IV. The Scope of the EFP Exception

A. Section 4c and Statutory Interpretation

As noted earlier, Section 4c(a) of the Act generally prohibits wash sales, cross trades, accommodation trades, fictitious sales, and transactions which cause prices to be reported, registered, or recorded which are not true and *bona fide*. Section 4c(a) further provides that:

> 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.

The most fundamental principle of statutory interpretation is that, in construing a statutory provision, the intent of the legislature is controlling, and the primary role of statutory construction is to ascertain and declare the intention of the legislature and to carry such intention into effect. [156/] The legislative intent must be determined primarily from the language of the statute [157/] resorting to the application of the rules of

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156/ *E.g.*, *Philbrook v. Glodgett*, 421 U.S. 707, 713 (1975); *U.S. v. Cochran*, 235 F.2d 131, 134 (5th Cir.), *cert. denied*, 352 U.S. 941 (1956).

157/ *Central Trust Co. v. Official Creditors' Committee of Geiger Enterprises*, 454 U.S. 354, 359-60 (1982); *Consumer Product Safety Commission v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980); *Caminetti v. U.S.*, 242 U.S. 470, 485 (1917).

statutory interpretation and extrinsic circumstances only where the statute is ambiguous. 158/

There is no language in the statute or legislative history expressly limiting the meaning of an "exchange of futures in connection with cash commodity transactions or of futures for cash commodities." Instead, the legislative history concerning Section 4c(a), to the extent it exists, focuses on the definitions of those trading abuses from which EFPs are excluded. The intended meaning and scope of the EFP exception must, therefore, be determined through statutory interpretation and an examination of those terms which are defined. 159/

The language "[n]othing in this section [barring accommodation trades, etc.] is to be construed to prevent [EFPs]" [emphasis added] is unambiguous. The word "construed," as it is defined and commonly understood, means "interpreted." 160/ Thus, the language in Section 4c(a) prohibiting specific transactions (including wash sales, cross trades, accommodation trades, and fictitious trades) is intended to prevent the named transactions

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158/ See U.S. v. Turkette, 452 U.S. 576, 580 (1981); U.S. v. Apfelbaum, 445 U.S. 115, 121 (1980).

159/ See Russellor v. U.S., 464 U.S. 16, 21 (1983); Diamond v. Diehr, 450 U.S. 175, 182 (1981).

160/ Funk & Wagnalls New Comprehensive International Dictionary (Encyclopedic ed. 1973). Statutory words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them. Caminetti v. U.S., 242 U.S. at 485-86.

from being defined to include EFPs. Without the specific exception such transactions might have been interpreted to include, and hence to prohibit, EFPs. 161/

161/ This interpretation is further supported by an examination of the common understanding of those transactions at the time the legislation was passed. The Federal Trade Commission's Report to Congress on the grain industry contains a section describing an "accommodation trade" as a type of transfer trade in which a commission house holding an open futures position substitutes another commission house for itself with respect to the open position and in that manner avoids margin obligations. FTC Report, supra note 3, at 248. That report also describes a "transfer" as a trade related to a cash transaction involving "the shifting of a hedge from one owner of grain to the next owner" (one type of EFP) where no commission need be charged, so long as the futures position is a hedge. Id. at 250.

Similarly, remarks made by a member of the Senate Committee on Agriculture and Forestry in the Congressional Record at the time the bill which was to become the Commodity Exchange Act was being considered define wash sales, cross trades, and accommodation trades in terms which, broadly construed, might be interpreted to include the futures portion of at least some types of EFPs. Specifically, the following definitions were contained in those remarks:

> Wash sales are pretended sales made openly in the pit or trading place for the purpose of deceiving other traders. They are employed to give a false appearance of trading and to cause prices to be registered which are not true prices. They may be entered and recorded as real trades, but by agreement between the parties privately are either cancelled or washed out by other trades. . . .
>
> Cross trades are fictitious trades recorded and cleared through the exchange clearing house as real trades. They are a device commonly employed by floor brokers for becoming buyers in respect to selling orders of customers, and vice versa. They take the form of a recorded double purchase and sale between two brokers. Each broker is recorded as having bought from and sold to the other the same quantity of the same future at the same price. . . .

(Footnote Continued)

Section 4c(a) clearly excepts EFPs from the general prohibition against the specific types of transactions listed. Generally, an EFP which meets the requirements of Section 4c(a) may not be found to be a wash trade, accommodation trade, cross trade, or fictitious sale in violation of that Section. In order to qualify for the exception, an EFP transaction must comply with Section 4c(a), which, by its terms, includes compliance with all applicable exchange rules approved by the Commission. A transaction which is apparently in such compliance with these terms will, with certain limited exceptions discussed below, not be subject to the prohibitions contained in Section 4c(a).

More particularly, the language of the exception exempts the "exchange of futures in connection with cash commodity transactions or of futures for cash commodities." To be a _bona fide_ EFP there must be integrally related cash and futures transactions, the cash commodity contract must convey the right to receive the commodity, and there must, in fact, be separate

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(Footnote Continued)

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.

80 Cong. Rec. S. 6162 (1936) (statement of Senator Pope on H.R. 6772). Therefore, absent an express exception, the futures portion of EFPs could have been prohibited by the preclusion of those transactions.

parties to the transaction. [These elements are examined in greater detail in subsection IV.B., _infra_.] In addition to these essential elements, the EFP exception expressly requires an exchange of _futures_ (not forward contracts, options, or cash contracts) for cash commodities or in connection with a cash (not a futures or option) transaction. [This element of an EFP is discussed in greater detail in Section V., _infra_.]

The language of the statute itself, however, does not indicate whether _all_ transactions structured as EFPs are excepted (and, therefore, not prohibited by Section 4c(a)), or whether some transactions which may be structured as EFPs may nonetheless be determined to not be _bona fide_ and therefore prohibited by Section 4c(a). In this regard, it is important to note that, by its terms, the EFP exception only applies to certain prohibited transactions set forth in Section 4c(a) of the Act. As such, it does _not_ exempt EFPs from the operation of other portions of the Act, such as those prohibiting manipulation, regardless of whether the EFP is consistent with the language of Section 4c(a) and in compliance with applicable exchange rules.

To the extent the statute does not fully articulate the intended scope of the exception, it is appropriate to turn to other tools of statutory construction. 162/ As a general rule,

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162/ As the Supreme Court has stated: "It would be anomalous to close our minds to persuasive evidence of intention on the ground that reasonable men could not differ as to the

(Footnote Continued)

a strict or narrow construction is applied to statutory exceptions. 163/ Thus, courts favor a general provision over an exception, and one seeking to be excluded from the operation of the statute must establish that the EFP exception particularly applies. 164/ The purpose of the statute as a whole, 165/ the historical setting giving rise to its enactment, 166/ and the customs and usage of the time when the statute was enacted may be relevant to an appropriate construction of its scope. 167/

The report of the House Committee on Agriculture accompanying the introduction of the bill which was to become the Commodity Exchange Act stated that its fundamental purpose was "to insure fair practice and honest dealing on the commodity

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(Footnote Continued)

meaning of words," and, further, "The meaning to be ascribed to an Act of Congress can only be derived from a considered weighing of every relevant aid to construction." U.S. v. Dickerson, 310 U.S. 554, 562 (1940); see U.S. v. Turkette, 452 U.S. at 580.

163/ Great Atlantic & Pacific Tea Co. v. Federal Trade Commission, 106 F.2d 667, 674 (3d Cir. 1939), cert. denied, 308 U.S. 625 (1940); see U.S. v. Scharton, 285 U.S. 518 (1932).

164/ U.S. v. Moore, 613 F.2d 1029, 1044 (D.C. Cir. 1979), cert. denied, 446 U.S. 954 (1980); see U.S. v. McElvain, 272 U.S. 633, 639 (1926).

165/ Philbrook v. Glodgett, 421 U.S. at 713.

166/ Feitler v. U.S., 34 F.2d 30, 33 (3rd Cir. 1929), aff'd sub nom. Denovitz v. U.S., 281 U.S. 389 (1930); see Leo Sheep Co. v. U.S., 440 U.S. 668, 669 (1979) (quoting U.S. v. Union Pacific R.R., 91 U.S. 72, 79 (1875)).

167/ Feitler v. U.S., 34 F.2d at 33; see Leo Sheep Co. v. U.S., 440 U.S. at 669.

exchanges." 168/ In recommending passage of that bill, the Senate Committee on Agriculture and Forestry cited the Department of Agriculture's report, which stated in part that experience under the Grain Futures Act demonstrated the need for regulatory power to limit speculative trading and for stronger measures than under the then-existing law to address fraudulent trade practices or manipulation. 169/ An earlier report of the House Committee on Agriculture stated that self-regulation in the past had been a failure. 170/ It is within the framework of the Act as a whole that Section 4c(a) must be analyzed. Moreover, in 1936, EFP transactions took place only in the context of commercial dealings, and it was those practices that Congress sought not to disallow.

Considering the principle that exceptions are to be narrowly construed, the general purposes of the Act, the history of EFP practices at that time, and the specific statutory language, the Division believes it is unlikely that Congress intended that the EFP exception be interpreted to apply to all

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168/ Commodity Exchange Act, H.R. Rep. No. 421, 74th Cong., 1st Sess. 1 (1935).

169/ Amend the Grain Futures Act to Prevent and Remove Obstructions and Burdens Upon Interstate Commerce in Grain and Other Commodities by Regulating Transactions Therein on Commodity Futures Exchanges, To Limit or Abolish Short Selling, to Curb Manipulation, and for Other Purposes, S. Rep. No. 1431, 74th Cong., 1st Sess. 3 (1935).

170/ Amend Grain Futures Act, H.R. Rep. No. 1522, 73d Cong., 2d Sess. 3 (1934).

transactions structured as EFPs regardless of their _bona fides_. To conclude otherwise would provide a ready means for traders to engage in the types of detrimental practices prohibited by Section 4c(a) or other abuses proscribed by provisions of the Act, without regard to the benefits of EFPs which Congress intended to preserve.

