seller to the cash buyer; and (v) whether the cash buyer acquires an enforceable claim on the title to the cash commodity.

⁷The Release noted that the EFP Report discussed a method of effecting an EFP transaction in the grain markets called "string trades." As this practice is not used in either the Exchange's energy or metals markets, NYMEX has no special expertise on this practice and will refrain from commenting upon it. (Release Question 9).

In general, the Exchange believes that these factors are acceptable and useful criteria. With regard to (iv), NYMEX Rule 6.21(D), for example, presently provides that, upon request by the Exchange, documentation relating to the EFP, including "evidence as to the change of ownership of the cash commodity or a commitment therefor," shall be obtained by the Clearing Member from the buyer or seller and made available for examination by the Exchange. (Release Question 11).

Transitory and Contingent EFPs

The Commission also sought comment concerning criteria appropriate for determining whether a "transitory" EFP is bona fide.⁸ Returning to the central theme of this comment letter, markets vary significantly and an exchange is in the best position to determine what procedures provide utility to its markets. Therefore, to the greatest extent possible under current law, the Commission should respect determinations made by exchanges as to the procedures that offer the greatest benefits to their markets. In this regard, an exchange may determine, for example, that its markets are served best by permitting certain types of EFPs because they provide needed market access to the contract at times other than during the regular trading session. (Release Questions 12 and 13).

Elements of a Bona Fide EFP: Price of the Transaction

In the Release, the Commission also asked whether it should require that one or more of the legs of an EFP should be within the daily range of their current respective markets. NYMEX's recommended approach for the Commission, which is supported by NYMEX's current rules, would be to not require the price of either leg of an EFP to be bound by pricing in the respective market. As to the futures market, the Exchange notes that an EFP's price will not affect prices transacted during the trading session or the futures settlement price, as the EFP price is not part of the settlement calculations. (Release Question 14).

NYMEX further believes that contract markets should obtain documentation regarding the business purpose (underlying the pricing of an EFP) on an as-needed

⁸The Exchange notes that some EFPs, which are negotiated with an entity making a market in EFPs and which involve "transitory" ownership of the physical, appear to create an unhedged or "naked" futures position for the dealer. However, to protect against the market risk associated with this position, a dealer typically would enter into a counterbalancing cash market transaction with a third party. Thus, it is the Exchange's understanding that transitory EFPs ultimately can and do result in a change in the physical position of the dealer.

basis.⁹ If the price of the futures leg and/or cash leg was inconsistent with current prices, then an exchange today typically would consider requesting an explanation. However, if the prices were consistent with current prices, there would appear to be scant justification for making further inquiry or requiring additional documentation for that EFP. The determination as to whether such an inquiry was necessary should be left to the judgment of the exchanges, which review EFPs on a regular basis; requiring exchanges to make this inquiry whenever examining an EFP transaction would be unproductive and unnecessarily burdensome. (Release Question 15).

Other Regulatory Requirements Governing EFPs: Reporting and Recordkeeping

NYMEX believes that current reporting and recordkeeping requirements relating to EFPs are adequate, both with respect to records maintained by FCMs, such as commodity statements, and to records maintained by exchanges, such as clearing, compliance, and floor records. As concerns commercial accounts, the Exchange does not believe that the CFTC needs to establish any rigid requirements in this area.

NYMEX rules require customary commercial documentation to support an EFP's bona fides. Neither the CFTC nor the exchanges should seek to define for the commercial market the precise format for documenting cash market transactions. The Exchange notes that different cash markets may use slightly different means of maintaining records of cash transactions. NYMEX believes that it would be inappropriate for the Commission to impose extensive and burdensome requirements upon cash market participants that do not take into account the normal corporate records maintained by such participants.

Instead, the Exchange recommends that the Commission confirm that it is willing to rely upon the standard business records maintained by cash market users as part of their normal course of business. As a normal matter, when EFP participants are commercial entities with business operations in the underlying commodity, the transactions should be accepted at face value as bona fide, absent some reasonable belief to the contrary. Also, the Commission should provide the exchanges with some flexibility in terms of their recordkeeping rules so that exchanges may modify their rules over time as warranted. (Release Questions 16 and 41).

Transparency

The Commission noted in the Release that exchanges do not require and

⁹Exchanges, acting pursuant to Commission and exchange reporting and recordkeeping requirements, already have the authority to obtain documentation from their clearing members regarding the business purpose underlying the pricing of an EFP and do request such documentation when it appears appropriate to do so.

generally do not have mechanisms for providing timely information about EFP bids, offers, and transactions. NYMEX believes that existing price reporting standards provide adequate transparency to the marketplace.

