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New York
Mercantile Exchange

NYMEX/COMEX. Two divisions, one marketplace

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COMMENT

April 12, 2002

VIA FACSIMILE AND EXPRESS MAIL

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

Re: Request of the New York Mercantile Exchange, Inc. for Approval of Proposed NYMEX Rule 6.21D for Exchange of Futures for Futures 67 Fed. Reg. 11286 (March 13, 2002)

Dear Ms. Webb:

The New York Mercantile Exchange, Inc. ("NYMEX" or the "Exchange") appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc. ("COMEX"), to the Commodity Futures Trading Commission ("CFTC" or "Commission") on the request for Commission approval of proposed NYMEX Rule 6.21D. The proposed new rule would permit the exchange of futures for futures ("EFF") transactions in the Exchange's NYMEX Brent Crude Oil ("Brent") futures contract.

NYMEX is a for-profit corporation organized under the laws of the State of Delaware. It is a designated contract market for the trading of numerous commodity futures and commodity futures option contracts. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. In 2001, more than 103 million contracts were traded at the Exchange. Public investors in our markets include institutional and commercial producers, processors, marketers and users of energy and metals products.

The proposed new rule would establish a non-competitive trading procedure that would operate in a manner that is analogous in some respects to exchange of futures for physicals ("EFP") rules. In other respects, the EFF procedure is analogous to block trading rules currently in operation at some exchanges. NYMEX intends for the proposal to enable "eligible contract participants," as that term is defined by the Commodity Exchange Act, to liquidate open positions in Exchange-specified substantially equivalent contracts at another exchange and to establish comparable positions in the Exchange's Brent contract. The proposed rule essentially provides a mechanism to transfer Brent futures positions from another exchange to NYMEX. The Exchange proposes to implement the rule on a one-year pilot program basis.

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The New York Mercantile Exchange is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, propane, platinum, palladium, and the FTSE Eurotop 300® index. The COMEX Division offers trading in gold, silver, copper, aluminum, and the FTSE Eurotop 100® index.

As noted in the Commission's Federal Register release, the Exchange indicated in its rule submission that this mechanism would provide a means for sophisticated market participants to liquidate open Brent positions at another exchange and to individually negotiate transactions that would essentially result in the transfer of those positions to NYMEX. This procedure thus would permit parties to make those transfers, while avoiding exposure to the possibility of significant price slippage in a thinly traded market. NYMEX believes that by facilitating the transfer of positions between markets, this procedure would serve to increase competition between markets and, thus, benefit all market users.

Before turning to the questions contained in the Federal Register release, the Exchange believes that it is critically important to consider the relevant statutory language in its proper context. As an exchange operating in the contract market regulatory tier, NYMEX is subject to Section 5(b)(3) of the Commodity Exchange Act ("Act"); this provision provides that the criteria for designation as a contract market include, among other things, appropriate rules for trading through the facilities of the contract market. In addition, this provision specifies certain exceptions to the competitive execution requirement.

The key consideration to note is that this list of exceptions is introduced by qualifying language that states that the "rules may authorize --..." rather than qualifying language that states that "the rules may ONLY authorize." The Exchange believes strongly that the Commission thus has authority to permit other exceptions provided that there is no harm to the public interest or violation of other core principles.

Such a reading of this provision is extremely important to the Exchange's core business goal of competing against markets in other countries, and on other platforms. Such a reading is also critically important in keeping liquid, regulated markets innovative enough to meet public needs. In this connection, the Exchange notes that included among the purposes in Section 3 of the Act is "to promote responsible innovation and fair competition among boards of trade, other markets and market participants."

The Commission expressed particular interest in any responses that might be submitted to certain questions specified in the Federal Register release. The Commission's questions are repeated below (in bold) and the Exchange's response immediately follows each of these questions.

(1) NYMEX contends that its proposal would facilitate the transfer of positions from one futures market to another and, thus, would promote competition among markets that ultimately would benefit participants in both markets. Would such a procedure in fact increase competition between the markets?