There are two situations in which the Division believes that a transaction should not be considered a _bona fide_ EFP. First, a transaction which fails to comply with the conditions of the Section 4c(a) exception or with exchange rules governing the transaction would be prohibited, even if it is characterized as an EFP by the parties to the transaction and cleared as such by an exchange. Second, a transaction which apparently complies with Section 4c(a) and any applicable exchange rules, but which is intended to accomplish some illegal purpose (_e.g._, wash sales, manipulation, or tax evasion) will be prohibited as outside the scope of the exception provided by Section 4c(a). 171/

171/ This analysis is similar to that applied in tax cases where a transaction is structured to comply with the literal terms of the Internal Revenue Code and yet is a sham designed purely for tax evasion and, therefore, illegal. In those cases, the substance of the transaction is examined to determine whether, apart from the tax motive, the transaction was actually that which was intended by the statute, or whether the taxpayer would realize anything of substance beyond a tax deduction. _Knetsch v. U.S._, 364 U.S. 361, 366 (1960); _Gregory v. Helvering_, 293 U.S. 465, 469 (1934). As the Supreme Court has stated: "The rule which excludes from consideration the motive of [otherwise lawful] tax avoidance is not pertinent to the situation, because the

(Footnote Continued)

For purposes of this analysis, the Division has identified essential elements of an EFP transaction and other indicia that should be applied to the examination of an EFP transaction in connection with establishing its bona fides. A transaction not classified properly as an EFP would violate the competitive execution requirements of Commission Regulation 1.38 irrespective of whether it were a wash trade, accommodation trade, or fictitious trade. Even assuming apparent compliance with the elements contained in Section 4c(a) and applicable exchange rules, an EFP transaction may be a sham with no purpose other than to circumvent the trading prohibitions of Section 4c(a) or to accomplish some otherwise unlawful act. In those cases, the transaction would violate Commission Regulation 1.38 and, as applicable, other provisions of the Act and regulations. Notwithstanding the foregoing, an EFP should not be precluded if the only "purpose" otherwise proscribed by the Act or regulations is prearrangement. EFPs are by their nature prearranged, and prearrangement cannot, therefore, be an illegal purpose of such a transaction.

The Division does not suggest, however, that EFPs must be confined to commercial practices or to practices common at the

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(Footnote Continued)

transaction on its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Gregory v. Helvering, 293 U.S. at 470.

time the exclusion was adopted to be bona fide. It is a general rule of statutory construction that, in the absence of a contrary indication, "legislative enactments in general and comprehensive terms, prospective in operation, apply alike to all persons, subjects and business within their general purview including those that come into existence subsequent to their passage, thus admitting adjustment of the legislative intention when broadly expressed to new conditions." 172/ Thus, the EFP concept can accommodate the evolving trading strategies discussed earlier in this Report, which, among other things, are to reduce basis risk, identify delivery partners, obtain a specific cash commodity at a time and location not necessarily available under the exchange delivery procedures, and arbitrage.

In summary, although the Division does not believe that the EFP exception must be confined to practices in evidence at the time the Act was passed, bona fide EFPs should be limited to those which strictly comply with the terms of Section 4c(a) and exchange rules and which are not designed to accomplish some otherwise illegal purpose, as determined by an examination of all relevant criteria. The responsibility for this examination lies, in the first instance, with the exchanges in carrying out their self-regulatory responsibilities. As with other trading

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172/ Feitler, 34 F.2d at 33 (citation omitted); accord, Fortnightly Corp. v. United Artists Television, Inc., 392 U.S. 390, 395 (1968).

practices, the exchanges must, as required by Section 5a(8) of the Act and Commission Regulation 1.51, maintain an affirmative surveillance program which is designed to detect potential violations of exchange rules. This includes whether particular EFPs are in accord with exchange rules, Section 4c(a), and are not designed to accomplish an illegal purpose. Exchange EFP rules cannot, of course, confer an exception to competitive trading which is broader than that provided for by Section 4c(a). In this regard, the Division has articulated below what it believes to be the essential elements for excepting an EFP transaction from the prohibitions of Section 4c(a) as well as certain additional indicia to examine in assessing the bona fides of any such transaction.

B. Assessing the Legitimacy of EFPs

The EFP exception to the proscriptions of Section 4c(a), by its terms, excepts only the "exchange of futures in connection with cash commodity transactions or of futures for cash commodities." The essential elements for all EFPs then may be fairly implied from this language:

(1) There must be both a cash transaction and a futures transaction, which transactions must be integrally related.

(2) The cash commodity contract must provide for a transfer of ownership of the cash commodity to the cash buyer upon performance of the terms of the contract, with delivery to take place within a reasonable period of time thereafter in accordance with prevailing cash market practice (subject, of course, to the buyer's obligation to pay for the commodity). Actual delivery need not take place should the selling party offset that obligation by other means.

(3) There must be separate parties to the EFP -- that is, the accounts involved must have different beneficial ownership or be under separate control.

The first of these elements -- that there must be separate but integrally related cash and futures transactions -- means that the two trades must be essential to one another. For instance, in the typical grain EFP, a cash contract is made in which the parties have agreed to price the grain at a basis to the futures, with the buyer electing the time when the futures price is established. When the buyer is ready to set the price, an EFP is executed, futures positions are exchanged, and the price of the cash grain is determined based on the elected futures price (which under current practice must be within the daily trading range). Subsequently, the cash grain is paid for and delivered. In this situation the futures and cash trades are essential to one another, and without the EFP the parties could be disadvantaged in fulfilling the terms of the original cash contract, if the basis changed before the cash trade was consummated. On the other hand, a situation in which two parties exchange futures only, and one party then enters into a separate cash transaction to cover its futures position risk (i.e., purchases or sells the cash commodity from a third party) could not be properly characterized as an EFP because the futures and cash transactions are not integrally related, although the cash

trade was necessary to cover the risk resulting from the exchange of futures. 173/

Secondly, the term "exchange" implies that the cash commodity transaction will be fulfilled, and that the buyer is entitled to receive the cash commodity in exchange for the transfer of a futures position and payment. If title to the cash commodity is not transferred or intended to be transferred according to the terms of the contract, then no "exchange of futures in connection with [a] cash commodity [transaction] or of futures for cash commodities" can be said to have taken place. Moreover, if any intervening conditions are imposed on the buyer's right to receive the cash commodity (other than payment therefor or terms that are consistent with industry practice), the EFP transaction may be a subterfuge. 174/ Thus, for example,

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173/ This analysis would not preclude "string trades," however. In a string trade, for example, A has contracted to sell grain to B and receive (buy) futures, and B has contracted to sell grain to C and receive futures from C. When C (as the cash buyer) is ready to sell futures to B to fix the cash sale price, B directs C to execute the futures trade with A. A and C execute an EFP in which A buys futures, and C sells futures. In the absence of the string trade, A and B and B and C would execute two separate EFPs consistent with their contractual obligations. The string trade serves to match the mutually exclusive futures obligations so that only one EFP is reported to the exchange. All parties to the string have complementary cash commitments and corresponding obligations to buy or sell futures to the next party in the string. For a discussion of this practice in the grain market and CBT's interpretation of its EFP rule in this regard <u>see</u> note 50, <u>supra</u>.

174/ Such a condition may be a condition precedent to the

(Footnote Continued)

a requirement that the buyer agree to resell the cash commodity to the seller or enter into future contractual arrangements could indicate that the parties did not intend that an actual transfer of a cash commodity take place. However, this may not prevent the parties individually from transferring their contractual rights or obligations with respect to the cash commodity to a third party (subject, of course, to the terms of the contract and principles of contract law) or from offsetting those positions or obligations prior to delivery taking place. Thus, for example, a third party could assume the seller's obligation to deliver the cash, or the cash seller could contract to purchase the cash commodity from the third party and direct that delivery be made to the cash buyer in the EFP.

Finally, as noted above, the futures and cash transactions must be between separate parties. Quite simply, one cannot effect an "exchange" with oneself. The Division believes that an appropriate basis for determining whether separate parties are involved is whether the accounts have different beneficial owners or are under separate control, the same tests which are applied

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(Footnote Continued)

existence of a contract or a condition precedent to a party's obligation to perform under the terms of an existing contract. Whether there is a condition precedent to performance will not necessarily affect the transfer of title, but may affect that transfer if that is the intent of the parties.

in evaluating possible wash trades. [175/] This analysis applied to EFPs would permit separate profit centers of an FCM to engage in EFP trades to accomplish their trading strategies and fulfill business needs.

In addition to these essential elements, the Division has developed a non-exclusive list of other indicia to be considered, in conjunction with applicable exchange rules, in evaluating whether an EFP is eligible for the Section 4c(a) exception. These indicia provide additional bases for determining whether the essential elements of an EFP have been satisfied in evaluating the *bona fides* of a particular transaction:

(a) The degree of price correlation between the cash component and the futures contract.

(b) The prices of the futures and cash legs of the EFP and their relation to the relevant prices in either market.

(c) Whether the seller has possession, the right to possession, or the right to future possession of the cash commodity prior to the EFP.

(d) The cash seller's ability to perform on his delivery obligation in the absence of prior possession of the cash commodity (*i.e.*, the cash seller's access to the cash market).

175/ *In the Matter of LaMantia*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,472, at 26,216 (CFTC Docket No. 79-52) (1982); *see* *Citadel Trading Co. of Chicago*, 2 Comm. Fut. L. Rep. (CCH) ¶23,082, at 32,190 (CFTC Docket No. 77-8) (May 23, 1986). The standard of separate accounts subject to independent control is also applied to futures transactions in determining whether they may be executed as cross trades. *See*, *e.g.*, Coffee, Sugar & Cocoa, Inc. Guide (CCH) ¶2272 (May 19, 1982) (interpretation of Exchange cross trade rule).