For a variety of reasons, the Commission should not impose requirements upon contract markets to obtain and disseminate information concerning bids and offers for EFPs. First, the value to the marketplace of such information is not immediately apparent to the Exchange, as the EFP spread for a particular transaction (between the futures leg and the cash leg) necessarily incorporates the specific details of that privately negotiated transaction between the two principals. Thus, the market might find it difficult to compare and contrast different bids and offers without additional information.

Second, some institutional market users might find such a requirement, which could publicize their efforts to unwind a large position, a sufficient deterrent to prevent them from using EFPs and, perhaps, from using the futures markets altogether. Finally, participants in EFP transactions have understood that, EFPs, as privately negotiated ex-pit transactions, generally do not have the same degree of transparency as that of transactions executed by open outcry on the trading floor of a futures exchange. Historically, EFP participants have been willing to accept this lesser transparency in order to obtain the advantages associated with EFPs. (Release Questions 22, 23 and 44).

NYMEX's Exchange of Futures for Swaps Proposal

Before turning to the specific questions posed by the Commission with regard to EFS transactions generally, it may be helpful to review specific aspects of the Exchange's proposal. The Exchange has submitted to the Commission proposed new Rule 6.21A ("Exchange of Futures For, Or In Connection With Swap Transactions"). Like Rule 6.21, upon which it was modeled, Rule 6.21A would apply to any NYMEX Division contract.¹⁰ In other words, NYMEX's proposal would establish, for EFS transactions, provisions that would be parallel to, but separate from, those governing EFP transactions. Thus, an EFS transaction would follow the structural form of an EFP transaction except that a swap agreement would be substituted for the physical component of the transaction.

Proposed new Rule 6.21A also would include all of the applicable substantive provisions contained in Rule 6.21. Hence, the reporting and recordkeeping requirements for EFS transactions would be the same as those applicable for EFP

¹⁰At present, the trading rules for COMEX Division contracts are governed by Chapter 4 of the COMEX rulebook. The Exchange intends that eventually the NYMEX and COMEX rulebooks will be merged into the NYMEX rulebook.

transactions.¹¹ With regard to EFS trades, the Exchange confirms that it agrees to comply with Commission requirements relating to EFP transactions.¹²

The Exchange's submission of proposed new Rule 6.21A identified a significant number of economic reasons that firms might have for engaging in EFS transactions. In addition, the submission identified other benefits, including the potential benefits to domestic futures markets, to over-the-counter markets, and to financial markets generally.

With regard to the benefits to be derived by EFS participants, EFS transactions would offer many of the same advantages offered by EFP transactions, including the ability to adjust quality grade and to address basis risk.¹³ NYMEX also views the

¹¹Currently, floor members, after being informed of an EFP transaction, record an "E" on the same line as the details of the trade on their integrated pit card/trading card. This identifier tags the trade as an EFP transaction and is included as part of all subsequent Exchange records of the transaction, including with respect to the Exchange's trade register, *i.e.*, the "Streetbook," as well as Exchange Compliance Department computer runs. For example, subsequent to submission of the EFP trade to clearing, the Compliance Department, for each trade date, will distribute to Clearing Members an "EFP Activity Summary." This reports lists transactions flagged as EFP trades and includes essential trade information such as price, quantity, commodity and opposite clearing member. The Clearing Member must review the accuracy of this information and supply the name(s) of the customer(s) to the transaction. The Clearing Member also must sign the last page of this summary to attest that each EFP transaction was a bona fide transaction and was conducted in accordance with Exchange rules and procedures. The same reporting and recordkeeping requirements also would apply to EFS trades.

¹²For example, Commission Regulation § 1.35(e) requires contract markets to identify on their trade registers, by uniform symbols, transactions (such as EFPs) that have been made "non-competitively" in accordance with contract market rules. In addition, Regulation § 16.00(a)(4) requires contract markets to submit reports to the Commission showing, for each clearing member, and further identified by house and customer account, the quantity of EFP transactions. Regulation § 16.01(a)(2) also requires contract markets to publish for each trade date the total quantity of EFP transactions included within the total volume of trading.

¹³With regard, for example, to the crude oil market, historically, firms in a variety of geographic areas that sought to manage the risks associated with the physical commodity directly hedged those risks by participating in centralized exchange markets. Indeed, NYMEX crude oil futures contracts have served as a benchmark for market participants seeking to hedge price risks related to physical barrels of oil. Nonetheless, differences in price may exist across different grade and quality specifications and

financial safeguards of the on-exchange trading environment as potentially beneficial, and attractive to, swap market participants. The Exchange believes that access to these financial safeguards, including those associated with the position limit and margining systems, either for purposes of creating or extinguishing swap agreements, would enable swap market participants to enhance the credit quality of swap positions.

