Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823
202.466.5460
202.296.3184 fax
www.futuresindustry.org

FIA

04-7
(2)

COMMENT

August 27, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: Execution of Transactions: Rule 1.38 and Guidance on Core Principle 9
69 *Fed.Reg.* 39880 (July 1, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA")[1] welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed amendments to Commission rule 1.38 and the related proposed Guidance on Core Principle 9 ("Guidance"). For the reasons explained below, FIA supports the proposed amendment to rule 1.38. However, FIA opposes adoption of the Guidance, which would impose detrimental restraints on the terms and conditions of designated contract market ("DCM") block trading rules.

Commission Rule 1.38

Commission rule 1.38 generally provides that all transactions on a DCM must be executed "openly and competitively," except as set forth in the rules of the DCM that have been submitted to and approved by the Commission. The Commission proposes to amend rule 1.38 to authorize a DCM to certify, rather than submit for approval, rules permitting transactions that are allowed to be executed non-competitively.[2] FIA supports this proposed amendment.

Rule 1.38 also provides that persons executing non-competitive trades, including trades involving "the exchange of futures for cash commodities or the exchange of futures in

---

[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 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 eighty percent of all customer transactions executed on United States contract markets.

[2] Pursuant to the provisions of section 5c(c) of the Commodity Exchange Act ("Act") and Commission rule 40.6(a), a DCM may implement any new rule or rule amendment if, among other requirements, the DCM certifies that the rule "complies with the Act and the regulations thereunder."

connection with cash commodity transactions," must identify and mark all "orders, records, and memoranda" pertaining to such orders. The Commission proposes to amend rule 1.38 by deleting the phrase "the exchange of futures for cash commodities or the exchange of futures in connection with cash commodity transactions," and substituting in lieu thereof the phrase "the exchange of futures for a commodity or for a derivatives position." The purpose of the proposed amendment is to "specifically expand[] the types of transactions that may be lawfully executed off of a DCM's centralized market." Again, FIA supports this proposed amendment. As the markets and the needs of market participants continue to evolve, it is essential that the Commission's rules provide DCMs with the necessary flexibility to develop prompt and effective responses to such changes. The proposed amendments achieve this goal.

Guidance on Core Principle 9

FIA understands that the underlying purpose of proposed Guidance on Core Principle 9 is to assist DCMs in drafting rules that would permit eligible participants to effect block trades. Further, the provisions of the Guidance specifically addressing transactions between affiliates are intended to provide a "safe harbor" with respect to such transactions. FIA appreciates the spirit in which the Commission has proposed the Guidance. Nonetheless, we must oppose the Guidance in its present form. As explained below, we believe the Guidance conflicts with the spirit, if not the provisions, of the Commodity Futures Modernization Act of 2000 ("CFMA") and effectively denies DCMs the flexibility that the amendments to rule 1.38 would appear to grant them.

As the Commission is aware, an underlying purpose of the CFMA was "to promote responsible innovation and fair competition among boards of trade, other markets and market participants." To effect this goal, the Commission, in part 38 of its rules, exempted DCMs from complying with all but a handful of the Commission's more prescriptive regulations, which had restricted the manner in which DCMs could conduct business.[3] In lieu of such regulations, the Commission directed DCMs to comply with the core principles set out in the Act, including Core Principle 9, which provides: The [DCM] shall provide a competitive, open and efficient market and mechanism for executing transactions. Section 5(d)(9) of the Act.

We recognize that the Commission has the authority under section 5c(a) of the Act to issue an interpretation that would describe "what would constitute an acceptable business practice" under section 5(d). Nonetheless, we do not believe that Congress intended to authorize the Commission to adopt an interpretation that would effectively impose on DCMs a prescriptive regulation in the form of an interpretation.[4] On a more practical level, we are concerned that the proposed Guidance would have the effect of stifling innovation with respect to transactions that may be executed off a DCM's centralized market.

---

[3] The Commission did not exempt DCMs from complying with Commission rule 1.38.

[4] Certainly, the proposed Guidance is far more prescriptive than the Application Guidance and Acceptable Practices that the Commission has adopted with respect to other Core Principles governing DCMs set forth in Appendix B to Part 38.