(e) Whether the cash buyer acquires title to the cash commodity.

V. The Cash Component

EFPs require the exchange of a futures contract for a cash commodity. Exchange rules (and interpretations thereof) generally provide guidance as to what constitutes an acceptable cash component of an EFP. If the cash component of the EFP is itself deliverable on the futures contract, it obviously is acceptable as the cash component of an EFP, and in practice, the cash component of an EFP often is deliverable on the futures contract exchanged in the EFP. On the other hand, EFPs sometimes are used to facilitate cross-hedging techniques, such that the cash component of an EFP would not have been deliverable on the futures contract. In addition, EFPs may involve futures contracts which are settled in cash. In such cases, it is appropriate to evaluate the acceptability of the cash component.

A. Exchange Rules [176/]

Comex Regulation 4.36 specifies that the cash component need not meet the futures contract's delivery specifications but must be the substantial economic equivalent thereof. The Rule also provides that the physical commodity may not be a futures contract or contract for future delivery traded on a designated contract market. According to Exchange staff, a forward contract

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176/ In this, and subsequent sections of the Report, the descriptions of exchange rules generally are confined to the five exchanges whose contracts were the focus of this Report, with footnotes or references to the rules of other exchanges as appropriate.

or other forward cash commitment would be acceptable. CSC Regulation 3.06(e) specifies that the cash component must meet contract specifications or be a derivative, by-product, or related product. In addition, the cash commodity exchanged for futures must be of approximately equivalent quantity to that covered by the futures. 177/

NYMEX rules for crude oil, heating oil, and gasoline EFPs (Rules 200.20, 150.14, and 190.14, respectively) specify that the cash component of an EFP must be the physical product covered by the futures contract or a derivative, by-product, or related product. NYMEX has been relatively restrictive in its interpretation of the acceptability of the cash component. It does not consider a given commodity to be acceptable as the cash component merely because the product can be hedged. Thus, NYMEX would disallow an EFP where the cash component is not a derivative of the product covered by the future, even if the product might qualify the user for a hedge exemption. As a result, even though natural gas, for example, could be hedged with crude oil futures, it cannot be used as the cash component in a crude oil EFP.

The CME's EFP rules and the CBT's general EFP rule do not specifically address the cash component. However, in practice both of these exchanges require a reasonable correlation between the cash component of an EFP and the futures-deliverable

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177/ NYFE Rule 432 specifies that the cash product must be of equal quantity to the futures contract.

commodity and apply this standard on a case-by-case basis. Staff at both of the exchanges have advised the Division that they have avoided the use of a statistical correlation standard as unworkable. Both exchanges also decline to explicitly approve or disapprove a particular transaction in advance, but do provide traders with guidance on correlation. In practice, CME requires a "high" correlation between the futures contract and the cash component, and looks to the Commission's definition of bona fide hedging, contained in Commission Regulation 1.3(z), as a guideline. According to Exchange staff, "high correlation" means correlation as to value, quantity, and maturity. CBT staff interprets Exchange rules as requiring a "reasonable correlation." (More specifically, CBT rules governing liquidation of futures positions during the last seven days of the delivery month for the T-bond, GNMA II, and T-note contracts, require that an EFP be for the contract-deliverable or comparable instrument.) 178/ Furthermore, at both the CME and CBT the parties to the EFP are responsible for demonstrating that sufficient correlation exists between the cash and futures.

178/ CBT Regulations 1709.02, 1809.02, and 2409.02. Rules in other contracts provide that contracts remaining open after trading has ceased may be liquidated by a bona fide exchange of such current futures for the actual cash commodity, but no later than the last business day of the delivery month (or sooner for some contracts). CBT Regulations 1009.03, 1109.02, 1209.01, 1409.02, XX09.01 (100 oz. gold; 5,000 oz. silver), 1509.02.

B. Analysis of the Cash Component

1. Reasonable Correlation

As a starting point, it is generally accepted that if the cash component of an EFP is a deliverable product, it qualifies as an acceptable cash component in an EFP. When the cash component of the EFP is not deliverable on the futures contract, a determination must be made by exchange staff as to its acceptability.

As noted earlier, each of the five exchanges discussed herein, either by rule or interpretation, requires that the cash component have some type of correlation with the futures contract for which it is being exchanged. Three focus on whether the cash component is the economic equivalent of or is a commodity which derives from the futures component, while the remaining two, CME and CBT, require a "high" or "reasonable" correlation, both in economic equivalence and price correlation. The former type of standard focuses specifically on the physical or economic properties of the commodity to be exchanged, while the latter also includes consideration of the price relationship between the commodity and the futures contract.

Accordingly, one determinant in establishing a "reasonable" correlation is price correlation. The cash component of the EFP should exhibit price movement that historically has paralleled the price movement of the futures contract, with the cash and the futures prices typically moving in the same direction and at consistent relative rates of change. In short, there should be a reliable and demonstrable price relationship.

This is not to imply that the price movement must be perfectly correlated, but rather that a strong correlation should exist. For example, there is normally a strong price relationship between T-bonds and T-notes, and the CBT considers T-notes to be an acceptable cash component in a T-bond EFP. [179/]

In the absence of a stable price relationship, the parties will be at risk that the basis (spread between the cash and the futures) will change significantly prior to the conclusion of the EFP transaction and, therefore, adversely affect the utility of the transaction. Thus, the absence of a stable price relationship may mean that the parties' motive for the EFP may have been to circumvent the requirements of the Act and regulations (such as the requirement of open and competitive execution) rather than to facilitate a commercially appropriate transaction.

The use of a correlation standard for evaluating the cash component of an EFP is consistent with previous determinations of the CEA. As noted above, the CEA published A.D. 239 on December 16, 1974, which instructed that the hedge definition should be used in evaluating the acceptability of the cash

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179/ Nonetheless, there is a directional bias in the relationship between price movement in T-bonds and T-notes: because of the former's longer maturity, T-bond prices are more sensitive to interest rate changes than T-note prices.

component of an EFP. [180/] It seems appropriate to allow hedgeable commodities to be exchanged for futures. If a commodity qualifies as hedgeable, it is reasonable to accept that it is a legitimate cash component. Along similar lines, if the commodity does not qualify as hedgeable, its acceptability as the cash component of an EFP would be dubious since it probably would lack the necessary correlation and basis stability. Furthermore, the current definition in Regulation 1.3(z) provides for cross commodity hedging. Specifically, 1.3(z)(2)(iii) provides that the cash and futures positions need not be in the same commodity provided that value fluctuations in each are "substantially related."

The Division understands the terms "reasonable" or "high" correlation to imply a reasonable basis relationship. In statistics, the correlation coefficient measures the degree to which the movements of two variables are related. (In an EFP, the

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180/ This Determination stated that: "If a commodity, product, or by-product is hedgeable under the Act, it may be exchanged for futures. If it is not hedgeable, it may not be exchanged." Commission Regulation 1.3(z) provides that hedge transactions must be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and sets forth other guidelines and specific permissible transactions. The Commission recently published an interpretation of the hedge definition which clarifies the "incidental and completion tests" (concerning the nature of the risks that _bona fide_ hedging positions or transactions must address) and that the temporary substitute criterion in Regulation 1.3(z)(1) is not a necessary condition for classification of positions as hedging. 52 Fed. Reg. 27195 (July 20, 1987).

variables are the price of the cash component and the price of the futures contract.) None of the exchanges has adopted a statistical correlation coefficient to be used in assessing the acceptability of the cash component even though correlation coefficients have been used to justify specific transactions to the exchanges in particular stock index transactions. In one stock index EFP, for instance, the trader submitted that the proposed cash portfolio had a .96 correlation to the futures and confirmed after the EFP that the anticipated level of correlation was achieved with the selected basket of stocks. 181/

The development and application of a minimum required level of correlation would appear to be problematic because of the wide array of EFP transactions. Further, such matters as the selection of a timeframe and development of a cash price series may substantially influence the correlation results. Although it is not unreasonable to eschew a standard based upon a specific correlation coefficient, some of the market participants

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181/ In certain circumstances, the parties to a planned EFP transaction nonetheless could calculate a specific level of correlation for a particular commodity which could be submitted to exchange staff for preliminary approval of the commodity selected. For instance, in the S&P 500 and VLA indices, one firm has discussed with exchange staff the desired level of correlation to be applied in assembling a basket of stocks for EFPs. Once the exchanges have approved the proposed level of correlation, it could be applied without obtaining advance approval of the specific groupings of stock in each EFP. This may be particularly appropriate with index futures because the cash component could be a subset of the group of cash instruments composing the index.

interviewed by the Division believe that the current standard of "high correlation" employed by some of the exchanges (and, in particular, the CME) is too ambiguous, and that more guidance is needed.

In the interest of providing some guidance to the users of EFPs, the Division believes that it would be useful and appropriate for the exchanges to make public their determinations with respect to the acceptability of particular commodities as the cash component in an EFP. Where these determinations are of general applicability, the provisions of Section 5a(12) of the Act and Commission Regulation 1.41 must be met.

2. Quantitative Equivalence

The cash position should be approximately equal in quantity or dollar value to the futures contract. If the futures position represents 50,000 bushels of corn, the cash component should equal approximately 50,000 bushels of corn. Appropriate hedge ratios may be used to create dollar equivalency. For example, traders might hedge a 182-day T-bill by using two 91-day T-bill futures contracts. 182/ Therefore, the cash component

182/ The risk of a basis change in the yield and, correspondingly, the risk exposure on the principal amount of the T-bill increases the longer time there is left to maturity. In this example, the appropriate hedge ratio would be two to one. Other instruments with differing maturities and yields, however, would require different hedge ratios.

could consist of one 182-day T-bill, with the futures component consisting of two 91-day contracts.

