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COMMENT (64)

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August 26, 1998

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

Re: Concept Release on Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market - Block Trading

Dear Ms. Webb:

The Committee on Futures Regulation of the Association of the Bar of the City of New York (the "Committee") respectfully submits this letter to the Commodity Futures Trading Commission (the "Commission") in response to its solicitation of comments respecting those portions of its Concept Release on Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, published in the Federal Register on January 26, 1998, that are related to block trading. The Association is an organization of approximately 22,000 lawyers. Most of its members practice in the New York City area. However, the Association also has members in 48 states and 51 countries.

The Committee consists of attorneys knowledgeable in the field of futures regulation and has a history of publishing reports analyzing critical regulatory issues which affect the futures industry and related activities. One of those reports, entitled "Large Order Execution in the Futures Markets" and published in *The Record* of the Association in January of 1989, examined the legal principles applicable to block trading in the futures markets and discussed possible approaches to providing mechanisms for executing block orders. In response to the Commission's request for comment, the Committee respectfully submits the enclosed copy of that report.

Sincerely yours,

Emily M. Zeigler, Chair

Association of the Bar the City of New York
Committee on Futures Regulations

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Mr. Hickson did not participate in this letter.

Large Order Execution in the Futures Markets

By THE COMMITTEE ON FUTURES REGULATION

INTRODUCTION

Every so often, traders in both the securities and the futures markets have orders that are so large that merely to bid or offer the entire order could have a disruptive effect on the market—and make the order difficult to execute. The size that has such an effect varies according to the depth and liquidity of the particular market.

In securities, this problem can be handled on the exchanges through the technique known as "block trading," whereby the entire order can be executed in a single prearranged transaction or group of transactions, as provided for by stock exchange rules. With certain exceptions, it can also be dealt with by negotiating one or more transactions off the exchanges in one of the over-the-counter markets.

In futures, there is no lawful over-the-counter market, so that all orders must be executed on or subject to the rules of an exchange. However, there is at present no specific mechanism for executing a large order in one or more prearranged transactions, as there is in the securities markets. The entire order must be quoted by open outcry on the floor of the exchange, either in a single bid or offer, or (more realistically) as series of bids and offers over some period of time. This situation is at least in part attributable to issues regarding the legality of prearranged trading in futures. Nevertheless, it has been of concern to commercial and institutional entities that wish to accomplish efficiently various trading strategies, such as hedging of futures against physical commodities or securities or asset allocations using futures.

In addition, in the aftermath of the October 1987 market break, the Securities and Exchange Commission (SEC) staff has suggested that it might be appropriate for the Commodity Fu-

tures Trading Commission (CFTC) and the futures exchanges to consider permitting block trading to better accommodate portfolio trading and its effects.[1]

This report will briefly describe block trading in the securities markets, will examine the applicable legal principles in the futures markets, and will discuss certain possible approaches to providing mechanisms for executing large futures orders with minimum adverse market impact.

DISCUSSION

Large Order Execution in the Securities Markets

In approaching a discussion of large order execution in the futures markets, one useful starting point is a description of the block trading practices in the securities markets. This is particularly appropriate since much of the impetus for developing large order execution systems in the futures markets comes from securities firms and their customers, who are familiar with those practices.

In the securities market, a "block" is generally considered to consist of 10,000 shares or more.[2] The execution of orders to buy or sell a block of securities is governed by special rules. For example, block trades on the New York Stock Exchange (NYSE) are governed by its Rules 76 and 127.[3]

The typical execution process for a block trade on the NYSE begins generally with an institutional market participant that wishes to purchase (or sell) a block of shares and is willing to pay a premium over (or accept a discount from) the current market price in order to do so. Often, the transaction will be arranged by the brokerage firm for the large investor initiating the transaction. The firm "probes" the market to determine whether it can absorb the order without a significant effect on the price. If it can, then there is no need to use the block trading procedure. If not, the firm will generally inquire among its other customers or among other persons it believes may be interested in the shares in an effort to locate sufficient interest to take the other side of the order. Alternatively, the firm may determine to take all or part of the other side for its own account.

The price at which the block will finally be crossed, after all better bids (or offers) have been accepted, is called the "clean-up price." It will be outside of the current quotations, but by an amount presumably less than the perceived effect on the current quotation that would result if the block were simply bid or offered on the floor.

Once a block is assembled and a clean-up price established, an order to execute both sides of the transaction will be given to a broker on the floor of the exchange. Rule 127 requires that the specialist be informed of the broker's intention to cross the block (*i.e.*, to execute it between the two sides assembled by the upstairs firm) at the particular price. If the broker believes that the number of shares that will be accepted or sold by the specialist and the crowd at that price is "excessive," he or she has two alternatives.

The first alternative is that he or she may adjust the price, and announce the adjusted price to the crowd, in which case: (a) any part of the block may be picked off by a bid (or offer) higher (or lower) than that at which the block is announced, and (b) if the specialist or odd-lot dealer has in hand any orders that were in existence prior to the announcement of the block trade and that are at the same (or a better) price as that at which the block trade is announced, those orders must be filled from the block before the block trade may be crossed. The firm holding the block order may not make any intervening trades between the time that the block trade is announced to the crowd and the completion of the trade or trades to clean up the block.

If all or any portion of the block will have the effect of establishing or increasing the member firm's position, public orders limited to the clean-up price must be filled before any amount may be retained for the member firm's account (except any amount needed by the member firm to cover a short position or to liquidate a long position).

The other alternative for the broker is to retain the original clean-up price, but limit his or her obligation to fill public orders to limit orders at that price on the specialist's book, up to one

thousand shares or 5% of the total amount crossed, whichever is more.[4]

In some instances, a member firm may direct a block trade to a regional exchange, where the crowds are often smaller than on the NYSE, and blocks can be crossed with less likelihood of interruption.

Legal Principles Applicable to Futures Markets

The key to block trading in the securities markets is the ability of the upstairs member firm to solicit interest in all or part of a large order from parties on both sides of the market, to determine a clean-up price, and then to arrange for the block to be traded at the price. This is of course permitted by the securities laws and (subject to certain restrictions) the rules of the various exchanges. However, such activities in the futures markets would appear to raise serious issues under the laws regulating futures trading, at least as they are presently interpreted by the CFTC.

In the futures markets, each transaction consists of entering into one or more standardized executory contracts for the purchase and sale of a specific commodity for delivery at some time in the future.[5] Under the Commodity Exchange Act (hereafter called the "Act"), futures contracts must be effected on an exchange that has been "designated" by the CFTC as a "contract market" for the particular commodity.[6] With certain exceptions, the price of each contract is arrived at by open outcry.

Presently, this means that any exchange member offering to enter into a contract for his or her own account, or for the account of any other person, will audibly bid to buy or offer to sell the particular futures contract in the appropriate pit or ring on the exchange trading floor, where all other qualified exchange members have the opportunity to accept the bid or offer. A bid or offer may be for more than one contract. However, if a member makes a bid or offer for a number of contracts, it is possible that it will be accepted for less than all of them. This means that completion of the order may take more time than would be needed to execute a single transaction. It also means that the order may be executed at a number of different prices—a circumstance that could impair the effectiveness of trading strategies. Furthermore, if the number of contracts involved is large enough, in view of the particular market, the order might not be capable of execution without disruption of the market.