Yes. An exchange that is required to compete with another exchange for customers, and to retain open interest, would, like all businesses, need to offer benefits in the form of better services or products, and lower costs to customers than would be the case if there were no competition. Although OTC markets compete to some extent with exchanges, that competition is generally for uncleared business; hence, for practical purposes, it can be viewed to some extent as a separate category of product, and thus not directly competitive.

Over the past two years, the financial community has witnessed the benefits to customers in the equity options business resulting from multiple listings. This change has forced competition through the advent of at least one new exchange (the International Securities

Exchange), and the consolidation of market-making functions as that business became less profitable (meaning customer costs had been lowered). In the context of the EFF procedure, the members of two exchanges competing for customers, as EFF would promote, would need to make tighter markets and reduce brokerage commissions to entice customers to participate on their respective market rather than on the competing market. When customers have a choice, markets perform to obtain and retain customers. EFF promotes that competitive process.

In particular, it is axiomatic that any action that lowers the cost of choosing between alternatives increases competition. Under current regulation, the transfers of positions this proposal would accommodate arguably can be accomplished through other means. This proposal, however, materially reduces the cost and effort entailed in accomplishing this result.

Currently, in terms of off-exchange procedures, two parties that sought to accomplish this transfer could enter into two separate transactions involving the exchange of futures for swaps ("EFS"). The first transaction would liquidate (or transfer) an open position at the first exchange, while the second transaction would establish the position at the second exchange. In short, then, at least two transactions would be needed to accomplish the transfer under current regulation, and each transaction would entail financial as well as opportunity costs. The Exchange's EFF rule proposal would reduce this transfer to just one direct transaction, thereby reducing all costs. In other words, the lower cost to accomplish this transfer translates into increased competition.

It also should be noted that in light of the flexible regulatory structures in many jurisdictions outside the U.S., virtually any other exchange based in a home country with such a regulatory structure would be free today to implement an EFF program on its own, thus subjecting NYMEX to a similar competitive threat. The Exchange is not seeking protection from such competition; indeed, NYMEX is simply seeking permission to compete. The fact that no other exchange has yet come up with a similar mechanism (to our knowledge) suggests either that such markets have not considered this approach or alternatively are unwilling to become subject to competition for business. The Exchange respectfully suggests that regulators should not be in the business of encouraging such non-competitive interests.

(2) Would a non-competitive trading procedure at one exchange designed to encourage the transfer of positions from another exchange affect the integrity of price discovery at either or both markets?

As noted above, there are already non-competitive procedures to accomplish the same result achieved under the proposal, so the effect on price discovery is neutral. When two parties enter into two EFS transactions, the first would liquidate (or transfer) their IPE position; the second would establish the NYMEX position. The impact on price discovery between this existing apparatus and the proposed EFF procedure is neutral.

This should not be confused with simultaneous competitive execution (or attempts thereof) which could result in reducing IPE positions and increasing NYMEX ones. The purpose of each of these transactions is different. The competitive transactions are entered into to perform arbitrage, both directly and indirectly, and often are part of series of transactions that extend to other markets such as: NYMEX WTI, cash-market in crude grades, and petroleum products markets (futures and otherwise).

The transfers envisioned under the EFF proposal are <u>not</u> arbitrage transactions. The

EFF procedure is intended to maintain existing positions, but transfer them among very similar alternatives as cheaply as possible. Indeed, since the purposes served by EFF transactions are clearly independent of any of the fundamental aspects of the underlying market, both physical supply and demand and expectations of supply and demand, the integrity of price discovery is arguably best served by non-competitive execution of these trades. This way, no unintended set of price impacts hits competitive execution of either IPE Brent or NYMEX Brent-- i.e. simultaneously raising the price for IPE Brent and lowering the price for NYMEX Brent, clearly misleading signals for a transaction motivated by keeping positions as they are.