C. Forward Contracts and Futures Contracts as the Cash Component

The EFP exception of Section 4c(a) permits exchanges of futures in connection with a cash commodity transaction or exchanges of futures for cash commodities. The language of Section 4c(a) does not require that a cash transaction involving immediate delivery be executed, but only that a cash transaction occur. The Division believes that a sale of any cash commodity for deferred shipment or delivery (as referred to in Section 2(a)(1)(A) of the Act), otherwise known as a forward contract, is one type of cash transaction which would be acceptable as the cash component of an EFP. A forward purchase or sale is one traditional method to effect cash transactions, and the exchanges consider a forward contract to be an acceptable cash component of an EFP. The forward contract, to be acceptable as the cash component of an EFP, must represent a commitment to execute a cash commodity transaction which entails delivery.

On the other hand, it is clear from the language of Section 4c(a) that the use of a futures contract as the cash component of an EFP is not acceptable. Futures contracts are neither "cash commodity transactions" nor "cash commodities".

As the Commission previously has stated, there are several important, commonly referred to distinctions between futures and cash or forward contracts. Futures contracts are entered into primarily for the purpose of shifting or assuming the risk of

change in value of commodities rather than for transfer of ownership of the actual commodities. Thus, in general, most parties to futures contracts do not take delivery but rather offset their obligations with equal and opposite transactions prior to delivery. Forward (deferred delivery) contracts, by contrast, entail "the generally fulfilled expectation" that the contract will lead to the delivery of commodities. 183/

The Commission has noted several other distinctions between forwards and futures. The terms of futures contracts are standardized, while the standardization of forward contracts is optional. 184/ Futures are margined and cleared through a central clearinghouse, while forwards are not and thereby create credit risks directly between the parties. As the Commission has been careful to point out, however, these elements are not necessarily present in all futures (or forward) contracts, nor is this an exhaustive list of factors to be considered in every case

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183/ In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,941, at 23,777-78 (CFTC Docket No. 75-7) (1979).

184/ Id. at 23,777. Futures contracts are also characterized by significant public participation, while forward contracts are used by commercial participants in the underlying commodity market. Some commenters have suggested that to the extent that a contract is held by noncommercial or noninstitutional interests for speculation, these factors suggest that the contract is a futures contract. Committee on Commodities Regulation of the Association of the Bar of the City of New York, The Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Based Instruments, 41 Bus. Lawyer 853, 873-75 (1986).

to determine whether an instrument is a futures or forward contract. [185/]

Since futures contracts are not intended or designed to function as cash contracts, it is readily apparent that they are not cash commodity transactions within the meaning of Section 4c(a). Forward contracts, on the other hand, are one type of cash contract and should be permitted as the cash component so long as they do, in fact, provide for delivery.

In a recent disciplinary action, the CBT determined that a T-bond futures contract traded on LIFFE was unacceptable as the cash component in a T-bond EFP. The Exchange found a violation of Exchange Regulation 444.01 on the basis that no exchange for cash commodities was involved, rejecting the member firm's argument that a futures contract may serve as a proxy for a forward contract. Because there was no _bona fide_ EFP, the Exchange also found that the firm had engaged in noncompetitive transactions in CBT T-bond futures outside the hours for trading. [186/]

As noted earlier, on November 10, 1986, the CME issued a Special Executive Report (S-1708) that states that forward rate

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185/ _In re Stovall,_, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,941 at 23,779.

186/ A description of this case can be found in Appendix 15, item b., along with descriptions of other investigations and disciplinary actions mentioned in this Report and additional matters.

agreements ("FRA") 187/ and interest rate swaps do not satisfy the cash component of EFPs in Eurodollars. CME staff stated that, at this time, it believes FRAs too closely resemble futures contracts and, therefore, are not acceptable as the cash component. No rationale was articulated for the decision not to permit interest rate swaps as the cash component. Exchange staff has indicated, however, that these determinations are subject to reevaluation. 188/

D. The Cash Component in Cash-Settled Futures Contracts

As is the case with physical delivery contracts (*e.g.*, sugar or gold), EFPs involving cash-settled futures contracts have been used to acquire, or to dispose of, a cash position. These EFPs typically have been motivated by a commercial need to take possession of or to sell the cash commodity. In stock indices, for example, traders use EFPs so that they can purchase (sell) the actual stocks at an agreed-upon basis. EFPs in cash-settled contracts therefore provide an alternative for those traders who prefer actual physical delivery instead of cash settlement. As would be the case with any other contract, the

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187/ An FRA is an agreement by two parties to loan a given amount at a fixed rate for a stated period which is then settled in cash to the current London Interbank Offered Rate at maturity rather than an actual loan being made.

188/ Exchange staff subsequently has advised the Division informally that it has determined that interest rate swaps are not an acceptable cash component of a Eurodollar EFP because of varying degrees of correlation depending on the level of interest rates.

acceptability of the cash component would be evaluated through the methods described above.

E. Options

Options on a physical commodity, being neither cash contracts nor cash transactions, are not an acceptable cash component of an EFP. An option contract on a physical commodity is structured so that the purchaser has the right and the seller (grantor) has the obligation upon the buyer's exercise of that right to execute a cash transaction. The purchaser of a call option has the right to buy, and the grantor has the obligation (upon exercise of the right) to sell, a cash commodity at a given ("strike" or "exercise") price. The purchaser of a put option, on the other hand, has the right to sell, and the grantor has the obligation (upon exercise of the right) to buy a cash commodity at a given price. Entering into an option contract does not confer ownership of a cash commodity, but rather the right or the obligation (contingent upon exercise of the right) to effect a cash transaction. The buyer of an option pays a premium to the grantor for the option. The premium is not applied toward any eventual cash transaction and is not a down payment. Quite often, the option is abandoned and the purchaser foregoes his right and, therefore, a cash transaction does not occur. In other instances, the option is offset. Here, again, a cash transaction does not occur. Options on physical commodities,

therefore, are not "cash commodity transactions" (much less "cash commodities") within the meaning of Section 4c(a). [189]

189/ As discussed earlier, a futures contract can never be the cash component of an EFP. *A fortiori*, an option on a futures contract, which is further removed from the cash market than an option on a physical commodity, is not acceptable as the "physical" or cash component of an exchange of futures for physicals. For a discussion of the acceptability of exchanges of options on futures for physicals and of options on physicals for cash commodities see Section X. of this Report, *infra*.

VI. EFP Pricing

EFPs require prices for both the futures and cash components ("legs"). Since EFPs are not required to be executed competitively in the trading pit, the futures price is mutually agreed-upon by the parties to the transaction. Likewise, the cash leg is priced by mutual agreement. There are few limits in current exchange rules on the parties' ability to set these prices. In most EFPs, however, the futures and cash components are executed at prices prevailing in their respective markets, and the futures are usually priced within the trading range of the day on which it is executed or reported.

A. Exchange Rules

As described in Section III.B.3. of this Report, the CSC requires that if the price of the futures component of an EFP is reported to the Exchange, it must be priced at the "current market price." (The public reporting of the price in coffee and sugar EFPs is voluntary, while price reporting in cocoa EFPs is mandatory. In either case, the price of the futures transaction must be reported to the clearinghouse before the trade can be cleared). NYFE requires that the futures price at which the exchange for physicals is made bear a reasonable relationship to the cash market price of the underlying commodity interest. The other futures exchanges, including the CBT, CME, Comex and NYMEX, do not have restrictions on the pricing of EFPs. The futures prices reported for EFPs are not used in calculating the settlement price at any of the exchanges.

B. <u>Pricing Practices</u>

Typical grain EFPs reflect prevailing prices in both the cash and futures markets. Grain EFPs are usually executed to complete the pricing of a cash contract which has been priced at a basis to the futures. Since the trade is priced at a basis, the cash buyer effectively prices both legs by selecting the futures price. Moreover, although the cash grain buyer typically has the right to price the futures (at least when the situs of the contract is the United States), he usually is limited contractually to a futures price within the trading range of the day on which the trade is executed. Since the cash buyer is selling futures in the EFP, he typically will select the high price of the day. Therefore, one trader (the cash grain buyer) will receive funds and earn interest overnight, while the other (the cash grain seller) will incur interest costs. Depending on the quantity, interest rate, and price change, this could be a substantial amount of funds and a significant cost factor.

A substantial volume of precious metal and foreign currency EFPs apparently is executed to facilitate 24-hour trading. The cash leg of these EFPs is priced according to the prevailing cash market. Unlike the grain markets, where the cash transaction is priced relative to the selected futures price, the futures leg of most overnight gold and foreign currency EFPs is priced at a basis to an agreed-upon cash price. Although the futures market is closed, the futures price reflects an agreed-upon differential between the then-prevailing cash market

quotation and an estimate of the price in the futures market if the market were then open. 190/ In EFPs that are not executed to facilitate 24-hour trading, the cash and futures legs usually are priced at the prevailing prices in the respective markets.

The futures leg of a petroleum EFP usually is priced at the settlement price of the day on which it is reported. The cash leg is priced at a current market price for that cash component, or may instead be priced at a differential to the futures price which reflects the appropriate spread between the futures and the cash component being exchanged.

EFPs in sugar and cocoa are similar in their pricing procedures. The futures leg is priced at the current futures price (at the time the EFP is reported) and the cash is traded at an agreed-upon premium or discount to the futures market.

The majority of EFPs, therefore, are priced at current levels in both the cash and futures markets. Although EFPs are noncompetitive and transacted outside the trading pit, the prices must be mutually agreeable to both parties to the trade. Original and variation margin must be paid on futures positions resulting from any EFP, and those EFPs in which the futures price is away from the market will result in greater margin obligations

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190/ In foreign currency EFPs, furthermore, the futures price frequently is adjusted so that the broker's commission is incorporated into the futures price in lieu of a separate commission charge. In other words, the broker will sell futures above the current market or buy below the current market.

for one party to the transaction. For that reason, the parties likely will agree on a price which will best reflect the market and their expectations with respect to margin requirements.