The open outcry requirement is set forth in CFTC Regulation Section 1.38(a), which provides that:

> All purchases and sales of any commodity for future delivery, and of any commodity option, on or subject to the rules of a contract market, shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods, in the trading pit or ring or similar place provided by the contract market, during the regular hours prescribed by the contract market for trading in such commodity or commodity option: *Provided, however*, That this requirement shall not apply to transactions which are executed noncompetitively in accordance with written rules of the contract market which have been submitted to and approved by the Commission, specifically providing for the noncompetitive execution of such transactions.[7]

Regulation Section 1.38 was adopted in 1953 by the Commodity Exchange Authority (CEA) of the Department of Agriculture.[8] Three years after this section was adopted, the Administrator of the CEA stated that:

> . . . a primary purpose of a futures market is to provide a common meeting place for all orders of all persons who wish to buy or sell. It follows that if any of such orders are diverted from such common meeting ground or withheld from truly competitive bidding and offering so that everyone interested may not have equal opportunity to buy or sell, the market falls short of its purpose.[9]

Although the competitive execution requirement does not explicitly appear in the Act, Regulation Section 1.38 has long been known to, and endorsed by, the Congress. For example, in 1974, when considering the legislation that became the Commodity Futures Trading Commission Act of 1974 (the legislation

that created the CFTC), the Senate Committee on Agriculture and Forestry made the following observation:

> The purpose of this requirement (Regulation 1.38) is to ensure that all trades are executed at competitive prices and that all trades are focused into the centralized marketplace to participate in the competitive determination of the price of futures contracts. This system also provides ready access to the market for all orders and results in a continuous flow of price information to the public.[10]

This report will now discuss the effect of the competitive execution requirement on the ability of a futures commission merchant (FCM) or floor broker (1) to prearrange any aspects of a futures trade through discussion or negotiation before it is bid or offered on the contract market floor, and (2) to cross (or to instruct a floor broker to cross) a futures trade between principals at a pre-determined price.

1. *Prearrangement*

The principle of competitive execution promulgated by the CEA has been expanded by the CFTC. Thus, in December of 1975, the CFTC published for comment proposed new regulations, the main purpose of which was to prevent abuses of the relationships between floor brokers or FCMs and their customers.[11]

One of the provisions of those proposed regulations (Section 155.2) would have required each contract market to adopt rules which would, among other things, prohibit any floor broker from making any purchase or sale "which has been directly or indirectly prearranged." In its analysis of this provision, the CFTC stated that the purpose of the proposed ban on prearranged trading was to augment Regulation Section 1.38.

Thus, at the time Regulation Section 155.2 was adopted, the CFTC said:

> The prohibition against prearranged trading augments the requirement in Regulation 1.38 that: "all purchases

and sales of any commodity for future delivery on or subject to the rules of a contract market shall be executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods."[12]

Regulation Section 155.2 was adopted on December 23, 1976 as proposed, effective March 16, 1977.[13]

Regulation Section 155.2 is not self-executing. It does not literally ban prearranged trading; it requires contract markets to adopt rules banning prearranged trading, which all of the contract markets have done. Furthermore, by its terms, it only applies to floor brokers.

There is no provision in the Act or the CFTC regulations that explicitly bans prearranged trading or requires contract markets to have rules prohibiting anyone other than floor brokers from engaging in prearranged trading.[14] However, the CFTC has found a ban against prearranged trading implicit in certain provisions of the Act.

Section 4b(D) of the Act prohibits any person executing a futures order "to fill such order by offset against the order or orders of any other person." And Section 4c(a) of the Act provides that:

> It shall be unlawful for any person to offer to enter into, or confirm the execution of, any transaction involving any commodity . . .
>
> (A) if such transaction is, is of the character of, or is commonly known to the trade as, a "wash sale," "cross trade," or "accommodation trade," or is a fictitious sale; or
>
> (B) if such transaction is used to cause any price to be reported, registered, or recorded which is not a true and bona fide price.
>
> Nothing in this section shall be construed to prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities, or of transfer trades or office trades if made in accordance with board of trade rules applying to such transactions and such rules shall have been approved by the Commission.[15]

Sections 4b and 4c were added to the legislation regulating futures trading when the Commodity Exchange Act of 1936 was adopted. The previous legislation—the Grain Futures Act of 1922—did not clearly grant authority to regulate or prohibit trading practices such as those listed in Section 4c. Section 4c was adopted upon the urgings of the Grain Futures Administration, the division of the Department of Agriculture then charged with administering the law. However, having prohibited the practices enumerated in Section 4c, Congress did not define what they were.

Indeed, it would appear that Congress despaired of being able to define the prohibited practices, since it resorted to the technique of using colloquialisms in quotation marks and of relying on definitions based on what was "known to the trade." The history of Section 4c since its enactment shows that the courts and the various administrative agencies charged with its enforcement have come up with differing definitions, sometimes inconsistent with each other and differing from the statements of the framers.[16]

The CFTC has repeatedly held that prearranged trading violates Section 4c(a), but its theory as to why that is true has changed over the years and is not entirely clear to this day.

The first adjudicatory proceeding in which the CFTC faced the question of the legality of prearranged trades was the *Sundheimer* case.[17] There, the respondent had pleaded guilty to a criminal information charging him with aiding and abetting the filing of false tax returns, by effecting prearranged trades in the crude oil market of the New York Cotton Exchange for the purpose of creating tax losses for a certain oil company. The CFTC Division of Enforcement commenced a proceeding to revoke the respondent's registration as a floor broker and to impose other sanctions on the ground, among others, that he had violated Section 4c(a) of the Act insofar as he had admitted to prearranging trades. The Complaint averred that the prearranged transactions:

> . . . were of the character of, or were commonly known to the trade as, wash sales, cross trades, accommodation trades, or fictitious sales, or which were used to cause prices to be reported, registered, or recorded which were not true and *bona fide* prices, in order to create predetermined losses and gains in commodity futures accounts.[18]

The administrative law judge (ALJ) held, on the basis of the guilty plea, that Mr. Sundheimer had violated Section 4c(a) in that the trades in which he had engaged were prearranged and therefore fictitious. On appeal, the Commission observed that none of the subsections of Section 4c(a) proscribe "pre-arranged trading" *in haec verba*. However, it said, the allegations, if proven, would establish violations of Section 4c(a) (A) and (B) of the Act.[19] The Commission then, in effect, affirmed the decision of the ALJ, but disagreed with his analysis of the law, stating:

> Insofar as the prearranged transactions to which Mr. Sundheimer admitted were real trades, that is, they brought about an actual change in market position between respondent's company and the oil company, . . . they did not constitute "fictitious sales" as prescribed by Section 4c(a) (A). Therefore, the judge's conclusion in this regard is vacated. However, respondent's prearranged transactions did furnish the oil company with a vehicle for utilizing a commodity futures market for extrinsic advantage without exposure to market risk, and to that extent, they were tantamount to "accommodation trades," which are also prohibited by Section 4c (A) of the Act.[20]

Five years later, in the *Collins* case,[21] the CFTC announced that it no longer subscribed to its opinion in *Sundheimer*. The new case involved a series of trades in which a broker, who was (and whose customers were) long the May 1976 potato futures contracts on the New York Mercantile Exchange (NYMEX), sold and bought at the same price identical quantities of May contracts as the delivery period approached. The avowed purpose of the transactions was "to get behind the line" for receiving delivery (*i.e.*, to defer the probability of receiving delivery

notices on the long positions, because the clearing organization followed the practice of assigning delivery notices to holders of long positions based on the dates the long contracts were acquired). The Commission held that, regardless of motive, the transactions constituted wash sales. Although the case did not involve charges of prearranged trading, the Commission took the occasion to publish, by way of dictum, a number of observations regarding Section 4c in general, and its application to prearranged trades in particular.