NYMEX also believes that its rule proposal would make the liquidity present in NYMEX energy markets accessible to swap market participants via the EFS process. Additionally, NYMEX notes that swap participants would have the ability to close out futures positions more readily, as the underlying futures contracts approach expiration, and thereby could utilize the Exchange in managing price risk associated with swap market transactions as a potential benefit of the proposal. Thus, in summary, NYMEX concludes that several benefits would accrue to market participants from adoption of the proposed rule, including improvements in liquidity and price transparency, and reductions in basis and credit risk.

In addition, NYMEX believes that its EFS proposal would provide benefits to financial markets generally by enhancing competition among exchange and over-the-counter markets and by facilitating greater usage of NYMEX as a centralized market and as a risk transfer medium. Finally, NYMEX contends that its proposal could aid in linking the on-exchange futures and off-exchange swap markets. (Release Question 24).

Swap transactions, though not physical in the traditional sense, nonetheless subject market participants to the same types of price risk as physical transactions. This view is supported by several policy positions taken by the Commission and/or Commission staff. First, Commission staff have taken the view that swaps may be used as a bona fide hedging instrument.¹⁴ Second, consistent with this position, several

across different geographic regions. Although NYMEX crude oil futures prices generally move sympathetically to, or correlate with, price changes in a number of regions and grade specifications, a firm seeking to hedge risks related to the cash commodity could face exposure to some basis risk when participating in NYMEX markets. Commodity swap instruments play an increasingly prominent role in crude oil and in other markets because they provide a risk management function and also can be individually tailored. Thus, swaps can be modified so as to eliminate substantially the prospect of basis risk.

¹⁴In a 1974 Administrative Determination, the Commodity Exchange Authority stated that if a commodity, product or by-product was hedgeable under the Act, it could be exchanged for futures. Admin. D 239 (December 16, 1974). Exchange staff has not identified any instance in which the Commission later reversed this determination. In the EFP Report, the Division, in reviewing Administrative Determination 239 and three other Administrative Determinations, stated its belief that the Administrative Determinations "are of continuing value in providing guidance with respect to certain

years ago, Commission staff approved NYMEX Rule 9.29 ("Exemptions from Position Limits for Exposure from Commodity Swap Transactions").¹⁵ This rule allows an eligible person to apply to the Exchange for an exemption from NYMEX's speculative position limits, where such exposure is necessary to reduce exposure from commodity swap transactions. Third, through the issuance of the Commission's Policy Statement Concerning Swap Transactions,¹⁶ and the promulgation of Part 35 of the Commission's regulations, the Commission has tacitly acknowledged that swaps (which as previously noted were not in existence at the time the original EFP statutory language was adopted) are acceptable and appropriate instruments that are commonly used in commercial transactions today.

EFS transactions are, and should be recognized by the Commission as, a valid and appropriate means of also addressing these risks. EFS transactions are permitted on futures exchanges in other jurisdictions. For example, the International Petroleum Exchange of London, Ltd. ("IPE") has permitted the use of EFS transactions at that exchange since before April 1992. IPE staff, in discussions with Exchange staff, have indicated that there have been no special problems associated with these types of transactions since their introduction at the IPE more than six years ago.

In its submission to the Commission, NYMEX affirmed that it had not identified any evidence suggesting that adoption of the proposal would harm existing liquidity in NYMEX markets. More generally, the Exchange has not identified any potential costs or risks of permitting EFS transactions, including with respect to the effect on price discovery, risk transfer, and the competitive character of "on-exchange" transactions. (Release Question 25). Because NYMEX does not believe there is a need to ameliorate any competitive costs or otherwise safeguard the competitive conditions of the on-exchange market, the Exchange does not believe that special

aspects of EFPs." EFP Report, at 30. In addition, the Division noted that it was:

"of the opinion that the definition of bona fide hedging contained in Regulation 1.3(z) may be of some utility in identifying an acceptable cash component for an EFP, and several exchanges employ it as a guideline. The hedge definition is consistent with an examination of the correlation between the cash commodity to be exchanged and the futures contract." (Report, pp. 30-31).

Subsequently, the Commission issued a clarification of the definition of "bona fide hedging transactions and positions" provided in Commission Regulation § 1.3(z). 52 F.R. 27195 (July 20, 1987). Commission staff have advised Exchange staff that Regulation § 1.3(z) would permit the use of swaps in bona fide hedging.

¹⁵Rule 9.29 was approved by letter dated November 8, 1990.

¹⁶54 F.R. 30694 (July 21, 1989).

provisions are necessary. (Release Question 28).

