



# FUTURES INDUSTRY ASSOCIATION

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## COMMENT

August 31, 1998

Ms. Jean A. Webb  
Secretary  
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 -- Alternative Execution Procedures

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments in response to the request for comments by the Commodity Futures Trading Commission (the "Commission") on issues relating to whether alternative execution procedures should be permitted on or subject to the rules of designated contract markets. 63 Fed. Reg. 3708 (January 26, 1998) (hereinafter sometimes referred to as the "Concept Release"). By letter dated April 27, 1998, the FIA submitted comments to the Commission concerning various other issues raised in the Concept Release, including with respect to exchanges of futures for physical transactions, certain types of noncompetitive transactions, and the use of execution facilities for noncompetitive transactions. We have identified by number the particular questions to which these comments are responsive.

FIA, a not-for-profit corporation, is a principal spokesman for the futures industry. Its members include approximately 70 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 80 per cent of all customer transactions executed on United States contract markets.

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## I. DISCUSSION

The Commission is seeking comment on a variety of issues relating to whether alternative execution procedures should be permitted on or subject to the rules of designated contract markets. The Commission recognizes in the Concept Release that there is a range of possibilities which can be explored in this area.<sup>1</sup>

Consistent with the position that we have repeatedly taken on this issue, FIA sees a compelling need for alternative procedures to facilitate execution of large orders in the futures markets to enhance the ability of these markets to meet the needs of institutional participants concerning transaction size and price, including providing greater flexibility in the management of market exposures and price risks<sup>2</sup> (Concept Release Question 31). FIA believes that implementation of such procedures may be accomplished through approval of contract market rule proposals pursuant to Rules 1.38 and 1.39. We note that Rule 1.38 reflects the Commission's traditional view that on-floor execution in open outcry is competitive and that other methods may be noncompetitive. However, as described below, alternative execution procedures frequently can achieve more competitive pricing and better executions than traditional on-floor execution procedures. FIA will be pleased to work with the contract markets to assist them in developing appropriate rule proposals that will address the need for greater efficiency and liquidity in the execution of large orders. (Concept Release Questions 32-35). FIA hopes that the Commission's review of such proposals pursuant to Rules 1.38 and 1.39 will be conducted in a manner that facilitates the availability of alternative execution procedures.

Due to the dramatic growth in institutional participation in the futures markets during the last twenty years and the increasing integration of the financial futures and securities markets, major market participants increasingly wish to be able to trade large numbers of futures contracts as part of larger, structured capital markets transactions. Such transactions require size and price certainty in order to be implemented smoothly, efficiently and cost effectively. For example, if two entities enter into an interest rate swap transaction with each other, each of them may wish to manage the exposure by taking a related position in fixed income futures contracts. In these circumstances the most efficient, cost effective and least disruptive method of entering into such positions would be for them to negotiate such a transaction bilaterally and report it to their respective clearing FCMs for submission to the clearinghouse for clearance.

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<sup>1</sup> See 63 Fed. Reg. at 3718.

<sup>2</sup> See, e.g., Revision of Commodity Market Regulation: Hearings on H.R. 467 Before the Subcomm. on Risk Management and Specialty Crops of the House Comm. on Agriculture, LEXIS FDCH Cong. Testimony, April 17, 1997 (Statement of John M. Damgard, President, Futures Industry Association).

Similarly, an investment company that wishes to reduce its exposure to equities may sell equities rather than stock index futures contracts because of the need for size and price certainty. A broker-dealer/FCM may solicit potential buying interest in such an equity order off the floor and negotiate the transaction "upstairs," thereby obtaining size and price certainty for the customer, but may not execute such an order in the futures markets except in the pit. In the same vein, the writer of an over-the-counter equity index option contract that intends to hedge its exposure with stock index futures contracts cannot determine the cost of the hedge in advance under current law. The option buyer is therefore exposed to market risk until the option writer can execute its hedge on the relevant futures exchange. If alternative execution procedures were available in the futures markets, the option writer would be able to quote the buyer a firm price for the option and thereby provide price certainty.

These examples reflect that under current law market participants must submit futures transactions for execution on the exchange floors and are prohibited from negotiating such transactions off the floor. As a result, the sizes and prices obtained fail to achieve the desired economic objectives or to reflect accurately actual supply and demand of the market at large, but instead result in volume and price distortions. The resulting sizes and prices merely reflect the liquidity available on the floor in a particular contract at a particular time. Thus, while traditional on-floor execution methods are intended to achieve competitive trading and best execution, they do not produce the intended results in such circumstances, but instead result in aberrational pricing. Consequently, market participants frequently seek to implement their trading strategies and to satisfy their risk management needs by means other than futures transactions. In this regard, the availability of alternative execution procedures for large orders would facilitate institutional participation in the futures markets and also diminish any perceived need to expand the scope of the exemption for exchange of futures for physical transactions to provide greater flexibility in the management of market exposures and price risks.