With respect to its previous decision in *Sundheimer*, the Commission said:

> In a footnote in *In re Sundheimer*, . . . the Commission held that prearranged transactions that resulted in actual trades in the pit did not constitute fictitious sales. In light of our present examination of the legislative history demonstrating that wash sales and cross trades are forms of fictitious sales, and the fact that these trading techniques can also result in actual trades in the pit, we no longer subscribe to that distinction announced in *Sundheimer*. Based on the findings set out in that opinion, we should now hold that the transactions at issue were also fictitious sales within the meaning of Section 4c(a), as well as accommodation trades.[22]

And, even more broadly, the CFTC said: ". . . we embrace the view that all prearranged trades are, by their nature, fictitious."[23]

This conclusion appears to represent a major expansion of the concept of fictitious trades, which historically was applied to trades that either did not occur on the floor and were merely entered on the books, or were wash trades which lacked economic substance.[24]

The Court of Appeals for the Second Circuit reversed the CFTC decision in *Collins*, on the grounds (a) that the practice of moving to the end of the delivery line had previously been regarded as lawful, (b) that banning the practice represented a change in prior interpretations of the law by the CFTC, and (c) that the respondents had not been put on notice of this new interpretation at the time they effected the trades in question.[25]

The CFTC has most recently considered the question of prearranged trading in the *Gimbel* case.[26] In that case, which involved lumber contracts traded on the Chicago Mercantile Exchange, Respondent Mondi bought ten contracts from Respondent Gimbel and sold ten lumber contracts to Respondent Sasin. Sasin then sold ten lumber contracts to Gimbel. The parties had no open position before the first transaction or after the third transaction. The prices were such that Mondi and Gimbel incurred losses, while Sasin achieved a profit.

The ALJ found that the trades were prearranged as to contract, price, and quantity in order to pass funds to Sasin.

In affirming, the CFTC said:

> Prearranged trading is a form of anticompetitive trading that violates 17 C.F.R. § 1.38. Depending on the context of the prearrangement, such activity may also violate Section 4c(a) (A) or Section 4b of the Act, or both. For example, a prearranged transaction that is accomplished in the pit is a fictitious sale within the meaning of Section 4c(a) (A). [Citing *Collins, supra.*] . . . Such a transaction appears to be the result of open outcry but negates both the risk and price competition incident to an open outcry market. When a prearranged transaction in the pit is structured to produce an offset of customer orders, it is both a fictitious sale under Section 4c(a) (A) and an illegal offset under Section 4b(D) of the Act. *See Nichols & Co. v. Secretary of Agriculture,* 136 F. 2d 503, 505 (1st Cir. 1943). Similarly, when a prearranged transaction in the pit is structured to produce a wash result, it is both a fictitious sale and a wash sale under Section 4c(a) (A) of the Act.[27]

In footnote 7 to the passage just quoted from *Gimbel*, the CFTC elaborated its views on the meaning of the term "fictitious" as follows:

> To be "fictitious" within the meaning of Section 4c(a) (A), a transaction need not be structured in a manner calculated to negate both market risk and price competition. It is sufficient if the transaction is structured to negate price competition *or* market risk. [Citing Collins, *supra.*] . . . For these purposes, price competition or market risk is negated when it is reduced to a level that has no practical impact on the transaction at issue. *Cf. In re Goldwurm,* 7 A.D. 265, 278 (1948) (wash sale under Section 4c(a) (A) found when broker was instructed to fill buy and sell orders for the same commodity futures contract for the same account with no more than a three point loss).

The Commission appears to be of the view that, if a trade has been prearranged, then price competition and/or market risk must have been eliminated from the transaction. However, this conclusion does not necessarily follow, and could only be substantiated on a case-by-case basis after examining all of the relevant facts and circumstances surrounding the trade execution. In many instances, a portion of the prearranged trade is picked up by other brokers, which would seem to indicate that neither price competition nor market risk has necessarily been negated. It is not clear why a trade on an exchange floor, if properly executed by open outcry, should not be regarded as competitive merely because there has been some amount of prearrangement.

In any event, it appears that, if a trade has been prearranged, the CFTC will take the position that the trade will violate one or more of the following provisions of the Act and the CFTC Regulations, depending upon the circumstances: the requirement of competitive execution by open outcry in Regulation 1.38; the prohibition against offsets in Section 4b(D) of the Act; the requirement of execution at public outcry across the ring for cross trades contained in Section 4b of the Act; the prohibition against wash sales, cross trades, accommodation trades, and fictitious sales in Section 4c(a) (A) of the Act; and the prohibition against reporting a price which is not "true and bona fide" in Section 4c(a) (B) of the Act.

It is not clear, however, just what conduct constitutes "prearranging" a trade. More specifically, it is not clear whether and to what extent an FCM or a floor broker holding an order from a customer may discuss with other parties—or even just make inquiries about—possible interest on the other side of the market.[28] Indeed, in the *Collins* case, *supra*, the CFTC noted that there is "little in the way of adjudicatory guidance" from the CFTC as to what constitutes prearranged trading.[29]

Furthermore, the Court of Appeals decision reversing *Collins* stated:

> The fact that the Commission abruptly changed its own interpretation [regarding getting behind the line] in the middle of the proceedings in our judgment further demonstrates the need for a clearer and more explicit interpretation and for appropriate notice thereof to the public as to what conduct is permissible.[30]

The CFTC currently appears to be of the view that even the most preliminary prior negotiations are not permissible.

For example, in a proceeding recently instituted against Kidder, Peabody & Co., Inc. ("Kidder"),[31] the Complaint alleges that Kidder and one of its account executives (AEs) entered orders for the CBT Major Market Index Maxi Contract (XMI), which resulted in the execution of non-competitive trades, illegal cross trades, and the filling of orders by offset and caused the reporting of prices that were not true and bona fide.

In one instance, the AE apparently was advised by a Kidder customer that it would be shifting its portfolio from stocks to bonds by, among other things, purchasing futures on Treasury Bonds and Notes and selling XMI futures. The AE was given instructions to sell as many XMI September futures contracts as he could over a two-day period and was given time, price, and size discretion, subject to the customer's daily limit instructions as to overall position size. Orders were fed into the market piecemeal until 500 contracts remained to be sold. The AE exercised his discretionary authority to place a final sell order for 500 contracts with one broker at the same time he placed a purchase order for 500 contracts from another customer with a different broker. The orders were filled opposite each other, but it is not alleged that either broker was told of the order given to the other.

The CFTC Division of Enforcement contends that the quantities bought and sold, and the prices at which the transaction was

made, were determined by the AE's matching of the offsetting orders and the simultaneous transmission of those orders to the floor. This conduct is alleged to have resulted in the execution of non-competitive trades. Because the trades allegedly were not competitive, the Division contends that the prices resulting therefrom were not true and bona fide. In addition, as noted above, the trades are alleged to be illegal offsets and cross trades.

Another of the transactions involved three separate Kidder customers and an unrelated trader. The transactions allegedly resulted from numerous telephone discussions initiated by the AE after one of his customers indicated an interest in rolling forward its entire short position in the September future (2,850 contracts), if there was sufficient liquidity to sell the September 1986/December 1986 XMI spread. Among other things, the AE contacted the unrelated trader and allegedly told him that, if his firm was interested in buying the spread, it might want to have someone in the pit. He also ascertained that two other Kidder customers were interested in buying the spread. He then sent the sell orders to one broker and the buy orders to another. The sell orders were executed against the orders from the two other Kidder customers and the unrelated trader who had been contacted by the AE, except for ten spreads which were purchased by another unrelated trader.

The trades executed among the Kidder customers are alleged to have been illegal cross trades, offsets, and non-competitive trades, and to have caused the reporting of prices which were not true and bona fide. The trades executed between Kidder and the trader who had been contacted by the AE were alleged to have been executed non-competitively and to have caused the reporting of prices that were not bona fide.