FIA understands that, as a matter of law, the proposed Guidance would not provide the "exclusive means" for complying with Core Principle 9. Section 5c(a) of the Act. In practice, however, we believe that would be the result.[5] As the Commission notes in the *Federal Register* release, essentially every element of the proposed Guidance is based on exchange rules that the Commission has previously approved. The Commission, therefore, appears to be serving notice that any deviation from the terms and conditions of the existing rules would violate section 5(d)(9) of the Act.[6] At the very least, the Guidance would appear to impose on a DCM a significant burden in establishing to the Commission's satisfaction that any block trading procedures and other procedures for trading away from the centralized market that differ from those that the Commission has previously approved comply with this provision of the Act.[7] Nothing in the *Federal Register* release accompanying the proposed Guidance explains why the Commission would limit the discretion of the DCMs in this way.[8]

In some circumstances, the proposed Guidance would require rules to be more restrictive than those currently in place at several DCMs.[9] In particular, the Guidance establishes new

---

[5] For example, it is not clear whether, in light of the proposed Guidance, a DCM would be able to submit by certification block trading rules that deviate from the Guidance. If a DCM may submit by certification only those rules or rule amendments that conform to the proposed Guidance, the anticipated benefits of the proposed amendments to rule 1.38 are significantly reduced.

[6] The Commission states that it believes the proposed Guidance is necessary "based upon its experiences administering" rule 1.38. However, the Commission does not describe what those experiences have been or why they have led to Commission to seek to limit the discretion of DCMs in this way.

[7] In this regard, without limiting our opposition to the proposed Guidance in its entirety, we are particularly concerned with the provisions of paragraph (F)(ii), which would restrict the method by which the appropriate minimum size of a block transaction is determined. The Guidance appears to assume that the same factors should be taken into account in all markets. We respectfully disagree.

[8] In earlier comments on DCM rules relating to block transactions, FIA has suggested that the DCMs might want to consider additional changes to those rules that FIA believed would result in more efficient trading procedures. See, *e.g.*, Letter from Ronald H. Filler, President, FIA Law and Compliance Division to Jean A. Webb, Secretary to the Commission, dated April 24, 2000 (CME Proposed Rule 526); Letter from Eileen T. Flaherty, President, FIA Law and Compliance Division to Jean A. Webb, Secretary to the Commission, dated July 28, 2000 (Application of BrokerTec Futures Exchange). We fully expect that FIA member firms will continue to identify ways in which the existing block trading rules could be revised to meet their client's needs more effectively.

[9] For example, in addition to the restrictions on transactions between affiliates discussed below, the proposed Guidance appears to prohibit a DCM from permitting an advisor that is exempt from registration with both the Commission as a commodity trading advisor and the Securities and Exchange Commission as an investment adviser to effect a block trade on behalf of its clients. This prohibition would conflict with the provisions of section 415(b)(ii)(A) of the rules of the US Futures Exchange. There would appear to be no reason why a DCM could not elect to authorize advisors that have fewer than 15 clients and do not hold themselves out to the public to effect block trades on behalf of their clients. Such advisors would not be required to be registered with either the Commission or the Securities and Exchange Commission.

requirements with respect to block trades executed between affiliated parties. Adoption of the proposed Guidance, therefore, could require these exchanges to amend their rules to comply with the Guidance.

For example, paragraph (J) of the proposed Guidance provides that block transactions between affiliates may be considered "arm's length" only if executed during the contract's trading hours and at prices that fall within the bid/ask spread at the time the transaction occurs. Restricting the time during which the transaction may be executed and requiring the price of the transaction to fall within the bid/ask spread potentially deny these entities the economic benefits available to all other eligible participants. As the Commission is aware, block trades frequently occur at a price outside the bid/ask spread, because one side of the transaction desires a certain price in connection with one or more related transactions, because one side must pay a premium in order to effect a transaction of significant size, or simply because the market has moved since negotiations on the block trade were initiated.[10]

In addition, DCMs and FCMs would be required to adopt and implement new recordkeeping procedures. Specifically, FCMs would be required to indicate on appropriate records both at the time a block order is placed and at the time it is executed that the transaction is between affiliates. Further, DCM rules would have to identify transactions between affiliates on the trade register.