C. Pricing EFPs Away From the Market

Although the futures leg of an EFP usually is priced within the daily trading range, there are situations when this does not occur. Indeed, there are situations in which the futures price of an EFP has been significantly away from the prevailing market. Usually, however, one leg of the EFP, cash or futures, will be at the current market. The pricing of particular EFP transactions may be entirely consistent with the commercial needs of the parties to the transaction, even though the price of the cash or futures leg deviates significantly from the prevailing market. As aberrant pricing of an EFP can be a device to shift substantial sums of cash from one party to another or to allocate gains and losses between the futures and cash market sides of the transactions, price may be relevant to the bona fides of the transaction.

One of the salutary reasons to price the futures leg of an EFP away from the market would be to allow a trader to meet a margin call. In a hypothetical situation, a country elevator is short soybean futures and long cash soybeans. During the period the elevator is hedged in the futures, cash and futures prices soar and, as a result, the elevator is subject to margin calls. This poses a problem for the elevator. Although the elevator has a hedge in place, the margin calls must be met daily. (Although

the value of the elevator's cash position is increasing, it is an unrealized gain, and the elevator may not have sufficient cash to cover its expected margin obligations.) Usually the elevator borrows from its bank, using the soybeans as collateral, in order to meet its margin requirement. In this case, however, the elevator reaches its borrowing limit. 191/ In addition, the bank could have reached its lending limit, especially if it is financing other elevators in the same predicament.

The elevator is in a precarious situation. If it does not meet the margin call, its futures position will be liquidated, leaving it unhedged and facing uncertainty in the pricing of the grain. The elevator, therefore, contacts a grain company to negotiate the execution of an EFP. The EFP is structured so that the elevator's margin obligation is satisfied. Specifically, the grain company agrees to sell futures to the elevator at a price that is below the current futures price. The futures price is selected so that the margin requirement will be satisfied and, therefore, could be significantly below the current market. The grain company buys the cash grain for deferred delivery. The basis for the cash purchase is adjusted, in turn, so that the grain company is compensated on the cash side for the cost

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191/ Another possible situation which may cause an inability to finance the margin is where the basis between the cash and futures has moved against the trader, and the cash value of the grain has not gone up at the same rate as the futures, meaning that the cash value is inadequate to collateralize a loan to meet the margin requirement.

incurred in meeting the margin obligation and provided with a return on that margin payment. Suppose, for instance, that the elevator established its short futures position at $3.40 and over a period of time the futures price has increased to $4.40. The elevator has met margin calls by borrowing at a local bank. Subsequently, however, the price of the futures increases in one day to $4.50 resulting in an additional $.10/bushel futures loss. If at that point the elevator's margin on deposit with the clearinghouse is sufficient only to cover a loss of an additional $.02/bushel, the EFP could be arranged with the grain company to buy the futures at $4.42 and sell the cash at $4.41, thereby satisfying the margin obligation and giving the grain company a $.01/bushel return on the transaction above the cost incurred in meeting the margin obligation. The effect of this trade is that the elevator has transferred its hedged position (cash and futures) to the grain company. This situation apparently occurs infrequently, such as when there is a continued major upward or downward movement in prices. 192/

192/ One such situation occurred in 1973 at the time of the "Russian grain deal" when the grain contracts at the Chicago Board of Trade went "limit up" for 15 days, and EFPs were used by traders to get out of their positions. Notably, many of these traders were hedgers who had increasingly valuable cash grain inventories but who were nonetheless unable to meet the sustained calls for margin on their short futures positions.

Another use of EFPs for this purpose occurred in connection with the silver market situation in 1979/1980. From 1976 to

(Footnote Continued)

A foreign trader might also price the futures leg of an EFP away from the market to take advantage of expected foreign exchange fluctuations. The foreign trader must convert his currency into U.S. dollars in order to pay margin on a futures position. Thus, a foreign trader expecting the value of the U.S. dollar to increase could price an EFP so that it would receive a large credit in its futures account. If the trader anticipated a weaker dollar, it would price the futures leg in order to receive a margin call which it would meet with "cheaper" dollars.

In addition to the above-described situations, there are several other circumstances in which one leg of an EFP may be priced away from the current market. Since EFP prices can be pegged at any level, traders can adjust the prices to effect certain tax consequences. Assuming a typical basis trade, the price of either leg has no effect on the ultimate profit or loss of the EFP. However, the price of either leg can be used to create a desired profit or loss in a particular market. For example, if the ultimate result of an EFP would be a $20,000 profit which normally would be allocated equally between the cash

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(Footnote Continued)

1979 the Hunts had borrowed a substantial sum of money from one metals firm, which loans were collateralized by 10.7 million ounces of silver. In turn, the metals firm had used those silver positions as collateral to secure loans and had a large number of short silver futures positions. As the price of silver rose, the metals firm became unable to meet its margin obligations. The Hunts and the metals firm executed an EFP in September 1979 which had the result of transferring long futures positions from the Hunts to the metals firm to reduce that firm's short futures positions.

and the futures markets, a trader could price the EFP in such a manner that the entire $20,000 profit would be created in the futures leg with no profit on the cash market transactions, or could create a $30,000 futures profit and a $10,000 cash market loss. In either event, the immediate effect is the same, but profits or losses have been placed in the desired market for tax purposes. If there is a disparity between the tax rates in the cash market and the futures market, an EFP can shift profits or losses between the markets to the advantage of the trader. Although such transactions can be *bona fide* EFPs they could, as discussed earlier, be sham transactions effected for the purpose of tax evasion.

Similarly, commercial entities may use the pricing of EFPs to comply with inventory pricing policies. A firm will price the cash leg so that the cash product is bought (sold) in conformance with its internal corporate policy. In the same manner, some firms (including some that are active commercial users of the futures markets), price EFPs to avoid reflecting any profit or loss from futures trading or to conform to internal policies which restrict trading when futures losses reach a predetermined level. To the extent such techniques may be employed to disguise a firm's actual financial condition, internal corporate controls issues may be raised.

In summary, most EFPs are priced at prevailing cash or futures market prices. In the most active EFP markets, the grains, the cash contract typically requires the futures

component of an EFP to be priced within the day's trading range. In other markets, the common practice also is to price EFPs at the prevailing cash and/or futures market(s). Although there are exceptions, EFPs usually are priced at current price levels. Since EFPs are mutually agreed-upon transactions, both parties should benefit before EFPs will be priced away from the market, and those situations will be infrequent. In any EFP related to a basis trade, the net result to the traders is unaffected by either specific price as long as the basis remains the same. It appears that most EFPs executed away from current market prices are executed for specific and limited practical considerations or to simplify accounting procedures. Generally, even in those situations, one leg of the EFP will be priced at the market while the desired differential will be reflected in the price of the other leg.

EFPs that are priced away from the prevailing market provide participants with flexibility. This flexibility is often needed since the EFP integrates both cash and futures markets. Further, this flexibility may be important in cross-hedges where basis movements may not always correspond to the expected price movements or may be erratic. Restrictions on EFP pricing should, therefore, be carefully considered so that they do not unduly inhibit commercially appropriate transactions.

Based on the foregoing, the Division has concluded that the differential between the two legs should reflect commercial realities and that at least one leg of an EFP normally should

reflect the actual price in that market. This approach will permit the desired flexibility and still impose a limitation related to the commercial aspects of a transaction. When both legs are priced away from the market, it casts doubt on the legitimacy of the transaction because the transaction may not be commercially appropriate if, for example, one of the parties could obtain better prices in the market for the cash commodity and the futures position. An exchange should determine whether the pricing of the transaction is supported by a business purpose, although the absence of a business purpose for the prices selected will not in and of itself require a finding that the EFP is not *bona fide*.

VII. Ownership/Possession of the Cash Commodity

In evaluating EFPs, a number of issues arise in connection with the legitimacy of the cash commodity portion of the transaction. Some of these issues, such as questions relating to the cash component itself, already have been addressed. One of the important questions that must be resolved, however, is whether the seller must have either possession of the cash commodity, the right to possession, or a forward contract which confers the right to future possession of the cash commodity at the time the EFP is transacted. Another, related question is whether title to the cash commodity must pass to the buyer at the time of the EFP or whether entry into a contract for the sale of future goods is sufficient to effect a bona fide EFP. [193] In analyzing these issues, the Division has been guided by cash market practices and those provisions of the Uniform Commercial Code ("UCC" or "Code") governing the transfer of title in a contract for the sale of goods or securities, as well as other applicable provisions of the Code. [194]

193/ This Section analyzes the results of, and intent of the parties as to, the cash leg of an EFP, as compared with Section V., which discusses the permissible cash component of EFPs.

194/ Article 2 of the UCC together with pre-Code law and general principles of contract law govern the sale of goods and usually would govern the cash side of the EFP transaction. Under UCC §1-103 certain principles of pre-Code law and the common law continue to apply unless displaced by the Code. The general approach of Article 2 is that freedom of

(Footnote Continued)

A. Seller's Possession of the Cash Commodity

1. Exchange Rules

Comex Rule 4.36(c) and CME Rule 538.2 require that the seller of the cash commodity have possession, or (at Comex) a contractual right to future possession, of the cash commodity at the time of the EFP. The Comex Rule expressly provides that futures contracts are not included within the term "contractual right to future possession." 195/ In addition, in the currency market, CME staff determines whether one of the participants is a dealer or market participant which either possesses or is likely to possess the cash commodity. CME staff does not, however, examine how the seller acquired possession of the cash commodity or for how long that position has been held.

(Footnote Continued)

contract prevails, and the parties to a contract remain free to define their respective obligations under the contract in whatever manner they deem appropriate. For the most part, Article 2 is concerned with detailing what happens where the contract is silent on a particular point. 1 R. Anderson, Anderson on the Uniform Commercial Code §2-101:5 (3d ed. 1981) [hereinafter 1 Anderson]. Article 8 of the UCC relates to the rights, duties, and liabilities of parties to a sale of securities (including Treasury instruments).