In pre-hearing submissions, Kidder argues that it did not commit any violations of the Act because: (a) the orders were executed in the trading pit at open outcry and no one present in the trading pit was denied the opportunity to participate in the trades, (b) the AE's activities prior to sending orders to the pit produced a more competitive market, better price discovery, and the best execution for his customers, (c) the actions taken by

Kidder and the AE were required in order to fulfill their fiduciary duties to their customers, and (d) Kidder's activities were consistent with industry understanding and relevant legal authorities.

The matter is still pending.

One exchange proceeding that has addressed the question of prearranged trades is a disciplinary action brought by the CSCE against Merrill Lynch Futures, Inc. (MLF), stemming from the activities of two of its employees in the domestic sugar contract (then known as the Sugar No. 12 Contract). The particular contract was generally used only by commercial sugar interests, and was relatively thinly traded.

The CSCE Compliance Department alleged that the employees in question (independently and in concert with each other) solicited orders by conducting telephone discussions with MLF customers who were potential buyers and sellers, during which the employees negotiated price, quantity, and delivery month with the customers in order to match order specifications. Matched sets of orders were allegedly then sent to the floor by the employees either simultaneously, or within one minute of each other, to a single floor broker, who would then execute the orders in a cross trade. In some instances, a portion of the order was picked off by other floor brokers, who were trading for their own accounts or for a customer who apparently sent orders directly to the ring rather than through the MLF employees.

MLF contested the allegations in a hearing before the CSCE Adjudication Committee. In its defense, MLF cited the *Nichols* case[32] as a legal justification for its conduct, arguing that the fact that the trades had been executed as cross trades by open outcry in the ring dissipated any taint which might otherwise stem from prearrangement. In addition, MLF relied on a resolution interpreting the cocoa rules (the "Cocoa Resolutions") which had been adopted by the Board of Managers of the New York Cocoa Exchange (prior to its merger into the CSCE) and which remains in effect today, stating that:

> A prearranged trade is one arranged (before its announced execution) between two or more members in a manner designed to prevent other members from having a fair and reasonable opportunity of sharing in it, or otherwise conceived in violation of the spirit of fair, free and open trading.
>
> This interpretation, however, shall not extend to such trades as may by special circumstances attaching to them require preliminary negotiations, when such preliminary negotiations can be justified as reasonably necessary to the accomplishment of fair and orderly marketing, and provided such trades are executed at the ring in compliance with the By-Laws and Rules.[33]

MLF contended that the telephone conversations were merely "preliminary negotiations" within the intent of the interpretation, during which parties merely gave indications of interest. Witnesses testifying on behalf of MLF indicated that they did not consider any of the conversations as constituting the placing of an order. Ultimately, the issue which the Adjudication Committee had to resolve was at what point does preliminary negotiation become an order.

The CSCE Adjudication Committee found that the fact that the discussions consistently resulted in orders being sent to the trading floor in matched pairs, at the same price, in the same quantity, and at virtually the same time established that the employees' activities had gone beyond "preliminary negotiations," as that term was used in the Cocoa Resolution.

The Committee held that the Cocoa Resolution was inapplicable to sugar trading, but that in any event:

> . . . in soliciting indications of interest (whether general interest or "definitive interest" . . .) these individuals are performing the function of ring traders and floor brokers. As a result, the bid and offer process, both as to quantity and price, is accomplished in an upstairs environment, away from public view and public pricing.[34]

The Committee also rejected the MLF argument based on the *Nichols* case. It concluded that *Nichols* stands only for the proposition that an FCM may appear on both sides of a trade where there is open and competitive outcry, and that it would not be a violation of Sections 4b(D) or 4c, or CFTC Regulation 1.39, solely because two floor brokers know that offsetting orders had been given to them by the same FCM.

The Committee also concluded that analogues to block trading in the securities industry are not applicable.

MLF appealed the decision to a CSCE Appeals Panel, which affirmed the decision of the Adjudications Committee (by a vote of two to one), but it reduced the penalty. On appeal to the CFTC, the CFTC declined review.[35] MLF has taken an appeal to the U.S. Court of Appeals for the Second Circuit.

2. *Crossing*

The phrase "to cross an order" is generally considered to refer to a situation where a broker, having both a buy and a sell order, executes each order against the other.

Section 4c(A) of the Act prohibits entering into a transaction "if such transaction is, . . . or is commonly known to the trade as, a . . . 'cross trade,' . . . ." Neither the Act nor the CFTC regulations, however, defines what a "cross trade" is. However, it is apparently not intended to prohibit crossing orders. Rather, in the floor debates leading to the adoption of Section 4c(A), the term "cross trade" was described as a practice in which one broker sells to another, and the other then sells back to the first, so that the two trades cross each other out.[36]

Section 4b of the Act prohibits any person executing a futures order "to fill such order by offset against the order or orders of any other person, . . ." Crossing of orders could be considered filling them by offset (which would be unlawful), except that Section 4b goes on to provide that:

> Nothing in this section or in any other section of this chapter shall be construed to prevent a futures commission merchant or floor broker who shall have in hand, simultaneously, buying and selling orders at the market for different principals for a like quantity of a commodity for future delivery in the same month, from executing such buying and selling orders at the market price: *Provided*, That any such execution shall take place on the floor of the exchange where such orders are to be executed at public outcry across the ring and shall be duly reported, recorded and cleared in the same manner as other orders executed on such exchange: *And provided further*, That such transaction shall be made in accordance with such rules and regulations as the Commission may promulgate regarding the manner of the execution of such transactions.

In 1948 the CEA promulgated (and the CFTC has since adopted) Regulation 1.39,[37] which sets forth certain minimum requirements regarding the execution of such transactions, and leaves the final implementation to contract market rules that have been approved by the Commission.

Basically, Regulation Section 1.39(a) requires that the transaction must be in conformity with written rules of the contract market that have been approved by the CFTC, and that: (a) the order must be offered competitively on the contract market floor; (b) the order must be executed in the presence of an official representative of the contract market, and the floor member must specifically identify the transaction on his or her trading card, noting the time of execution and having the record verified by the official representative; (c) the contract market must keep records of such transactions; and (d) neither the FCM nor the floor broker may have any interest in the order, directly or indirectly, except as a fiduciary. Regulation 1.39(b) then provides:

> The execution of orders in compliance with the conditions set forth in this section will not be deemed to constitute the filling of orders by offset within the meaning of paragraph (D) of section 4b, nor to constitute cross trades within the meaning of paragraph (A) of section 4c, of the Act.

It will be noted that both the Act and Regulation 1.39 permit the execution of "orders" for different principals "for a like quantity of a commodity." Nothing in either the Act or the Regulations limits in any way the size of the order, or what the "like quantity" must be. In other words, insofar as the Act and the Regulations are concerned, it is permissible to cross more than one contract, and, indeed, it would be permissible to cross any number of contracts where the orders are of like quantity. To put it another way, there is nothing in the Act or Regulation 1.39 that would preclude the crossing of a large block.

One limitation is that the Regulation on its face appears to preclude either the FCM or the floor broker from taking all or any part of the opposite side of the trade. To some extent, this requirement appears to go well beyond what is required by the Act, since Section 4b(D) expressly permits an FCM or floor broker to take the opposite side of a customer order with the customer's consent. The CFTC has recognized this and has approved contract market rules permitting members to take the opposite side with the prior written consent of the customer.[38]

The contract markets have taken different positions with respect to the practice of crossing orders. Some have banned it entirely.[39] Others permit it by applying the requirements contained in Regulation 1.39, essentially unchanged.[40] One contract market goes so far as to provide that, even after a transaction has been executed competitively by open outcry in accordance with the requirements of Regulation 1.39, the broker executing the trade must then offer up one-half of the trade to the ring.[41]

Present Methods of Large Order Execution in Futures Markets

Although there does not now exist, on U.S. futures exchanges, any lawful mechanism for block trading of futures comparable to what exists in the securities markets, there are several trading techniques which to some extent can be used in the execution of large orders.