(3) Under NYMEX's proposal, the condition precedent liquidating transaction(s) at another exchange and the subsequent NYMEX transaction would not be a single, integrated transaction, as is the case with EFPs. Would this feature of EFFs create any incentives to engage in improper practices at either NYMEX or the other exchange?

No. In fact, if the Exchange required the transactions to be "integrated", NYMEX would de facto be requiring cross trades on the other exchange as a condition precedent to engaging in an EFF. The IPE and the U.K. regulatory regime have rules and an enforcement mechanism to require and enforce standards for open and competitive trading on the IPE. NYMEX's EFF proposal seeks a lawful liquidating transaction on the IPE, or another market where Brent futures might become traded, and the Exchange expects that local U.K. rule enforcement would be suited to the task of ensuring that such transactions are done appropriately. As we require no special type of liquidating trade, we do not believe we are encouraging any new or extraordinary methods of trading. Therefore, we do not believe that the EFF mechanism encourages any improper conduct. Finally, the requirement that transaction documentation be made available for examination, upon request of the Exchange, is also a strong deterrent to improper conduct.

(4) NYMEX analogizes its proposal to block trading rules that have been implemented at other futures exchanges. NYMEX represents that the proposed EFF minimum transaction size of 50 contracts exceeds in size more than 90% of the Brent futures contract transactions executed in recent months at NYMEX. The Commission has utilized the 90% minimum threshold test in evaluating previously approved block trading proposals. In applying this standard, however, the Commission has traditionally looked at trading activity not only at the exchange that proposed block trading procedures, but also at trading in related cash and futures markets.

(a) How should the Commission evaluate the minimum threshold for Brent EFF transactions?

We believe that this transaction should not require a minimum threshold. The Brent market is almost exclusively comprised of sophisticated commercial participants, and the EFF would be conducted under the regulatory scrutiny of the Exchange. However, in the context of considering how to view the relative size of 50 contracts (50,000 bbls.) compared to other trades, it might be illustrative to know that the NYMEX crude oil futures contract has traditionally had an average lot size per trade in the 10-15 contract range. The current margin requirement at NYMEX for a 50 contract crude position would be $135,000 (@$2,700/k), clearly an amount indicating a substantial and sophisticated market participant. In other words, it is safe to infer that a minimum 50 contract transaction size for EFF would be restrictive to the upper threshold of trade size and indicative of only large, sophisticated customers.

(b) Should the Commission also consider the size of transactions executed in Brent

futures contract at another exchange?

No. Based on the foregoing, we believe such a step to be unnecessary.

(c) How should that information best be obtained if the other exchange is not subject to the Commission's jurisdiction?

See the response to question 4(b) above.

(d) If volume and liquidity in the NYMEX Brent futures contract increase, should the minimum threshold be modified?

At that point, the Exchange would have a certain level of experience concerning how the transaction was used in practice. The minimum could be increased, decreased, or waived entirely depending on that experience; however, we believe that such a decision should not be prejudged at this time, but should await a restart of trading activity.

In conclusion, the proposed new rule would provide an innovative means for sophisticated market participants to liquidate open positions on one exchange and to enter into individually negotiated transactions that would in essence result in the transfer of such positions to the Exchange. The rule thus would permit eligible participants to make transfers through individually negotiated transactions under restricted conditions that would allow the parties to avoid exposure to the possibility of significant price slippage in a thinly traded market. The more frequently that this commercially reasonable mechanism would be utilized by market participants, the more that open interest and volume would grow at NYMEX, resulting in increased competition among markets that ultimately would benefit market participants in both markets. Accordingly, the Exchange requests that the Commission approve the proposed new rule on an expedited basis.

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NYMEX thanks the Commission for the opportunity to submit comments concerning the Exchange's rule proposal and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,

J. Robert Collins, Jr.
President

cc: Chairman James E. Newsome
Commissioner Thomas J. Erickson
Commissioner Barbara P. Holum