195/ NYFE Rule 432 and ACC Rule 908 (now repealed) also contain a requirement that the seller of the cash commodity have possession of the commodity at the time of the EFP. The Division's 1983 Comex rule enforcement review noted that Comex investigated several EFP transactions in which the total amount of the cash commodity covered by the futures contracts exchanged between the parties far exceeded an amount which was likely to be possessed by the seller or could have actually changed hands between the participants. Exchange staff obtained copies of confirmations for each of the physical transactions. The Business Conduct Committee issued warning letters in connection with these trades.

NYMEX's EFP rule no longer specifically requires that the seller have possession of the cash commodity at the time of the EFP. 196/ However, as a matter of policy, NYMEX prefers, in the energy contracts, that the parties to an EFP be commercials or hedgers, and Exchange staff continues to examine EFPs carefully to ensure that the seller of the cash will be able to fulfill its obligations.

The CSC EFP rule does not require that the seller have possession of the cash at the time of the EFP, but the seller must have the ability to fulfill its commitment under the EFP. Exchange staff considers the identity and dealing experience of the parties in evaluating whether this requirement has been met. The applicable rule requires that any member participating in an EFP provide on request copies of documents evidencing title to, or the contract(s) to buy or sell, the cash commodity involved in the transaction.

196/ NYMEX amended its EFP rules in 1986 to eliminate this requirement. Previously, the Exchange's general rule governing EFP transactions, Rule 53.12 (now Rule 6.21), as well as the EFP rules for specific contracts, stated that no EFP was to be "made by a seller who does not, at the time of the exchange, have in his possession the cash commodity to be delivered and no such exchange shall be made which does not require delivery of the cash commodity within a reasonable period of time." Also, Exchange Form EFP-1 previously required the seller's FCM to certify that the seller had adequate cash commodity in its possession to fulfill its obligations under the EFP. That form since has been amended to correspond to the changes in Exchange rules.

The CBT likewise does not require, either by rule or policy, that the seller have possession of the cash commodity at the time of the EFP. On the other hand, CBT members suggested that, at least in the grains, a trader would be unable to find a party with whom to transact an EFP if the trader were not an established participant in the grain business.

2. Seller's Possession of the Cash Commodity as an Indicium of the Bona Fides of an EFP Transaction

A requirement that the seller have "possession" or the right to future "possession" of the cash commodity at the time of the EFP is, in legal effect, a requirement that the seller have title to (*i.e.*, own) or have a contractual right to acquire title to the cash commodity. If the goods are identified and existing and the seller owns them at the time of the EFP, then the seller has title and has the legal right to possession even if the goods are presently in the physical possession of some third party. 197/ The seller then may legally transfer title (the legal right of possession) to another.

The logic of this is evident if one considers a common commodity situation. For instance, the seller may own wheat that is stored in a grain elevator owned by another. Although the grain is in the physical possession of the grain elevator (a

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197/ 1 Anderson, *supra* note 194, §2-105.9. Under the UCC, transfer of title is synonymous with delivery of possession absent a contrary intent of the parties to the contract. 3 R. Anderson, *Anderson on the Uniform Commercial Code* §2-401:34 3d ed. 1983 [hereinafter 3 *Anderson*].

bailee), the seller has title and may take physical possession at any time and dispose of the goods at its discretion. In this, and in many (if not a majority of) commodity contract situations, it clearly may be impractical for the seller or the buyer to have physical possession of the cash commodity at the time of contracting.

On the other hand, the EFP cash seller may not yet have title but may instead have a contractual right to future possession (a contract for the sale of future goods). 198/ This would be the case where the person with whom the seller has the contract does not own the goods or the goods are not existing or identified. This would also be the case if the contract between the EFP cash seller and the third party specifies that title will not be transferred until the occurrence of some other event, such as payment of the contract price or delivery to a particular location. In either case, the seller does not own the goods and may not transfer title to the cash buyer at the time of the EFP but then can only enter into a forward contract for the sale of future goods as the cash component of the EFP.

Whether the seller has possession (title), or the right to possession, of the cash commodity at the time of the EFP may be one indicium of the parties' intention to fulfill the cash

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198/ A contract for the sale of goods may be either a present sale of goods or a contract to sell goods at a future time. A present sale covers only goods in existence at the time of sale. UCC §2-106(1).

transaction entered into as part of the EFP, and in its absence closer scrutiny of the underlying cash transaction is appropriate. If the seller does not own (have the legal right to possession), or have a forward contract conveying the right to future possession of the cash commodity, its ability to obtain the cash commodity in order to fulfill its obligation to deliver that commodity in accordance with the cash transaction is one appropriate line of inquiry.

Of course, it is not legally imperative that a seller have possession of the cash commodity in order to undertake a contractual obligation to deliver it at some time in the future. In such a case, there would be a contract for the sale of future goods. Nevertheless, if there is evidence that the seller not only does not have possession of the cash commodity at the time of the EFP, but also is unlikely to be able to acquire it during the time preceding the maturity of the contractual obligation, the parties may lack the requisite intent to execute a cash transaction. In the absence of such intent the cash portion of the EFP would be without substance. 199/

199/ This analysis of the parties' intent with respect to fulfillment of the cash transaction at the time of the EFP does not (as noted in Section IV.B. of this Report) prevent the parties to a *bona fide* EFP from offsetting their obligations prior to maturity of their cash contract obligations, but is one indicium to be examined in evaluating the legitimacy of an EFP.

B. Transfer of Ownership of the Cash Commodity

1. Exchange Rules

According to Exchange staff, Comex requires a change in ownership of the cash but not a transfer of physical possession. The Exchange will accept documentation of the cash transaction (such as sales invoices or delivery instructions) as evidence that a legitimate EFP has taken place but will not inquire further unless there are indications that the EFP was transacted for an illicit purpose, such as manipulation or wash trading. 200/ Comex staff was unable to estimate how often an actual transfer of possession of the cash commodity occurs.

Similarly, CME staff obtains documentation of the cash commodity transaction to confirm that an actual change in ownership of the cash commodity has occurred, but does not require a transfer of possession. 201/ CME recently took disciplinary action against a floor broker and his clearing FCM concerning EFPs in foreign currency in which no underlying cash transaction took place. In that case a floor broker found himself with a large unfilled sell order after the close of trading. According to the broker, he sought to do an EFP in order to avoid having to

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200/ The Exchange has included such an inquiry in its investigations of EFPs. A description of one such investigation can be found in Appendix 15, item g.

201/ Memorandum from the Market Surveillance Department to the Ad Hoc Committee on EFPs (March 7, 1986); Memorandum to the Files, clarifying the March 7, 1986 description of EFP trades, following a meeting of the Ad Hoc Committee (July 14, 1986).

assume a long position in his own account to make the order good. Specifically, the broker sold the futures contracts to an FCM in an "EFP" approximately 30 to 45 minutes after the close. The trade was cleared as an EFP although the broker subsequently acknowledged that no exchange of the spot commodity took place. The FCM sold the cash commodity in a separate transaction to an affiliated corporation in order to cover the long futures position obtained in the "EFP." 202/

CBT Market Surveillance staff tries to determine whether there has been a change in ownership of the cash and an actual transfer of the position, whether there are confirmation statements to document the cash transaction, and whether those documents appear proper. When necessary, staff will interview the parties to verify completion of the cash transaction.

NYMEX Rules 6.21(C) & (D), which pertain to EFPs generally, require evidence of a change in ownership of the cash commodity, as do specific contract rules. In addition, the Exchange requires clearing members to submit documentation of the EFP transaction at the time of the trade stating that the trade resulted in a change of ownership (Form EFP-1 among other things) and subsequent documentation that actual delivery of the cash

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202/ A description of this disciplinary action can be found in Appendix 15, item d.

commodity has taken place (Form EFP-2). 203/ According to Exchange Compliance staff, it routinely reviews EFP-2 forms and checks underlying documentation, including notifications by delivery facilities, internal accounting, and confirmations. These efforts primarily are directed at ensuring that a bona fide cash transaction has taken place. The Exchange generally requires that a Form EFP-2 be submitted within a reasonable amount of time after the EFP takes place, although there is no absolute time limit on delivery of the cash. If such documentation is not forthcoming, the Exchange will request further detailed information about the transaction.

In monitoring EFPs, CSC staff examines brokers' trading cards and price "fixing letters" and other documents evidencing a change in ownership. The Exchange attempts to verify in this manner that a cash transaction, which has (or will) result in a change in ownership corresponding to the futures trade, has occurred. An EFP may be selected for examination because of its size, or because it took place after the delivery period and it is not apparent how the cash obligation was fulfilled.

203/ Sample copies of Forms EFP-1 and EFP-2 can be found in Appendix 17. A description of a disciplinary action taken by NYMEX because there was no change in ownership of the cash commodity can be found in Appendix 15, item i.

2. Transfer of Ownership of the Cash Commodity as an Indicium of the Bona Fides of an EFP Transaction

As noted earlier, Section 4c(a) of the Act requires, at a minimum, a transfer of ownership or a contract to effect such a transfer in order to find that an "exchange" of futures for cash commodities has taken place. Whether the parties have complied with this requirement will depend on whether the parties have contracted for or completed a transfer of ownership (title) under state law governing such transactions. Of necessity, an evaluation of whether a specific transaction satisfies this criterion will rely heavily on the examination of documents underlying the cash transaction, including confirmations, the contract between the parties, and any documents evidencing title. The general rules of contractual construction set forth in Articles 2 and 8 of the UCC (as well as pre-Code law and general principles of contract law) with respect to transfer of title in sales of goods or securities likely will apply to most circumstances occurring in an EFP cash transaction. Additionally, most cash transactions in EFPs will be contracts of sale between merchants and thus will be construed according to trade usages. 204/

In determining whether there has been (or will be) an actual transfer of ownership of the cash commodity, the critical inquiry is whether the buyer of the cash commodity has acquired, or will acquire upon completion of performance under the

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204/ 1 Anderson, supra note 194, §2-104:6. A merchant is one "who by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction." UCC §2-104(1).

contract, title to the cash commodity covered by the EFP. 205/ In this regard, the cash contract may contemplate an immediate transfer of title or transfer of title at some subsequent time, such as upon delivery. Both situations would be consistent with a bona fide EFP.