1. *Exchanges for Physicals (EFPs)*

Basically, EFPs are prearranged, fully negotiated transactions executed in a non-competitive manner, that are expressly permitted by Section 4c(a) and CFTC Regulation Section 1.38, provided they are conducted in accordance with contract market rules that have been approved by the CFTC.[42] While EFPs have generally been permitted by the contract markets, their rules "provide little guidance and place few limits on the permissible scope of EFPs."[43] To a large extent, what each contract market permits is a matter of staff interpretation, which is generally unpublished. The CFTC Division of Trading and Markets has published indicia which it believes should be examined in evaluating particular EFP transactions for their *bona fides* and their compliance with the intent of Section 4c(a).[44] In addition, while suggesting certain regulatory changes to enhance surveillance over EFP practices, the Division has recognized that they have assumed a significant role in many markets.[45]

Basically, an EFP is a transaction in which one party buys (or agrees to buy) a physical commodity from another, while at the same time the buyer of the physical commodity enters into a futures contract to sell (or transfers a futures contract to buy) the same or a related commodity with (or to) the other party. One contract market definition of an EFP is that it consist of two discrete but related transactions, in which the seller of the futures buys the actual commodity and the buyer of the futures sells the actual commodity.[46]

The essential element in all EFPs is that the futures transaction has a direct relationship to the physicals transaction. While the commodity underlying the physicals transaction need not be identical to the one underlying the futures transaction, it should be related to it—such as through price correlation—and should be in an equivalent quantity.[47]

Certain of the contract markets describe to some extent the required characteristics of the physicals component of the transaction, and those descriptions vary considerably. For example, several contract market rules define the physicals component to be either the underlying commodity traded on that market, the economic equivalent thereof, or a transaction involving the physical commodity (such as a forward contract).[48] Others authorize only the exchange of the underlying physical commodity traded on that exchange, or a derivative, a by-product, or a related product.[49] While some exchanges prescribe the parameters for pricing the transactions,[50] the rules of most of the exchanges are silent on the subject, or expressly permit the parties to price both the physicals and the futures aspects of the transaction by agreement, without regulation by the contract market.[51]

Forward contracts generally qualify for the cash component of the EFP, but futures contracts do not.[52] In the case of cash-settled futures contracts, such as stock index contracts, the physicals component may reflect the underlying commodity, such as a basket of securities.[53]

EFPs may be used to liquidate existing futures positions of both parties, to transfer a futures position from one party to the other, or to create futures positions for both parties.

An example of a situation where the parties both liquidate their futures positions is as follows:

> Grain elevator, S, contracts to sell wheat to an exporter, B, at a basis of 15 cents per bushel over the March futures price. The contract gives B the right to determine when to fix the price level of the cash trade. S is short March wheat futures contracts to hedge its inventory, and B is long futures contracts to cover a fixed-price export sale. On February 15, B selects a desired March futures price. B sells futures to S, and S buys futures from B, thereby liquidating their existing futures positions. S will deliver wheat to B and will receive payment of 15 cents/bushel over the futures price, as agreed.[54]

An example of an EFP resulting in the transfer of a futures position from one party to another is as follows:

> A trader, G, who has no existing cash or futures position, wishes to acquire 100 ounces of gold bullion and an accompanying short futures hedge. G contacts a bullion dealer, X, which has an inventory of 1,000 ounces of gold bullion hedged with short futures positions, and agrees to purchase 100 ounces at $350/oz. The parties arrange to effect this transaction via an EFP. X transfers one short futures contract to G at $353/oz., offsetting one contract of its existing short futures position, and G, as the counterparty, receives one futures contract from X at $353/oz., thereby acquiring a short futures position of one contract. X will deliver gold to G and will receive payment of $350/oz. as agreed.[55]

An example of an EFP resulting in new futures positions for both parties:

> A pension fund, P, with no existing cash or futures position, desires to buy shares of stock to replicate an index and sell the corresponding futures to establish an arbitrage position. P contacts its FCM to arrange the two trades. The FCM, which has no existing cash or futures position, agrees to establish the cash and futures position for P via an EFP at a given differential. The FCM will purchase the stocks in the index and then sell them to P in the EFP. At the same time, P will sell futures to the FCM. After the EFP, P will have a long cash position and be short futures; the FCM will have a long futures position.[56]

The examples given are all reasonably clear instances of an EFP being used in connection with a substantial physicals market transaction. However, it is not clear how long the physicals position must be held. For example, consider the following transaction:

> Suppose a trader, T, is long 10 gold futures contracts. After the close of the futures market, T decides that he does not want to carry the position overnight. T calls an exchange member firm that is an FCM and also a gold dealer. T agrees to sell 1,000 ounces of gold (the equivalent of 10 futures contracts) to the FCM, which confirms the sale to T out of its inventory. T immediately agrees with the FCM to exchange the gold it has just bought for a long futures contract via an EFP, whereby the FCM agrees to accept to repurchase the commodity at the same price as T purchased it and to accept the short side of the futures contract. T now has acquired a long futures position that will cancel out its short position without having had to liquidate any part of the short position at the ring or by open outcry.

This type of transaction apparently occurs with considerable frequency in the gold and foreign currency markets.[57] The legitimacy of an EFP is in the first instance subject to determination by the contract markets. They appear to take somewhat different positions as to whether a simultaneous purchase and sale of the physical commodity at the same price is acceptable. The CFTC Division of Trading and Markets does not take a position as to whether such transactions are *per se* lawful or unlawful, but it has expressed the view that the physicals (or "cash") transfer in such a transaction "should be examined especially carefully . . . ."[58] The Division expressed the belief that:

> . . . a predominant consideration in evaluating the *bona fides* of the resulting integrated transaction (cash transfer and EFP) is whether the cash transfer can stand on its own as a commercially appropriate transaction, with no obligation on either party to carry out the EFP.[59]

It thus appears that, to some extent, the EFP may be used as a device for executing a block trade in futures. It is, however, of limited utility because of the requirement of a separate physicals transaction. Therefore, the EFP is not a satisfactory technique for effecting block trades in futures where the parties are only interested in futures trades and have no genuine interest in a physicals transaction.

In this connection, the CFTC Report made the following statement:

> 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.[60]

Apparently, at the time the study was conducted, EFPs were not being used to a significant extent as a substitute for block trading. However, since publication of the CFTC Report, the percentage of transactions that constitute EFPs in certain financial futures contracts has significantly increased.[61]

2. *Sunshine Trading*

In the securities markets, there has evolved a practice of announcing large customer orders in advance of the time that the orders actually arrive on the floor, in order to attract buying or selling interest (as the case may be) at the time the orders actually arrive on the floor. Some participants in the futures markets believe that this practice would provide an acceptable approach to dealing with execution of large customer orders, an approach that would be compatible with the open outcry requirements. This practice has become known as "sunshine trading."

Proponents of sunshine trading believe that futures traders who wish to trade large-sized orders could benefit if they publicly announce their intentions to trade, and the price or price range at which they wish to trade, some hours before bringing the orders to the floor of an exchange for execution. During that time the market would be able to absorb this information and, if the pre-announced price is realistic, other member firms and their customers would be able to come in and compete by open outcry for the order at the pre-announced time.