The Commission states that these additional requirements are necessary because transactions between affiliates may be susceptible to abuse. However, the Commission has not cited any empirical evidence to support this assertion. Further, DCMs' existing trade practice and market surveillance compliance programs should be sufficient to detect any such abuses that may occur. We understand that all DCMs have programs designed to identify block trades that fall outside of established parameters or otherwise appear anomalous. Such transactions are then reviewed to assure compliance with DCM rules.[11] If the Commission has reason to believe that the DCM programs are inadequate, the Commission should work with the DCMs to enhance them.

Moreover, it is important to understand that an FCM would often find it impossible to indicate at the time a block order is placed that the transaction is between affiliates. The affiliated status of parties to a block transaction is not always evident to the traders responsible for effecting the transaction. Affiliate relationships may not be apparent from the names of the

---

[10] Paragraph (J) would also establish a presumption that block trades between any two parties (whether affiliated or not) would not be "arm's length" unless each party "has a separate account controller with its own responsibility to review and evaluate" the transaction.

[11] For example, as described in Division of Market Oversight's Rule Enforcement Review of BrokerTec Futures Exchange, the National Futures Association ("NFA") has programs in place to identify, among other transactions, block trades executed at a price outside the trading range on the day of the trade up to the time the trade was reported. (NFA's programs also prepare exception reports that identify block trades that fail to meet the minimum size requirements and that are not reported within the required time limits.) NFA reviews all trades identified on its exception reports as well as a sample of other block trades.

clients. In addition, traders employed by large institutional investment advisers do not always know the exact legal entity for which they are trading. For instance, a trader may only know an account number. This is particularly true in a give-up situation. Practically, an FCM cannot investigate the identity of each party to a block transaction and their possible relationship before submitting the transaction for posting within the short timeframes required by exchange rules

As noted above, we understand that the Commission may have intended this portion of the Guidance to provide a "safe harbor" for affiliated entities that engage in block transactions. However, our experience is that "safe harbors" are generally adopted to remove the legal uncertainty that would otherwise engulf the transaction in question. The Commission's Policy Statement Concerning Swap Transactions, 54 F.R. 30694 (July 21, 1989), is one example. The implication of the proposed Guidance, therefore, is that block trades between affiliates are at best improper and at worst, unlawful, unless they fall within the terms and conditions of the Guidance. We do not believe the Commission intends this result.

Exchange of Futures for Physicals

Finally, we are concerned that the proposed Guidance on exchange of futures for physicals ("EFPs") could be interpreted to prevent the use of transitory cash transactions. As the Commission is aware, so-called "transitory EFPs" have been permitted under the rules of DCMs, at least with respect to certain contracts, for approximately 20 years without incident.[12] If the Commission determines to go forward with adoption of this proposed Guidance, it should make clear that nothing in the Guidance is intended to prevent transitory EFPs.

We are also concerned that the proposed Guidance could be interpreted to prohibit EFP transactions in which the cash leg of the transaction does not take place directly between the two parties. As the Commission is aware, certain DCMs permit cash market dealers in interest rate products to facilitate EFP transactions between two parties by acting as the principal to each party on the cash leg of the transaction. The futures leg of the transaction continues to be effected directly between the two parties.[13] Again, if the Commission determines to go forward with adoption of this proposed Guidance, it should make clear that nothing in the Guidance is intended to prevent EFPs effected in this manner.

---

[12] The use of transitory EFPs was discussed in detail in the Division of Trading and Markets *Report on Exchanges of Futures for Physicals*, dated October 1, 1987 (pp. 192-201).

[13] See, *e.g.*, Chicago Board of Trade Regulation 444.01B; Chicago Mercantile Exchange EFP/EBF Trading Practices Q & A, dated June 28, 2004.

Conclusion

Thank you for the opportunity to submit our views on the proposed amendments to rule 1.38 and the proposed Guidance on Core Principle 9. For the reasons explained above, although the Commission clearly has the statutory authority to adopt guidance on acceptable business practices under section 5(d) of the Act, we strongly disagree with the manner in which the Commission has proposed to exercise its authority with respect to Core Principle 9. If the Commission has any questions concerning our comments, please feel free to contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner

Division of Market Oversight
Richard A. Shilts, Acting Director
Riva Spear Adriance, Associate Deputy Director