Title may pass to the cash buyer at the time of contracting 206/ if the goods are (1) physically in existence, (2) owned by the seller at the time of the transaction, and (3) identified to the contract at the time of contracting, 207/ and if the

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205/ In this regard, as with whether an "exchange" for cash has taken place, the existence of conditions precedent may be one indication of the parties' intent. See discussion of "exchange" in Section IV.B. of this Report, supra, and note 174.

206/ The time of contracting may or may not be the same time the EFP is transacted. However, when the time of contracting precedes the EFP (such as in the typical cash grain transaction) and the EFP is used to consummate that transaction, the cash contract is likely to specify (or the intent of the parties will be) that title will not pass until delivery is made or some other time in the future.

207/ UCC §2-105; 1 Anderson, supra note 194, at §2-105:9. Goods are identified when existing goods are designated or agreed-upon by the parties as the goods to which the contract refers. UCC §2-501(1). With respect to fungible goods, the making of a contract with reference to an undivided share in an identified bulk of fungible goods is enough to identify the goods unless the parties agree otherwise. Official Comment to the Uniform Commercial Code, §2-501. Any agreed proportion of said bulk or any quantity thereof which the parties have agreed-upon by number, weight, or other measure may, to the extent of the seller's interest in the bulk, be sold to the buyer who then becomes an owner in common as to the bulk. Goods and securities are fungible when one unit is, by nature or usage of trade, the equivalent of any other like unit. UCC §1-201(17). If in

(Footnote Continued)

parties intend for title to pass at that time. 208/ This will be the case if the cash commodity portion of an EFP involves the immediate transfer of the cash commodity from the seller to the buyer, or if the cash contract provides for a present sale of goods which are in existence and owned by the seller at the time of contracting with delivery and payment to be completed at a later time. The parties alternatively could agree that title will not pass to the buyer until delivery is made. For instance, a seller may own crude oil in a tanker in transit to the United States, which it contracts to sell to a cash buyer in an EFP. Since the crude oil is owned by the seller, is in existence, and is identified to the contract, title could pass to the buyer at the time of the EFP although the contract specifies that delivery is to be effected by placing the oil in a pipeline owned by the buyer, or the parties could agree that title will not pass until delivery is made.

(Footnote Continued)

commercial practice, one unit is treated as the equivalent of any other unit the goods are fungible, even though there is not an exact identity between each item or unit of goods. 1 Anderson, supra note 194, §1-201:350.

208/ The parties may specify another time for the passage of title. For instance, the cash seller may wish to condition the transfer on payment by the cash buyer. The cash buyer may wish to defer acceptance of title until delivery is made to a specified location in order to avoid assuming the risk of loss until the commodity is within its control.

With respect to securities, Article 8 of the UCC provides that title passes when delivery or transfer occurs. 209/ This

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209/ Article 8 was revised in 1977 to include uncertificated or "paperless" securities. Article 8 previously covered only certificated or conventional securities. Only a minority of states (20 to date) has adopted the 1977 Code version and even within those states most of the existing investment securities are the certificated securities. Those states which have not adopted the 1977 Code continue to apply the 1972 Code to transactions involving investment securities (*i.e.*, certificated securities).

A security is defined by Article 8 as an instrument which represents an interest in property or in an enterprise or an obligation of the issuer, issued in bearer or registered form, commonly traded on securities exchanges or markets or commonly recognized as a medium of investment, and is either one of a class or series of instruments. UCC §8-102(a) (1972 and 1977). An uncertificated security is similarly defined except that it is not represented by an instrument, and it need not be recognized as a medium of investment. UCC §8-102(a) (1977). An uncertificated security must also be registered.

Delivery of certificated securities (those represented by an instrument) occurs when the security is actually delivered to the purchaser or his designee, or, by a selling broker, when he effects clearance of the sale according to the rules of the exchange on which the transaction occurred. UCC §8-314(1) (1972). Delivery of certificated securities may be made in a number of ways including, among others, the buyer acquiring actual possession, the broker's possession, confirmation and book entry, acknowledgment by a bailee, or book entry on the books of a clearing corporation. UCC §8-313(1)(c), (e), UCC §8-320 (1972).

"Transfer," which applies to uncertificated securities, occurs when the security is registered to the buyer or designee or when a financial intermediary sends a confirmation and identifies securities as belonging to the purchaser, or by other means where bailees or clearing corporations are involved. UCC §8-313 (1977). A broker's duty to transfer an uncertificated security is fulfilled when he causes the security to be registered for the buyer, or places a transfer instruction for the security in the

(Footnote Continued)

principle applies to the stock index EFPs and to the interest rate EFPs involving Treasury securities discussed in Sections III.D. and III.E. of this Report. With respect to EFPs in T-bonds, the parties apparently have intended, consistent with delivery in the cash market, to effect an immediate transfer of title by book entry. With respect to stock index EFPs, the provisions of Article 8 are modified by stock exchange rules, Federal securities and banking laws, and industry practice. Stock transactions normally are settled within five business days, and title will not pass until a book entry signifying the transfer has been completed. Payment also must be made within five days. Stock transfers _may_ be settled (with title passing) at the buyer's option on the same day or the next day, or, at the seller's option within two to sixty days of the trade. The purchase price of the stock will reflect a premium or discount if settlement is earlier or later than the fifth day, respectively. If a buyer of stock sells the stock prior to settlement, it must have adequate margin in its account to transact a "short sale"

(Footnote Continued)

possession of the buyer, or effects clearance of the sale under exchange rules. UCC §8-314(1)(b)(ii), (iii), and (iv) (1977). Securities which are part of a fungible bulk may be transferred by book entry referring to a quantity of a particular security without any other identification. When appropriate, entries may be made on a net basis taking into account other transfers of the same security. UCC §8-320(2) (1972 and 1977).

(*i.e.*, a sale of stock which is not presently owned). 210/ The parties to EFPs in the stock indices apparently have intended to transfer title to the stock by book entry, or otherwise, consistent with cash market practice.

In each situation discussed thus far, the buyer either will acquire title at the time of contracting (or the time of the EFP), or upon delivery of a cash commodity which the cash seller owned at the time of contracting. Because it appears that in each case the parties intend that the cash buyer acquire title to the cash commodity, an "exchange" of cash commodities will have taken place which will qualify the transaction as an EFP.

Title will not pass until some subsequent time if the cash commodity transaction is a contract for the sale of future goods. 211/ In many EFPs, for instance, the cash commodity will not be both existing and identified, or owned by the seller at the time of contracting. If the goods are not existing and thus cannot be identified, or the seller does not have title to the goods at the time of contracting, title to the goods will not

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210/ Federal Reserve Regulation T sets forth the margin requirement. There is an exception to the short sale margin requirement which allows a purchase and sale of stock made in less than five days (or before settlement) where the transactions are effected for the purpose of arbitrage and are made in an arbitrage account.

211/ Goods not owned by the seller are "future goods" even in cases where the contract "identifies" the goods by describing them or even designates the goods as specific goods owned by a named third person.

pass to the buyer merely as a result of execution of the cash commodity contract. In the case of unidentified and future goods, title typically passes when the seller has completed his performance with respect to physical delivery of the goods under the contract. 212/ The latter would include destination contracts or shipment contracts, 213/ and contracts requiring delivery of documents of title. 214/

For instance, if a cash contract involves the sale of a commodity owned by the seller which is not identified, such as a

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212/ UCC §2-401(2). Only delivery of conforming goods is sufficient to pass title. However, title will pass to the buyer when the goods are delivered only if that is clearly the parties' intent. Otherwise, title passes as explicitly agreed upon by the parties. UCC §2-401(1). The transfer of title may be conditioned upon payment by the buyer. The buyer's obligation to pay for those goods may or may not have been fulfilled at the time of the transfer. In any event, if the goods are transferred prior to the buyer's payment, the seller may retain a security interest in the goods and will have contractual remedies should the buyer fail to pay.

213/ UCC §2-401(2). A shipment contract is a contract obligating the seller merely to deliver the goods to a carrier, and a destination contract is a contract obligating the seller to deliver the goods by a carrier to a specific destination. 3 Anderson, supra note 197, §2-401:36. Absent a contract term or trade usage to the contrary, a contract which contemplates the transportation of goods from the seller to the buyer will be deemed a shipment contract and not a destination contract. If the contract requires delivery of the goods to a particular carrier, delivery by the seller to another carrier does not complete the seller's performance so as to pass title to the buyer.

214/ UCC §2-401(3)(a). Of course, consistent with the principles of freedom of contract, the parties may agree that title will transfer at an earlier time, providing the goods are existing, identified, and owned by the seller at that time.

contract for the sale of 50 tons of sugar at an unspecified location, and the seller has in no other way identified a specific lot of sugar to the contract, no title can transfer to the cash buyer. Further, many EFPs concern cash contractual commitments for commodities not owned by the seller at the time of contracting, but which the seller may secure from a third party for subsequent transfer to the cash buyer in fulfillment of the seller's contractual obligations. Where such a contract constitutes the cash element of an EFP, delivery of the cash commodity frequently does not take place until some time, perhaps as long as a month or more, after the EFP transaction has cleared at the exchange.

Regardless of whether transfer of title is contemplated at the time of the EFP or upon delivery, delivery of the cash commodity normally should follow the EFP within a reasonable period of time in accordance with normal industry practice involving comparable cash market transactions. If delivery does not occur, the transaction should be scrutinized, the reasons for that failure identified (for instance, the substitution of parties, cash settlement, or other offset of the delivery obligation), and a determination made whether the EFP is not _bona fide_.