Objections have been raised that sunshine trading may violate CFTC rules against disclosure of customer orders. Further, concerns have been expressed that pre-announcement of customer orders may be used as a veil to prearrange orders prior to their execution in the trading ring, or that false or unrealistic pre-announcements may be used to manipulate the futures market.[62]

With respect to disclosure of customer orders, CFTC Regulation 155.3(b) provides, in relevant part, that:

> No futures commission merchant or any of its affiliated persons shall (1) disclose that an order of another person is being held by the futures commission merchant or any of its affiliated persons, *unless such disclosure is necessary to the effective execution of such order* . . . . [emphasis added]

Floor brokers, in executing customer orders on a futures exchange, are similarly barred from disclosing that they are holding customer orders. CFTC Regulation 155.2(d) requires every contract market to prohibit floor brokers from making such disclosures. When these rules were promulgated by the CFTC, it characterized their purpose as "to prohibit a floor broker from disclosing customer orders to other persons who may take advantage of that knowledge" and as a "traditional customer confidentiality rule designed to protect customers from disclosure of information concerning their orders to other parties."[63] Since, under sunshine trading, the customer believes that the dissemination of its trading intentions will be to its advantage in fulfilling its trading objective, and would waive confidentiality, it does not appear that these rules would be violated by the proposed public announcements.

Concerns as to possible prearrangement of trades through use of sunshine trading also appear to be a matter of policy consideration, rather than raising issues as to permissibility of the practice under existing law. Prearrangement is unlawful insofar as, "by determining trade information such as price and quantity outside the pit, then using the market mechanism to shield the private nature of the bargain from public scrutiny, both price competition and market risk are eliminated."[64] The sunshine trading advocates point out that sunshine trading does not contemplate parties reaching individual agreements outside the trading ring; rather, by openly pre-announcing trading intentions, competitive trading should intensify at the announced time of order execution, since the orders of all interested takers of the pre-announced trade should be drawn into the pit at the announced time. The only policy consideration should be the minimum advance time which would be necessary to assure dissemination.

Advocates of sunshine trading contend that a trader that has prearranged a trade will be unlikely to announce the trade publicly and subject it to the scrutiny of other traders and of exchange regulators. Similarly, they argue that efforts to manipulate a futures market through sunshine trading are most unlikely. Manipulation has been defined as "any and every operation or transaction or practice the purpose of which is not primarily to facilitate the movement of the commodity at prices freely responsive to the forces of supply and demand."[65] One means of manipulation is to create false rumors or announce false intentions. But sunshine trading proponents believe that public pre-announcement would serve to pinpoint the source of an announcement, render it subject to public scrutiny, and make the announcing party responsible for fulfilling its stated intentions. Proponents contend that in contrast to an effort to unbalance free market forces of supply and demand, the purpose of sunshine trading is to open up the sources of supply and demand, by spreading knowledge of market conditions.

At present, no contract market has rules specifically dealing with sunshine trading. One contract market, NYFE, submitted rules to the CFTC which would formalize sunshine trading procedures. The exchange proposes to provide its facilities for the public dissemination of announcements of trading intentions by members and their customers. Members who pre-announce trading intentions would be required to attempt to execute the trade at the intended time of trading unless the market at that time is outside the price range set forth in the notice, or the bid or offer in the pit moves away from a customer's order before it can be executed. In doing so, the exchange indicated that it expects not only that futures trading will benefit from the practice, but that it will be able to monitor the practice for any potential abuses.[66]

Consideration of the exchange's proposal was placed in abeyance while the exchange worked with market data vendors to assure that complete messages of trading intentions can be widely disseminated to its market data subscribers.

3. *"All-or-Nothing" Bids and Offers*

"All-or-nothing" orders are understood in the trade to mean orders—of either the "market" or "limit" variety—that are to be executed only if the full quantity is accepted by one trader. Currently all contract markets prohibit such orders, either explicitly by rule or implicitly by interpretation.[67]

The benefit to the customer of "all-or-nothing" orders is that the customer may be able to have a large order filled at a single price. The drawback is that the order may not be filled even when the collective interest in the trading ring is sufficient to fill the order at a price satisfactory to the customer. In other words, while a broker might bid for 1,000 contracts on an all-or-nothing basis, and while there might be brokers in the pit or ring with sell orders that individually are less than the quantity bid for but in the aggregate exceed the quantity bid for, the order will not be executed. Of course, the risk of not being able to execute a large trade at a satisfactory price exists for any large order, regardless of the method utilized. However, no other method carries that risk even though the interest is present in one location.

Neither the Act nor the CFTC Regulations explicitly prohibit all-or-nothing bidding or offering. Accordingly, it would appear that the contract markets are not precluded from adopting rules to implement that basis of trading. Any such rules would, of course, have to be approved by the CFTC, where a number of regulatory concerns might be raised.

One concern might be that all-or-nothing bids and offers could be used to manipulate a market. For example, a trader could make a bid or offer for a large quantity which a trader has no intention or expectation will be accepted. This could be done to influence a market price. Such a bid might be considered fictitious and therefore violate contract market prohibitions against fictitious bids or offers. Of course, it may be difficult to prove that a particular bid or offer was not *bona fide* but was for a manipulative purpose.

In addition, there is a basic question as to whether the requirement of competitive execution and open outcry means that each individual contract within a particular order must be subjected to competitive execution and open outcry, or whether a requirement could be satisfied if contracts for several customers are packaged together in a single block and are bid or offered and transacted as part of a block.

All-or-nothing orders also raise questions from an economic standpoint. Their use, for such time as they are being offered or bid in the ring, would eliminate all those traders on the other side of the market whose bids and offers are for smaller quantities, with a resultant loss of market liquidity. As an example, assume a trader is bidding 975, "all-or-nothing," for 1,000 contracts and that his or her bid is the highest in the ring. The consequence of that bid is that any seller who is willing to sell at that price, or even lower, but for lesser quantities, would be shut out of the market. If there are other bidders at 975, sellers of lesser quantities would be shut out when the bidders for lesser quantities are satisfied. In addition, the price movements of the market are more likely to be choppy, with larger gaps between prices than would be the case if the smaller traders were constantly able to take portions of the larger orders. Finally, permitting "all-or-nothing" trades of large blocks might be deemed anti-competitive, in that it might result in excluding certain brokers from participation.[68]

4. *Transfer Trades and Office Trades*

Section 4c of the Act, as noted above, provides:

> Nothing in this section shall be construed to prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities, or of transfer trades or office trades if made in accordance with board of trade rules applying to such transactions and such rules shall have been approved by the Commission.[69]

Regulation 1.38(a) similarly excepts from the requirement of competitive execution at open outcry "transactions which are executed noncompetitively in accordance with written rules of the contract market which have been submitted to and approved by the Commission . . . ." This exception in Regulation 1.38(a) is not on its face limited to EFPs, office trades, and transfer trades (as is the exception in Section 4c of the Act). Regulation 1.38(b) imposes certain record-keeping requirements with respect to "trades, transactions or positions which are not competitively executed, *including* transfer trades or office trades, or trades involving the exchange of futures for cash commodities or the exchange of futures in connection with cash commodity transactions . . ." (emphasis added). On its face, therefore, it would appear that Regulation Section 1.38 contemplates lawful non-competitive transactions other than EFPs, transfer trades, and office trades.[70]

In any event, while both Section 4c and Regulation 1.38 permit non-competitive execution of "transfer trades" and "office trades," neither the Act nor the CFTC regulations defines what these transactions are. During the floor debate on the legislation that was to become the Commodity Exchange Act of 1936, the following definition was offered:

> Office trades and transfer trades: Board-of-trade rules contemplate that all ordinary transactions for future delivery shall be made in the pit or place provided for that purpose. However, unusual conditions as well as merchandising methods and established trade practices make it necessary at times to close futures trades as between customers of the same house or to transfer interests from one house to another by bookkeeping entries without trades being actually made in the pit. These are referred to as office trades or transfer trades.[71]

Presumably, the permission to "transfer interests from one house to another" contemplates that there will be no change in beneficial ownership. In other words, presumably it contemplates a situation where a customer wishes to transfer his or her account from one firm to another, in which case Congress was acknowledging that it would be unnecessary to effect trades on the floor since the customer is not in fact buying or selling anything.

