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PREBON YAMANE
(U S A) INC.

INTERNATIONAL MONEY & FOREIGN EXCHANGE BROKERS

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April 27, 1998

VIA FACSIMILE TO: 202/418-5221

COMMENT

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COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

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

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

Dear Ms. Webb:

Prebon Yamane (USA) Inc. ("Prebon") appreciates this opportunity to make its views know to the Commission regarding the regulation of exchange of futures for physicals ("EFP") transactions. Prebon is an interdealer broker (or "brokers' broker") in debt securities, foreign currency, and certain physical commodities. Prebon is one of the leading interdealer brokers in the market for repurchase agreements (including "repos" and "reverse repos") involving United States Treasury securities. Prebon also is, with Ceres Limited Partnership, one of the two equity owners of Chicago Board Brokerage, L.L.C., a government securities broker-dealer that will provide facilities for the trading of Treasury securities, including transactions in Treasury securities that are effected as basis trades. Finally, Prebon was one of the sponsors of TEDS™[1], an

[1] TEDS™ (or "Treasury-Eurodollar Spreads") were developed in response to expressions of interest from government securities dealers, interest rate swap market participants and other users of the Eurodollar futures contract. TEDS effectively allowed a customer to trade the "basis" (i.e., the spread) between a series (or "strip") of Eurodollar futures contracts and the Treasury securities yield curve without the risks ordinarily associated with the contemporaneous establishment of multiple positions in different markets. The Chicago Mercantile Exchange ("CME") unfortunately viewed this innovation as a threat to the livelihood of the "locals" and floor brokers who ordinarily profit from the flow of customer orders into the Eurodollar pit. The CME, therefore, proposed an amendment to its Rules governing EFPs to prohibit any EFP involving the Eurodollar contract beyond the second listed quarterly month in the

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innovative product that sought to bridge the cash Treasury securities market and the Eurodollar futures market through the use of EFPs. Prebon is, therefore, vitally interested in the matters raised by the Commission's Concept Release relating to the regulation of noncompetitive transactions. *See* 63 Fed. Reg. 3708 (January 26, 1998). Prebon also is a member of The Bond Market Association and endorses the views expressed in the Association's April 1, 1998 comment letter. We are writing separately, however, to express our views on this important subject.

EFPs have been a vital adjunct to the futures markets for decades. That is because EFPs effectively allow commercial counterparties -- whether farmers, oil refiners or government bond dealers -- to customize a futures contract by specifying the precise instrument that will be delivered and the time of delivery. Of perhaps greater importance, EFPs facilitate the use of the futures markets by hedgers and other commercial users of the markets by eliminating basis risk -- by allowing the parties to predetermine the difference between the price of the cash instrument and the related futures contract (the "basis"), they are able to "lock in" a price for the cash instrument and for the futures contract on terms that are mutually acceptable. Without such a facility, some futures transactions would never be effected at all because the basis risk -- i.e., the risk that the cash and futures prices will diverge before the cash and futures "legs" can be established or liquidated independently -- is simply too great. In this regard, the Commission should understand that the data contained in Table 1 of the Concept Release (relating to EFPs as a percentage of trading volume) effectively

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March quarterly cycle. The Commission requested public comments on the proposed CME rule amendment. 59 Fed. Reg. 52674 (October 19, 1994). The Commission ultimately approved the CME rule amendment in November 1995, despite virtually unanimous opposition from futures commission merchants, banks and the Futures Industry Association. Prebon continues to believe that the Commission's action was in error as a matter of law and public policy and has contributed to the decline in Eurodollar futures contract volume. In any event, it appears that the CME regrets its decision, as indicated by public statements made by leaders of the Exchange to the effect that suppressing EFP activity is almost inevitably counterproductive. *See* "CME Reconsiders Ban on EFPs," Futures and Options Week (April 18, 1997) ("Banning anything is not of lasting value, because markets have a way of getting around it," said [CME Senior Policy Advisor Leo] Melamed. "You can't ban competition. You need to find a way to compete.")

understates the importance of EFPs to the futures markets. That is because each EFP transaction can be said to have a "multiplier effect" – commercial users of the futures markets frequently will establish a position in the open outcry markets because they are secure in the knowledge that they can "lift" their hedge through an EFP, and *vice versa*.