Accordingly, NYMEX again urges the Commission to approve proposed new Rule 6.21A and to allow this proposed innovation to be implemented and tested in the marketplace. (Release Question 26). With regard to the question of whether EFS transactions should be limited to particular markets, participants or types of transactions, the Exchange notes that, under the NYMEX proposal, the swap component of the EFS transaction would need to comply with the requirements of Part 35, with the Commission's 1989 Policy Statement Concerning Swap transactions, or otherwise qualify for or fall within other exemptions or jurisdictional exclusions under the Act or Commission regulations. The effect of this requirement would be to limit the participants who would be eligible to participate in EFS transactions. Concerning the issue of particular markets, the NYMEX proposal, as noted above, would permit an EFS transaction to be effected for any NYMEX Division futures contract. (Release Question 27).

Disclosure

The risk disclosure statement set forth in Commission Regulation 1.55(b),¹⁷ as noted in the Release, does not specifically address EFPs. However, a futures commission merchant or an introducing broker has a duty to provide its customer with all material information relating to a transaction.¹⁸ The Commission expressed its belief in the Release that some guidance as to the form and content of disclosure concerning EFPs might be appropriate.

The Exchange believes that it may be appropriate for the Commission to offer some guidance on such disclosure. The Commission might consider adding a short description of EFPs to the standard risk disclosure statement. Such a description could explain that such transactions are negotiated privately, rather than through the usual auction method of execution, and that a customer's FCM might take the opposite side of the EFP. (Release Question 19). However, the required disclosure should vary according to the commercial sophistication of the EFP participant. In this regard, in the

¹⁷Commission Regulation §1.55(a)(1) prohibits a futures commission merchant ("FCM") or an introducing broker ("IB") from opening a commodity futures account for any customer unless the FCM or IB first provides the customer with a written risk disclosure statement prepared by or approved by the Commission and receives a signed acknowledgment from the customer that he or she has received and understood this statement.

¹⁸Under Commission Regulation § 1.55(f), compliance with the specific disclosure requirements of Regulation § 1.55 does not relieve an FCM or IB from any other disclosure obligation it may have under applicable law. These disclosure obligations arise under Section 4b of the Act as well as under state and common law.

event that the Commission determines to issue rules in this area, the Exchange urges the Commission to move toward the adoption of a uniform definition for sophisticated investors. (Release Questions 17, 18 and 42). Furthermore, the Exchange would argue against an explicit requirement that Commission registrants obtain customer consent before executing an EFP on the customer's behalf. (Release Question 20.)

Internal Controls

In the Release, the Commission noted that a basic purpose of Commission Regulation § 166.3 is to protect customers by ensuring that their dealings with employees of Commission registrants will be reviewed and overseen by other officials in that firm.¹⁹ The Commission noted further that Commission Regulation § 166.3 currently applies to EFPs. The Commission then expressed its belief that some guidance may be appropriate as to the types of internal controls necessary to ensure compliance with regulatory requirements concerning the essential elements of bona fide EFPs, reporting and recordkeeping, and disclosure.

NYMEX questions the need for special guidance pertaining to internal controls on EFP requirements. Again, the Commission has yet to identify publicly any significant or wide-spread problem concerning firm compliance with exchange EFP requirements, which are based upon the EFP Report standards. Further, the Exchange believes that a firm's internal controls for EFP compliance do not pose any unique challenges to a firm's compliance with its regulatory requirements; instead EFP requirements are perhaps most appropriately viewed as a subset among many regulatory requirements that need be addressed as part of a firm's general internal controls programs.

Therefore, It may be appropriate for the Commission, in issuing guidance on internal controls, to provide more general guidance on a firm's overall approach to compliance with regulatory rules and procedures. However, in the event that the CFTC determines to speak on this particular issue, the Exchange urges the Commission to provide guidance that would be commercially reasonable. Thus, for example, NYMEX requires its Clearing Members to provide documentation on the cash side of an EFP to NYMEX upon request by the Exchange. The Exchange does not require our Clearing Members to obtain this information for every transaction. (Release Questions 21 and 43).

In summary, the Exchange strongly recommends that the Commission accord to exchanges the greatest possible discretion to design procedures and make use of

¹⁹Commission Regulation § 166.3 generally requires all Commission registrants, except associated persons who have no supervisory duties, to supervise diligently the handling by its partners, officers, employees and agents of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities relating to its business as a Commission registrant.¹

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facilities that best serve the needs of their market-users, including procedures for the execution of EFPs and for the execution of other types of transactions, such as EFS trades. In addition, the Exchange urges the Commission to refrain from codifying the standards in the EFP Report.

* * * *

NYMEX thanks the Commission for the opportunity to submit comments concerning this concept release and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,



R. Patrick Thompson
President

cc: Chairperson Brooksley Born
Commissioner Barbara P. Holum
Commissioner David D. Spears
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