However, the permission to close trades "as between customers of the same house" is very different, since by definition there is a transfer of beneficial ownership. Congress did not supply any justification for this exception from the competitive execution requirement, other than the existence of "unusual conditions as well as merchandising methods and established trade practice." A question could be raised whether this should be read to imply that a trade practice could be developed whereby FCMs

could transfer large blocks of futures from one customer to another on their books in order to "close futures trades."

CONCLUSION

The requirement of competitive execution on a contract market floor exists for three purposes, *viz.*: (1) to protect traders by assuring them that their orders are being executed at the "right price", in that they are not paying more (or receiving less) than what the free forces of supply and demand determine to be the fair market value; (2) to give all market participants an opportunity to accept each bid or offer; and (3) to let the market reflect the impact of each bid or offer (*i.e.*, price discovery).

It is the view of this Committee that competitive execution of futures trades is desirable for these purposes and others. However, the legal requirement for such execution is not absolute or inflexible. As discussed, several categories of non-competitive transactions currently are permitted, including EFPs, office trades, and transfer trades. This Committee believes that activities by brokers and traders prior to the submission of larger orders to the floor for execution—including solicitations of interest, discussions, and negotiations—can be permitted by contract market rule without undermining the purposes of competitive execution.

It is the conclusion of this Committee that the CFTC has sufficient authorization under the Act, as it now stands, to approve contract market rules that would permit execution of large futures orders in blocks under procedures such as are used on the securities markets, provided appropriate conditions are met. Those conditions might include the following:

1. The size of order eligible for such procedures should be such that: (a) in view of the liquidity of the particular market, there is a reasonable probability that the order could not be effected without itself causing a substantial effect on price; and (b) the order is of a size typically used by commercial participants;

2. The transaction should have to be bid or offered on the

contract market, by open outcry or other competitive method, with adequate opportunity for public participation; and

3. Any portion of the transaction that is not promptly taken up at the ring may be crossed, with the floor broker and/or the FCM taking the opposite side (with the consent of the customer), but only at the price bid or offered on the contract market.

It is further the view of this Committee that approval of such a system would not be inconsistent with any of the CFTC regulations as presently in force. However, it will require the CFTC to make revisions in certain of its current interpretations of the Act and those regulations. For the reasons stated above, we believe that neither the language nor the purposes of the Act are inconsistent with making those revisions, and we believe it would be in the public interest to revise.

In reaching this conclusion, the Committee recognizes that the decision on whether and how to permit large futures orders to be executed in blocks must be made, in the first instance, by the contract markets themselves. If a contract market adopts rules to permit a mechanism for large order execution, those rules will need the approval of the CFTC. If the rules reasonably satisfy the basic policy concerns regarding competitive execution and price discovery, the CFTC has sufficient flexibility to approve them, even if they involve some amount of prearrangement and/or involve crossing. If the CFTC does not agree that it has that flexibility, Congress should act to make clear that it exists.[72]

January, 1989

Committee on Futures Regulation

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ENDNOTES

[1] SEC Staff Report, *The October 1987 Market Break* 3-18, n. 49 (February 9, 1988); Testimony of David S. Ruder, *SEC Recommendations Regarding the October 1987 Market Break* 13 (February 3, 1988).

[2] 2 N.Y.S.E. Guide (CCH) ¶ 2127.10.

[3] 2 N.Y.S.E. Guide (CCH) ¶ 2076, ¶ 2127, respectively.

[4] For further description of the block trading process, *see*, Seifert & Turnbull, *Institutional Trading Mechanisms in Futures and Securities*, FIA Review 12, 13 (July/August 1988).

[5] Common parlance speaks of "buying" or "selling" futures contracts. Technically, however, the parties do not buy or sell contracts. They enter into contracts to buy or sell commodities for future delivery.

[6] Act § 4(a), 7 U.S.C. § 6(a) (1982). A similar prohibition applies to commodity options. CFTC Regulation § 32.11. However, they will not be discussed in this report because there has not as yet developed a problem in large order execution for commodity options. Among other things, off-exchange commodity options are permitted where the purchaser is a commercial user of the underlying commodity. CFTC Regulation § 32.4(a).

[7] The Act itself does not explicitly require transactions to be executed at open outcry except where a broker executes a buying order for one principal against a selling order for another principal. Act § 4b, 7 U.S.C. § 6b (1982). However, the CFTC and others have taken the position that such a requirement is implicit in the Act. *See, e.g.*, CFTC order disapproving rules of Commodity Exchange, Inc. ("Comex") for straddle call session, 46 Fed. Reg. 23,516 (1981); letter from Thomas R. Donovan, President of The Board of Trade of the City of Chicago (CBT), to Ms. Jean A. Webb, Secretary of the CFTC, dated July 13, 1988, regarding application by

Amex Commodities Corporation for designation as a contract market in ten-year Treasury securities, at 13; letter from Thomas R. Donovan, President of the CBT, to Ms. Jean A. Webb, Secretary of the CFTC, regarding Chicago Mercantile Exchange (CME) rule amendments relating to implementation of Globex trading system dated September 6, 1988, at 17-18.

[8] 18 Fed. Reg. 176 (1953). The CEA was the predecessor agency of the CFTC, which came into existence in 1975.

[9] CEA Administrative Determination No. 159 (1956).

[10] S. Rep. No. 93-1131, 93d Cong., 2d Sess. 16, reprinted in 1974 U.S. Code Cong. & Admin. News 5843, 5857.

[11] 40 Fed. Reg. 58,660 (1975).

[12] 41 Fed. Reg. 56,134 (1976).

[13] 41 Fed. Reg. 56,134 (1976); 42 Fed. Reg. 4120 (1977).

[14] Most contract markets have adopted prearranged trading prohibitions which are applicable to all their members, not just floor brokers. *See, e.g.*, CBT Rule 350.05(I), CME Rule 539, Comex Rule 4.27 and Coffee, Sugar & Cocoa Exchange (CSCE) Rule 1.13(11).

[15] 7 U.S.C. § 6c(a) (1982).

[16] Indeed, in one case, the prohibition against "fictitious trades" was held to be too vague to sustain a criminal charge for its violation. *United States v. LaMantia*, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,667 (N.D. Ill. Aug. 9, 1978).

[17] *In the Matter of Sundheimer*, [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,245 (Sept. 5, 1981).

[18] *Id.* at 25,217, n.1.

[19] *Id.* The opinion speaks of Sections 4c(a) (A) and (C). Paragraph (C) has subsequently been redesignated as paragraph (B). Futures Trading Act of 1982 § 206(1), Act of January 11, 1983, P.L. 97-444, 96 Stat. 2294.

[20] *Id.* at 25,219. This applies a different meaning to the term "accommodation trades" than was described in the congressional floor debates leading to the adoption of the 1936 Act, which was:

> An accommodation trade is a transaction between two commission houses whereby, one being long with the clearing house and the other being short, the one that is long sells to the one that is short enough of a given future to give each house an even or nearly even position, thus reducing the amount of the margin to be put up with the clearing house. At some later date another transaction is made, unwinding and undoing the first transaction. In the meantime, each house has had free use of the margin money put up by its customers without having to redeposit with the clearing house. Clearing houses require margins only on net positions, so that where a commission firm has customers both long and short in equal or nearly equal positions, the firm as such has little or no net position with the clearing house. Such a practice would also be prohibited. 80 Cong. Rec. S. 8088 (May 27, 1936).