The Commission recognized in the context of its Part 36 rules for professional markets that off-floor transactions are appropriate for institutional market participants. Among other things, the Part 36 rules authorize exchanges to adopt rules that permit (i) a member to trade for the member's own account opposite the account of another member; (ii) an FCM or floor broker to take the opposite side of a customer's order for its own account; (iii) the execution of customer orders of different principals directly between customer accounts; and (iv) market participants to negotiate a particular transaction between themselves and to report that transaction to their respective clearing firms. See Rule 36.3, 17 C.F.R. § 36.3 (1998). Such procedures have securities industry analogues which the Commission notes in the Concept Release.<sup>3</sup> The Part 36 rules, however, provide that an exchange may not seek professional market designation with respect to existing futures contracts. See Rule 36.2(a)(4), 17 C.F.R. §36.2(a)(4) (1998). FIA believes that this type of exemptive relief should be made available with respect to existing futures contracts as well. Such relief also should address

<sup>3</sup> See 63 Fed. Reg. at 3716-18.

related issues such as permitting off-floor transfer trades in situations that may involve a technical change in beneficial ownership such as in connection with the restructuring of a pension plan portfolio due to a merger or acquisition of the sponsor corporation.

The Commission is also requesting comment on a series of questions relating to the need for qualifying standards and continuing regulatory requirements in this area. FIA believes that adequate safeguards already exist to prevent fraud and manipulation (Concept Release Questions 45, 46). First, transactions that are not effected openly and competitively would remain prohibited under Rule 1.38, unless they are effected pursuant to contract market rules approved by the Commission which provide otherwise. Second, the antifraud and antimanipulation provisions of the CEA would remain applicable to these transactions. Third, the contract markets would remain responsible for market surveillance and rule enforcement, including prohibitions against fraud, manipulation and noncompetitive trades, subject to Commission oversight. Finally and perhaps of greatest significance, the experience of the securities exchanges demonstrates that it is feasible to introduce large order execution procedures within the environment of a centralized marketplace that is subject to a framework of regulation comparable to the CEA and the rules and regulations thereunder, without having adverse effects on market volume, liquidity or transparency or customer protection.<sup>4</sup>

FIA believes that the Commission generally should permit contract markets to experiment with different types of alternative execution procedures so that decisions can be made on an informed basis through observation of actual transactions and review of empirical data gathered over a period of time (Concept Release Questions 2, 3, 38). Thus, the contract markets should evaluate in the first instance which type of alternative execution procedures are best suited to particular contracts. We do not find it necessary or appropriate to attempt to develop a comprehensive set of qualifying standards for such procedures in advance and in the absence of reviewing the particular terms of specific proposals (Concept Release Question 39). Similarly, FIA finds it premature to attempt to formulate an all-inclusive list of prospective requirements that would be applicable to any such rule proposal (Concept Release Questions 40-42). FIA does not question that significant issues of law and policy must be addressed in this area, but we believe that the Commission has ample authority to permit experimentation with alternative execution procedures in a controlled trading environment and to deal effectively with any issues that might arise.

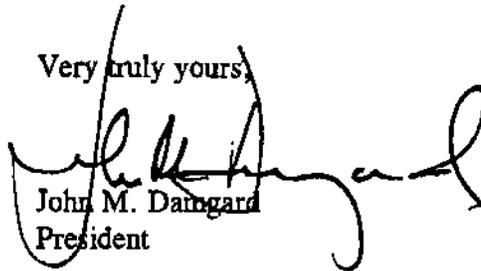
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<sup>4</sup> Id. See also Committee on Futures Regulation of the Association of the Bar of the City of New York, Large Order Execution in the Futures Markets, 44 Bus. Law. 1335, 1336-37 (August 1989).

II. CONCLUSION

FIA appreciates the opportunity to submit these comments in response to the Commission's publication of the Concept Release. If the Commission or any of its staff has any questions regarding this letter, please contact the undersigned or Barbara Wierzynski at 202-466-5460.

Very truly yours,



John M. Daingard  
President

cc: The Honorable Brooksley E. Born, Esq.  
The Honorable John E. Tull, Jr.  
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