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MORGAN STANLEY

COMMODITY FUTURES TRADING COMMISSION RECEIVED

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COMMENT

April 27, 1998

APR 28 5 28 PM '98 COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

Ms. Jean A. Webb
Secretary of the Commission
U.S. 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:

Morgan Stanley & Co. Incorporated ("MS&Co.") appreciates the opportunity to respond to the Commodity Futures Trading Commission's (the "Commission") request for comments concerning the regulation of Exchange of Futures for Physicals ("EFPs") and other transactions executed through methods other than the regular trading floor facilities or procedures of a Commission-regulated contract market. 63 Fed. Reg. 3708 (January 26, 1998) (hereinafter referred to as the "Concept Release").

MS&Co., a wholly owned subsidiary of Morgan Stanley Dean Witter & Co., is a registered futures commission merchant and broker-dealer, a clearing member on principal U.S. contract markets and a primary dealer in U.S. government securities. MS&Co. and its affiliates provide a wide range of financial services. Their businesses include securities underwriting, distribution and trading, securities and futures brokerage, and trading in futures and commodity options, physical commodities, foreign currencies, forwards, and over-the-counter options, as well as derivatives on a broad range of asset categories, rates and indices. These services are provided to a large and diversified group of clients, including corporations, governments, financial institutions and individual investors, with a focus on the institutional marketplace. In connection with their activities, MS&Co. and its affiliates often engage in EFPs in the equity, fixed-income, currency, metals and energy markets on their own behalf and on behalf of their clients.

Introduction

The Concept Release requests input on a broad range of issues concerning EFPs, other proposed types of off-exchange transactions, the use of execution facilities and block-order procedures. This letter does not attempt to respond to each of the 57 questions with respect to which the Commission is soliciting comment. Rather, we have focused our comments on those issues which are particularly germane to our business and the needs of our clients. We have indicated by number the particular questions to which our comments respond.

EFP Transactions

Generally, we believe that the current regulatory scheme of contract market self-regulation combined with Commission oversight for EFPs is appropriate and should not be modified or enhanced at this time. EFPs perform an important market function in integrating cash and futures prices and in providing market access and liquidity. In the more than sixty years since agricultural market participants began using them, EFPs have worked extremely well without any significant drawbacks, and thus there is no need for the Commission to increase the regulation of such transactions at this time.

We also believe the exchanges are generally providing adequate guidance with respect to EFP transactions and, in particular, the standards relating to cash component correlation and transitory EFPs. Accordingly, there is no need for the Commission to codify into its regulations the standards embodied in the REPORT OF THE DIVISION OF TRADING AND MARKETS: EXCHANGES OF FUTURES FOR PHYSICALS (October 1987) (Concept Release Question 1). Instead, the Commission should continue to provide the exchanges with broad latitude in order to promote regulatory flexibility.

The Commission is soliciting comment as to the extent of the duties of contract markets in determining the acceptability of a particular cash commodity as the cash component of an EFP. Specifically, the Commission has asked: (i) whether contract markets should be required to adopt a minimum statistical correlation coefficient for use in assessing cash component acceptability (Concept Release Question 5), and (ii) what type and scope of guidance should be provided by contract markets to the public with respect to cash component acceptability (Concept Release Question 7). These matters should be left to the discretion of the contract markets, so as to promote regulatory flexibility and to permit EFP practices to develop in response to changing markets. The Commission should not compel contract markets to codify standards for determining whether particular cash commodities may be used as the cash component of an EFP. Instead, the Commission should continue to permit contract markets to define the relationship of cash commodities to futures as the exchanges are most sensitive to the needs of the participants and development of the markets. Likewise, the exchanges currently provide adequate guidance with respect to the cash component criteria in the form of written and verbal staff rule interpretations. Therefore, absent manifest problems, there is no need to change the methods by which such guidance is provided by the exchanges.

The Commission is also seeking comment as to what criteria are appropriate for determining whether a transitory EFP is bona fide (Concept Release Question 12). Again, we believe this determination should be left to the relevant exchanges. For example, in the context of foreign currencies, transitory EFPs as permitted by relevant exchange rules have provided many benefits to market participants. Transitory EFPs have provided market access and liquidity after floor-trading hours and have been particularly useful during regular floor-trading hours in less liquid markets (*e.g.*, Australian dollars and Canadian dollars). In addition, by contributing to overall exchange open interest in currency futures contracts, transitory currency EFPs eventually result in greater business on the floor, and thus are complementary to pit-traded transactions. If transitory EFPs become overregulated, however, the currency EFP business would likely dissipate and move away from the exchanges and into the interbank market. Given the benefits provided by transitory currency EFPs and the absence of any compelling reasons to increase the regulatory burdens on sophisticated institutional participants in the foreign exchange markets, we believe the Commission should continue to permit exchanges to ascertain the appropriate criteria for determining whether a transitory EFP is bona fide.

Further, the Commission is soliciting comment as to whether it should require that either or both of the futures and cash components of an EFP be priced within the daily range of their current respective markets (Concept Release Question 14) and whether contract markets should be required to obtain documentation regarding the business purpose underlying the pricing of an EFP (Concept Release Question 15). We believe the Commission should not constrain the pricing of EFP transactions and should allow flexibility as to the pricing of both the cash and futures components of EFPs. As the Commission is aware, an EFP is a basis trade. Therefore, it is not the individual prices, but rather the price differential of the underlying components that is relevant. It is especially important to preserve price flexibility in low volume, illiquid contracts where posted price ranges may not reflect the true bid-asked for large transactions. Additionally, price flexibility is necessary to facilitate cross-market spreads, particularly in situations where market convention allows prices to be adjusted to take into account factors such as the loading tolerances for physical cargoes (*e.g.*, an EFP involving NYMEX crude oil futures against cash crude for delivery in Singapore) or differences in timing of the respective price sources (*e.g.*, an EFP involving NYMEX heating oil futures against cash jet fuel, or an EFP involving CME S&P 500 futures against a basket of stocks).