C. _Transitory Ownership of the Cash Commodity_

A question arises as to the _bona fides_ of the cash transaction when a trader purchases a cash commodity and immediately resells it to the person from whom it was purchased

in exchange for a long futures position (or, conversely, when the trader sells the cash commodity and repurchases it, together with a short futures position) by means of an EFP. In either case, both parties to the transaction, while acquiring a futures position, end up with the same position in the cash market as they had before the trade took place. These transactions occur with considerable frequency in both the gold and foreign currency markets and appear to raise a serious question of whether there has been a bona fide exchange of the physical commodity.

1. Exchange Rules

CME, CBT, and Comex all interpret their rules to permit transactions in which one party acquires the physical from another and then transfers the physical back to the original owner via an EFP in order to acquire a futures position. 215/ CME's Ad Hoc Committee on EFPs views these transactions as involving a change in ownership of the cash commodity even though there is ultimately no change in possession. The Ad Hoc Committee has further determined that the cash commodity transfers involved in these transactions are legitimate cash market trades. 216/ As noted above, Comex examines EFPs for a cash commodity transfer but essentially relies on documentation

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215/ Comex Notice 83-63 (April 20, 1983); CME Memoranda (March 7, 1986 and July 14, 1986); CBT Office of Investigations and Audits Report 85-MSR-38 (October 16, 1985).

216/ CME Memorandum to the Files (July 14, 1986), supra note 201.

of the cash transaction as evidence of a legitimate EFP unless there are other indications that the trade was effected for an illicit purpose. 217/

CBT staff told the Division during interviews that trades involving the simultaneous purchase and sale of the cash are not acceptable if there is no identifiable cash transfer. However, such trades appear sometimes to be used by local traders (particularly in T-bonds) to correct errors or to trade out of positions immediately after the close. 218/ Some CBT members interviewed stated that they were unable to distinguish this type of EFP from other EFPs. Some of the members interviewed suggested that these virtually simultaneous transactions (cash commodity only, followed by an exchange of that cash commodity for futures) are analogous to a case such as a local trading in and out of a position within seconds. The CBT members also noted that with basis trading in deferred months the cash commodity may not yet exist. If the taking of transitory positions is

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217/ This issue was not addressed in interviews with CSC and NYMEX representatives because of the apparent absence of this practice in those markets.

218/ One such case investigated by Exchange staff involved a number of EFP transactions in T-bonds which appeared to have been executed to facilitate after-hours trading. The cash transactions "netted out" on the day of the trade. The Business Conduct Committee determined, however, that the cash transactions were legitimate. A more detailed description of this case can be found in Appendix 15, Item a.

legitimate generally, the CBT traders reasoned that there should be no problem with EFPs involving transitory ownership.

2. Assessing the Bona Fides of a Transitory Cash Commodity Transfer in Conjunction with an EFP Transaction

In evaluating whether a transitory cash commodity transfer and an ensuing EFP are *bona fide*, and whether the EFP thus may properly be excepted under Section 4c(a), the cash transfer and the EFP should be examined both separately and as an integrated transaction. As with other EFPs, this type of EFP transaction (which occurs in the gold and currency markets) should be analyzed to ascertain whether there are integrally related cash and futures transactions, a transfer of ownership, separate parties, price correlation, justifiable pricing of the cash and futures legs, and the possession by the seller of the cash commodity. Where there has been only a transitory exchange of the cash commodity, the cash transfer should be examined especially carefully because it is the exchange of cash commodities which permits the trader to acquire a futures position. In this regard, the Division believes 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.

A determination whether a cash transfer is commercially appropriate and severable from the EFP will depend upon whether

the terms and structure of the transfer are substantially the same in all material respects as other cash transactions executed by the participants and other cash transactions executed in that cash market. This determination should take the following matters into consideration:

(a) Whether the price of the cash commodity is determined in the same manner as for any other sale of the cash commodity in transactions not involving (or followed by) an EFP;

(b) The level of capital (creditworthiness) required of the initial cash buyer or seller;

(c) Whether the initial cash buyer has acquired title to the cash commodity; 219/

(d) Documentation of the transaction;

(e) The form of the contract and its terms; and

(f) The buyer's ability to take delivery and the seller's ability to make delivery.

If, based on a comparison to other cash transactions executed in the relevant market, the cash transfer appears to be severable from the EFP as a commercially appropriate transaction this is an important indication--but not conclusive evidence--that the integrated transaction is bona fide (assuming the EFP itself meets the other criteria for a bona fide transaction).

219/ Although this Report focuses primarily on transitory cash transfers and EFPs in which a trader buys the cash commodity and reconveys it to the seller via EFP in order to acquire a long futures position, the converse (i.e., a cash sale and an EFP in which the original cash seller obtains a short futures position upon the repurchase of the cash commodity) could also take place.

(a) Terms and Structure of the Cash Transfer

If the terms and structure of the cash transfer are not substantially the same in all material respects as other cash commodity transactions in that market, or more specifically for the particular participants, the entire transaction may not be *bona fide*. If, for instance, the price of the cash commodity is not determined in the same manner as for other cash market transfers engaged in by the participants, the cash transfer may not be commercially appropriate apart from the EFP. Likewise, if a lower level of capitalization is required of the customer for the cash transfer than normally would be required to engage in cash market transactions with the opposite party, it would be a strong indication that the parties did not intend to effect a genuine cash transfer, but intended instead to use the cash purchase and sale as a pretext for establishing a futures position. In this regard, various persons interviewed by the Division who have engaged in this type of EFP transaction in the gold and currency markets represented that the characteristics of the cash transfer in these EFPs were the same as those of cash transfers undertaken by them generally in the cash market.

Whether the buyer acquires title in the cash transfer likewise should be examined in accordance with customary cash market practices. If the provisions for delivery set forth in the transfer are consistent with normal cash market practice, and title transfers immediately, it is an important indication that the cash transaction is severable from the EFP. Unlike other

EFPs, these EFPs involve a cash transfer immediately prior to (or simultaneously with) an EFP in which the cash position acquired is reconveyed incident to the EFP. Because of the immediate reconveyance, if title does not pass in the initial cash transfer, the transaction may not be severable from the EFP. As noted in Sections III.F. and III.G., this type of transaction (involving a cash transfer and a related EFP) occurs in the gold and currency markets. In both markets, settlement (i.e., delivery and payment) on spot transactions typically takes place in two days. However, title may pass independently of settlement if that is the intent of the parties. 220/

Also relevant to the inquiry is whether the parties are obligated to complete both the cash transfer and the EFP (i.e., whether the transfer of title is conditioned on the execution of another contract, the EFP). The existence of conditions tying the EFP and cash transfer together may indicate that the cash transfer cannot stand on its own and that title was not transferred in the initial cash transfer. 221/

220/ As explained earlier, under the UCC, title may pass at the time of contracting if the goods are owned by the seller, existing, and identified, unless otherwise intended by the parties. Otherwise, title normally will pass upon performance by the seller (i.e., delivery).

221/ As noted earlier, however, dependent promises or conditions precedent to performance under the contract will not affect the transfer of title unless that is the intent of the parties (see note 174, supra).

(b) Evaluating the *Bona Fides* of the EFP

Once the cash transfer has been examined a determination must be made as to the *bona fides* of the EFP. Again, these types of transactions are unique in that the source of the cash commodity to be conveyed in the EFP is the cash transfer occurring immediately prior to (or simultaneously with) the EFP. The entire transaction results in the parties acquiring futures positions and maintaining the same position in the cash market as they had before the trade took place.

Although the Division's approach to the cash commodity "exchange" does not generally require that the cash seller in the EFP have possession of the cash at the time of the EFP, the cash seller must have the ability to fulfill the cash transfer. Because these transitory cash transfers and EFPs enable the parties to access the futures market noncompetitively, and the cash transfer is the source of the cash commodity to be conveyed in the EFP, the exchanges should consider whether it is appropriate to limit these EFPs by requiring that the cash commodity seller (in the EFP) have title to the cash commodity at the time of the EFP. Further, it would be reasonable for exchanges to limit these transactions to after-hours trading, when an EFP may be the only means available to enter or exit the futures market. The exchanges may consider whether these or other limitations should be imposed to address the purpose and special structure of these EFPs to assure that they are consistent with the intent of the exemption and other purposes of the Act and to facilitate monitoring of those transactions.

(c) Additional Considerations in Assessing the *Bona Fides* of the Entire Transaction

If the cash commodity transfer appears to be *bona fide* under the foregoing analysis, and the EFP meets the other criteria for a *bona fide* transaction, the entire transaction likely will qualify the EFP for excepted treatment under Section 4c(a). Nevertheless, there may be factual circumstances in which the transaction, despite apparent compliance with all criteria, is determined to constitute an illegal noncompetitive futures trade and, hence, is not *bona fide*.

As reflected by the above analysis, one factor which may be considered is the timing of the cash transfer and EFP. The simultaneity of these transactions, particularly when the same parties engage in more than one such transaction, can raise a question whether EFPs are being used to effect wash sales. Other situations which should be subjected to greater scrutiny are those in which the same parties have executed a number of such transactions, and, although the cash transfer could be severable from the EFP, the two trades never occur independently. Greater scrutiny is also warranted where there have been a series of transactions in which the same cash commodity is transferred repeatedly between the same parties, resulting in the liquidation of a futures position much larger than the exchanged physical commodity, and the cash commodity ultimately remains with the original owner (such as the silver transfers referred to at note 7). Depending on the circumstances as a whole, any of these situations might result in a finding that the transaction

constitutes illegal noncompetitive futures trading. Other circumstances, such as the relationship between the parties and their patterns of dealings, other futures or cash trades in related markets, or evidence of money passes between the parties would be relevant to determining the bona fides of the EFP as they are in investigations of futures trading activity generally.