[21] *In the Matter of Collins*, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 (April 4, 1986), *opinion clarified, id.* at ¶ 23,401 (November 26, 1986).

[22] *Id.* at 31,903 n.23.

[23] *Id.* at 31,903.

[24] *See, e.g.*, *In re Sundheimer, supra*; *In re O'Grady*, 30 A.D. 1635 (1971); *In re Gerstenberg*, 26 A.D. 816 (1967); *In re Sicinski*, 25 A.D. 302 (1967); *cf. In re Goldwurm*, 7 A.D. 265 (1948) (mutually offsetting transactions entered into solely for tax purposes are wash sales and fictitious trades).

[25] *Stoller v. Commodity Futures Trading Comm'n*, 834 F.2d 262 (2d Cir. 1987).

[26] *In the Matter of Gimbel*, 2 Comm. Fut. L. Rep. (CCH) ¶ 24,213 (April 14, 1988).

[27] *Id.* at 35,003-4. Citing *Nichols* as authority for this proposition seems curious, since *Nichols* reached the opposite result.

[28] One point which is clear is that, in doing so, the FCM or floor broker may not disclose the order from its customer except under such circumstances as may be necessary for the effective execution of the order. See CFTC Regulations §§ 155.2(d) and 155.3(b) (1). The cited regulations do not specify whether the prohibition against disclosure may be waived by the customer. Since the prohibition is presumably designed for the customer's benefit, it would appear that such a waiver should be permitted.

[29] *In the Matter of Collins*, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 31,901.

[30] *Stoller v. Commodity Futures Trading Commission*, 834 F.2d 262, 267 (2d Cir. 1987).

[31] *In the Matter of Kidder, Peabody & Co., Inc.*, CFTC Docket No. 88-6.

[32] *Nichols & Co. v. Secretary of Agriculture*, 131 F. 2d 651 (1st Cir. 1942), *rev'd in part on rehearing*, 136 F. 2d 503 (1st Cir. 1943).

[33] CSCE Cocoa Trade Rule Resolution No. 1, Coffee, Sugar & Cocoa Exchange, Inc. Guide (CCH) ¶ 5444.

[34] Opinion of the Adjudication Committee 20 (March 14, 1986).

[35] The appeal was filed prior to the effective date of amendments to Part 9 of the CFTC Regulations, which no longer authorize the Commission to refuse to entertain a request for review.

[36] 80 Cong. Rec. S8089 (1936). Such trades might also be regarded as wash sales or fictitious transactions.

[37] 13 Fed. Reg. 7834 (1948).

[38] *See, e.g.*, CSCE Rule 3.13; NYMEX Rule 6.41; *see also* Trading Standards Interpretation, 42 Fed. Reg. 35,004 (1977).

[39] *See, e.g.*, CBT Rule 332.

[40] *See, e.g.*, Comex Rule 4.24; CME Rule 533.

[41] CSCE Rule 3.13.

[42] EFPs are known as "Against Actuals," or "AAs" on the CSCE. EFP practices and the regulatory implication thereof have been the subject of an extensive study by the CFTC Division of Trading and Markets, which published the results of its study and conclusions in its Report on Exchanges of Futures for Physicals (October 1, 1987) ("CFTC Report").

[43] CFTC Report at 2.

[44] CFTC Report, *passim.*

[45] CFTC Report at 257-266.

[46] NYMEX Rule 150.14(A). *See also* CBT Rule 444.01; CME Rule 538; CSCE Rule 3.06; Comex Rule 4.36(b); Kansas City Board of Trade (KCBT) Rule 1128; New York Cotton Exchange (NYCE) Rule 1.02; New York Futures Exchange (NYFE) Rule 432; and NYMEX Rules 6.21, 150.14, 190.14, 200.20 and 230.17.

[47] CFTC Report at 152-160.

[48] *See, e.g.*, CBT Rule 444.01, KCBT Rule 1128, Comex Rule 4.36, NYFE Rule 432 and NYCE Rule 1.02.

[49] *See, e.g.*, NYMEX Rule 6.21 and CSCE Rule 3.06. While CME Rule 538 describes the physicals exchange as a transfer of a cash commodity, the CME has recognized use of forward of transactions at least with respect to foreign currency EFPs (CME Special Executive Report, September 27, 1979).

[50] *See, e.g.*, CSCE Rule 3.06, which requires all such transactions to be effected during trading hours, and, if prices are reported (as is required for cocoa EF 's, but is permissive for coffee and sugar EFPs), the price must be established at the current market trading in the ring, no higher than the lowest offer or lower than the highest bid at the time of report. NYFE Rule 432 requires that the transaction price bear a "reasonable relationship to the cash market price of the underlying commodity interest."

[51] *See, e.g.*, CBT Rule 444.01, CME Rule 538, Comex Rule 4.36 and KCBT Rule 1128.

[52] CFTC Report at 162-3.
[53] *Id.* at 163-4.
[54] CFTC Report at 14.
[55] CFTC Report at 16.
[56] CFTC Report at 17.
[57] CFTC Report at 193.
[58] CFTC Report at 195.
[59] *Id.*
[60] CFTC Report at 257.

[61] For example, according to statistics supplied by the CFTC staff, the number of EFPs in the Treasury Bond Futures Contract in 1986 were 394,594 (or 0.75% of total volume for the year), in 1987 were 770,729 (1.15%), and in the first nine months of 1988 were 1,751,878 (3.41%).

[62] Another concern is that pre-announced trades could adversely affect price discovery. This concern is related to more general objections against injecting block trading concepts into futures trading. Sunshine trading proponents believe, however, that pre-announced trading intentions would add to the sum total of relevant knowledge in the market place and, thereby, enhance the ability of traders to arrive at a fair price.

[63] 41 Fed. Reg. 56,134 (1976).

[64] *In re Collins, supra* n.21, [1986–87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,982 at p. 31,897 (April 4, 1986); *opinion clarified, id.* ¶ 23,401 (November 26, 1986).

[65] *In the Matter of Indiana Farm Bureau Cooperative Association, Inc.*, [1982–84 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, at 27,279 (December 17, 1982).

[66] NYFE submission to CFTC, December 17, 1986.

[67] See, for example, CSCE Rule 3.03(b) and NYMEX Rule 6.05(B) as illustrations of rules containing explicit bans, and CBT Rule 336.00 and CME Rule 523 as illustrations of rules that are interpreted as implicitly banning such orders.

[68] *See* Act, § 15.

[69] It is to be noted that this exception for non-competitive transactions says that nothing "in this section" shall be construed to prevent such transactions. This is to be contrasted with the exception for cross trades in Section 4b, which states that nothing "in this section or any other section of the Act" shall be construed to prevent cross trades which meet the prescribed requirements.

[70] To the extent that Regulation 1.38 were to permit non-competitive transactions beyond what is permitted by section 4c of the Act (*i.e.*, EFPs, office trades, and transfer trades), there could be a question as to whether it is statutorily authorized. However, it is not clear that the CFTC, in granting any such exception, is circumscribed by Section 4c, since Section 8a(5) of the Act grants the CFTC broad discretion in adopting such rules and regulations as in its judgment "are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this Act."

[71] 80 Cong. Rec. S8089 (May 27, 1936).

[72] In reaching this conclusion, the Committee expresses no opinion as to any pending proceedings, such as CFTC enforcement actions or appeals of exchange disciplinary actions.