We further believe that contract markets should not be required to obtain documentation regarding the business purpose underlying the pricing of an EFP because EFPs are privately negotiated over-the-counter ("OTC") transactions engaged in primarily by sophisticated institutional-type customers. Currently, participants in other OTC transactions are not required to provide documentation regarding the business purpose underlying the pricing of a transaction to any regulatory agency or self-regulatory organization. If problems arise with respect to pricing in an OTC market, the parties to the transaction have private means of dealing with such disputes. Moreover, requiring this type of documentation of EFP transactions would be very burdensome and would likely have a chilling effect on trading of EFPs because such transactions would be subject to more onerous documentation standards than other OTC products. In any event, exchanges currently regularly receive EFP pricing information from participants and are able to monitor the pricing of EFPs. As part of their ongoing monitoring of EFP transactions for compliance with exchange rules, exchanges have the ability to request, and often do request, documentation regarding the bona-fides of EFPs from market participants and, therefore, adequate documentation production requirements currently exist to address any regulatory concerns regarding the economic justification for pricing of particular EFP transactions.

Finally, the Commission has asked whether existing price reporting standards provide adequate transparency concerning EFPs to the marketplace (Concept Release Question 22). We believe that the existing price reporting standards are adequate. While EFP transactions do not have the same price transparency as products which are executed through regular trading floor facilities or procedures, participants in the EFP markets are willing to accept this lesser level of transparency in return for the ability to structure transactions which fulfill the participant's particularized need in a manner otherwise unobtainable using futures contracts traded on an exchange.

Exchanges of Futures for Swaps and Exchanges of Options for Physicals Transactions

Consistent with the goals of promoting responsible financial or economic innovation, we believe the Commission should permit the markets and exchanges to develop appropriate new risk-transfer mechanisms such as Exchanges of Futures for Swaps ("EFSs") and Exchanges of Options for Physicals ("EOPs").

The Commission is currently considering a New York Mercantile Exchange ("NYMEX") rule proposal that would permit EFSs, which are similar to EFPs, to take place on the NYMEX. In connection therewith, the Commission has sought comment as to what economic reasons exist for firms to engage in EFS transactions and what benefits might accrue thereunder, including the potential benefits to domestic futures markets, to OTC markets and to financial markets generally (Concept Release Question 24). We believe that by better integrating the swap and futures markets, price discovery and liquidity should be improved in the futures markets. Moreover, EFSs will permit cash market participants to substitute the credit of the clearinghouse for counter-party credit risk. This diversification of credit risk should lead to a reduction in systemic risk.

Finally, for risk management purposes a market participant's daily marking of its swap portfolio may be linked to the settlement price of a futures contract. It may wish to execute futures transactions for its hedges within or close to the contract's closing range in order to reduce the risk that its hedges will vary significantly from the settlement price. Because of congestion on the close, however, there may have been instances in the past where this goal has been difficult to achieve. EFS transactions may relieve such market congestion, providing more flexibility to market participants in hedging their positions.

We strongly support approval of the NYMEX rule proposal permitting EFS transactions (Concept Release Question 26). We believe it will add to the liquidity of the underlying markets. Further, we believe EFS transactions will be more useful than EFPs to participants in the energy markets because of regional differences in the cash energy markets that make it difficult to transact energy EFPs (*e.g.*, regional differences in physical delivery requirements). For example, EFS transactions would be particularly well suited for natural gas products. A very active swap market has developed in order to permit cash market participants to manage the basis risk arising out of the numerous published pricing points for natural gas. The availability of an EFS, which involves an exchange of a swap for a future, rather than an EFP, which only permits an exchange of a forward contract for a future, will provide hedgers with more efficient and flexible access to the futures market.

The Commission has also sought comment as to the efficacy of permitting EOPs, and, has asked, if such products are permitted, what limitations, if any, should be imposed in light of the risk characteristics of options (Concept Release Question 30). We believe the Commission should permit the exchanges to develop appropriate new risk-transfer mechanisms such as EOPs. We further believe that the Commission should permit EOPs to develop pursuant to guidelines that are developed by the exchanges with the input of market participants.

Alternative Execution Procedures

We also believe the Commission should permit exchanges to develop trading procedures that will facilitate the efficient execution of large futures and options transactions. The Commission is seeking comment as to whether alternative, noncompetitive execution procedures should be permitted on or subject to the rules of a contract market (Concept Release Questions 2 and 31). We strongly believe such procedures should be implemented in order to alleviate the current difficulty experienced by large institutional market participants in executing large futures and options orders. For example, procedures similar to the Chicago Board Options Exchange's Rule 6.74 ("crossing orders") would be useful, provided orders could be crossed outside of the prevailing bid-offer in the pit. Bid-offer ranges in the pit may not necessarily be representative of the market for larger orders. This is especially true in less liquid markets. As a result, it is imperative that large order execution procedures take into account the market impact of large transactions. Because exchanges and market participants are acutely aware of these issues, we believe that they are best able to determine what procedures will most efficiently and effectively accomplish the goals of the market participants without adversely affecting the integrity of the market. MS&Co. reserves the right to provide additional comments pursuant to the Commission's order today extending the comment period relating to alternative execution procedures to September 1, 1998.

Conclusion

We appreciate having had the opportunity to respond to the questions posed by the Commission in its Concept Release and would be pleased to respond to any questions the Commission or its staff may have regarding our comments.

Sincerely,

John P. Davidson III
Managing Director