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MINNEAPOLIS GRAIN EXCHANGE

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COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

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April 24, 1998

COMMENT

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COMMODITY FUTURES TRADING COMMISSION RECEIVED OFFICE OF THE SECRETARIAT

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

RE: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market

Dear Ms. Webb:

In response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") request for comments on the above referenced matter as published in the January 26, 1998 Federal Register, the Minneapolis Grain Exchange ("MGE" or "Exchange") submits the following comments. The Exchange's comments generally follow the summary of questions the Commission listed in the Federal Register.

To date, non competitive trade activity at the MGE has been limited to exchanges of futures for physicals ("EFPs") and transfer trades; in other words, only those exceptions which have traditionally been made available to a contract market. As a named contract market, competitive and permitted noncompetitive trades executed or cleared by the Exchange have been subject to a general regulating structure that has been inflexible and stifling at times. However, the Exchange was not subject to unfair treatment since all contract markets had to abide by the same surveillance and enforcement rules. The Exchange has consistently stated that all contract markets should compete on a level playing field. Therefore, the Exchange would expect changes to the Commission's regulations or codification of any standards articulated in the EFP Report to be uniformly applied to all exchanges. The MGE is concerned, however, that after adoption of any changes and rules, execution facilities for noncompetitive transactions will have still greater freedom from regulatory constraints than contract markets have now. As the Commission conceded in its concept release, "Indeed, it could be argued that some of these facilities have evolved to the extent that they are functionally the equivalent of designated contract markets." (Federal Register, page 3720.)

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The MGE does not believe such unregulated or under regulated facilities are in the best interest of the marketplace as a whole. If these facilities do not have to play by the same regulatory rules as designated contract markets, then the exchanges simply become a clearing house for the futures leg of an EFP while being burdened with the obligation to verify the essential elements of a bona fide EFP.

The Exchange believes there should be a strong price correlation between the futures and cash legs of an EFP. Indeed, it is the threat of delivery that forces convergence between cash and futures markets; the greater the perceived threat, the closer the correlation between cash and futures. Lack of a sufficient price correlation would naturally indicate to a contract market or the Commission that potential deficiencies exist in the futures contract or cash market. Even worse, market manipulation may be occurring. However, the Exchange does not favor a minimum correlation coefficient applied to each or all commodities involved in EFPs.

Proponents of block trading argue that it sometimes takes excessive time to execute a large trade in a futures pit. Also, during that time, prices may move against the block trading advocate. Is that not the function of price discovery in a futures pit -- to establish the point of equilibrium for each increment of supply and demand for a commodity? Is a country elevator manager in rural Minnesota going to have confidence in the price displayed by the futures exchanges, if he knows the big trades have already been completed out of his view?

Since price correlation can be a significant marketing tool, the MGE continuously updates and discloses to the public the price correlation for all of its contracts. This helps provide the public with confidence in the futures market. However, the MGE is concerned that execution facilities would be able to place a veil of secrecy over the cash leg and effectively distort the price correlation the Exchange uses. If these cash legs are excluded from the contract market's correlation factor, the question arises as to whether the public can rely upon the price correlation to trade the futures market. The Exchange would oppose any rule change or secondary EFP markets that would negatively affect the price correlation that current market participants utilize in their trade decisions. Furthermore, the Exchange believes that a contract market is best able to ensure all essential elements of an EFP transaction have been met, including separate parties, delivery, and qualitative correlation. The Exchange already informally uses much of the criteria in the Commission's EFP Report for judging whether the cash and futures legs of an EFP are bona fide. Since a contract market is best qualified to judge an EFP, the Exchange does not favor codification of the criteria including pricing requirements for both legs. However, to protect the general public, such detailed standards may be necessary, if execution facilities or market participants are permitted to conduct EFP trading, including block trading, secretly or by any form of prearrangement.

As a contract market, the MGE has found that the current reporting and record keeping requirements relating to EFPs are adequate. However, further risk disclosure to the public concerning EFPs may be needed if current standards are reduced or execution facilities are allowed to proliferate. Additionally, internal controls, such as a formal written policy and procedure for execution of EFPs, should be required of execution facilities. Such facilities not attached to a contract market do not have the surveillance controls or experience to protect the public that the contract markets have developed.

The MGE does not believe that it is necessary for most contract markets to publicize bids/offers for EFPs. Market basis and price correlation have proved adequate to provide the public with reliable market prices at the MGE.

The characteristics of EFPs executed on contract markets have been well established through the years. However, current, proposed and even potential execution facilities open another new trading venue to the public. Such new trading venues invite searches for potential abuses not available or looked for at designated contract markets.

Another significant concern with additional EFP execution facilities is the real potential for multiple market prices for commodities. A block trading facility providing services to sophisticated or commercial traders may have a different EFP price than that of a contract market. If the EFP prices at both markets are disseminated, which price would or should the public rely on for future commodity pricing? The MGE believes multiple EFP execution facilities could easily create multiple commodity prices. If execution facilities do not disseminate information about cash trade activity, the question arises as to whether or not real price discovery has occurred in the futures trading pit. The burden then rests with the contract market as to how, or even if, to disclose such activity to the marketplace. If market participants in the contract market cannot rely upon adequate or accurate price discovery, the price correlation will drop, thereby eroding confidence and participation.

It is argued that the cost of pit trading may exceed the cost of large-block matching outside the pit. Even while advancing that argument, it is conceded that the elimination of counter party risk, provided by exchange clearing houses, has value. The MGE respectfully suggests that the value of the clearing house has been based on a single, highly transparent price for more than 100 years. What will the addition of a second, opaque level of price discovery do to public confidence in exchange clearing houses?

In summary, rather than focus on the regulatory requirements execution facilities should observe, the Commission should step back and consider the limited benefits such facilities might offer the public and weigh it carefully against the beneficial services contract markets have provided the public, such as reliable price discovery. The MGE does not believe that providing certain large market participants another EFP trading vehicle would be in the public's best interest.

Sincerely,

James H. Lindau

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