With this background in mind, we believe it is imperative that the Commission proceed with the utmost caution before it seeks to superimpose an additional layer of regulation on a robust and highly competitive marketplace. EFPs -- and, in particular, EFPs involving the government securities market -- are already pervasively regulated. As the Commission itself notes in the Concept Release, EFPs are permissible only to the extent they are effected in accordance with the rules of a designated contract market. Those rules cannot be made effective without prior Commission review and approval pursuant to Sections 4c(a) and 5a(a)(12) of the Commodity Exchange Act (the "Act") and Commission Regulation 1.41(b). Once so approved, any such rules must be enforced by the contract markets, as required by Section 5a(a)(9) of the Act and Commission Regulations 1.51, 1.53 and 1.54. Moreover, the Commission can and does monitor the implementation and enforcement of these rules through its oversight of the contract markets' rule enforcement programs.

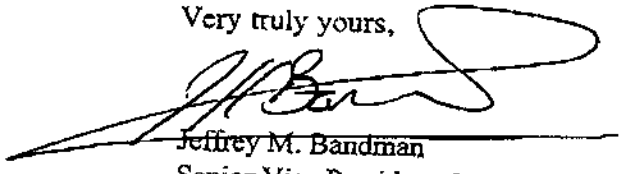
It is indisputably true that the jurisdiction of the Commission and of the contract markets in respect of the cash leg of an EFP is limited at best. That having been said, it remains unclear to us why the Commission believes it should seek to extend its authority. *The fact that EFPs are not regulated in their entirety by the Commission does not mean that new rules are needed.* This is particularly the case in respect of EFPs involving government securities, where the conduct of market professionals is already subject to regulation by the Securities and Exchange Commission and the Department of the Treasury. *See, e.g.*, Sections 15 and 15C of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§78o, 78o-5. Moreover, the parties to an EFP are amply protected by existing statutory and common law safeguards, including prohibitions against fraud and manipulation, both under the Act and under applicable provisions of the securities laws and the common law. *See, e.g.*, Sections 4b and 6(c) of the Act; Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b).

This is not an area where gaps in the regulatory scheme have given rise to abuse. To the contrary, our experience and that of our dealer clientele, together with the paucity of reported cases involving EFPs, convinces us that there is simply no need for additional regulation. Participants in interest-rate EFPs (including commercial banks, pension plans, broker-dealers, and foundations and endowments) are highly sophisticated users of the markets in which they trade. The Commission has no doubt heard this argument before, but it bears repetition: commercial and institutional users of the markets can and do obtain the degree of legal protection that they deem appropriate. Sophisticated, institutional market participants will limit their use of futures markets where undue regulatory burdens – whether in the form of additional disclosure, reporting or recordkeeping requirements or in the nature of Commission-imposed standards for the conduct of EFP transactions – make use of those markets relatively unattractive. It bears emphasis that these types of clients have alternatives to the use of the organized futures exchanges, including the over-the-counter derivatives markets. It would, therefore, be extremely ill-advised for the Commission to superimpose an additional layer of regulation where it is apparent that no additional regulation is necessary.

The Act provides the Commission with a vast array of remedial tools. It is indisputably true that certain subjects are best dealt with prospectively, through the rulemaking process, so that affected persons can know in advance what is required and what is proscribed. We respectfully submit that this is not such a case. We therefore urge the Commission to defer from taking any further action to regulate the conduct of EFP business by commercial users of the futures markets absent a demonstrable and compelling need to do so.

We would be pleased to discuss our views in greater detail at your convenience. I can be reached at (201) 557-5205 (fax (201) 557-5973).

Very truly yours,



Jeffrey M. Bandman
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