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APR 2 10 37 AM '98

COMMENT

April 1, 1998



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

APR 6 10 01 AM '98
COMMODITY FUTURES
TRADING COMMISSION
RECEIVED FOR
PUBLIC RECORD

Re: Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market

Dear Ms. Webb:

This letter is presented by The Bond Market Association ("Association")¹ in response to the invitation of the Commodity Futures Trading Commission (the "Commission") for comment² on a broad range of questions pertaining to the execution of futures transactions through media other than the regular trading facilities of a designated contract market (hereinafter the "Concept Release").³

¹ This letter was prepared by Association staff with the assistance of special outside counsel, and has been circulated and reviewed by the Association's CEA Working Group, Primary Dealers Committee, SEC Concept Release Task Force, and Primary Dealers Executive Committee, comprising approximately 129 legal and business representatives of 61 member firms.

² 63 Fed. Reg. 3708 (January 26, 1998), reprinted at 2 Comm. Fut. L. Rep. (CCH) ¶27,211.

³ The comments of the Association address broad issues posed in the Concept Release. The Association reserves the right to comment further on any specific regulatory proposals by the Commission in the future, including any concerns about proposed regulations related to matters that the Association favors on a conceptual basis.



I. EXECUTIVE SUMMARY.

Our comments, in addition to describing the Association, set forth the reasons the Association favors or urges against action by the Commission on those matters covered by the Concept Release. In brief:

1. The Association urges *against* greater regulation of the activity known as exchanges-of-futures-for-physicals (or "EFPs"). The Commission's existing jurisdiction over (i) futures trading on a board of trade (including futures exchanged in EFPs) and (ii) the contract markets where the acceptability of each tendered EFP is ultimately decided renders unnecessary any expansion of Commission regulation in that area;
2. The Association also urges *against* greater EFP regulation that would result in regulation of cash market activity because of (i) the Commission's questionable jurisdiction over cash market activity,⁴ (ii) the pervasive regulatory scheme already

⁴ The Commission's jurisdiction over activity involving government securities is already substantially circumscribed by Act §2(a)(1)(A)(ii), the "Treasury Amendment," which excludes from the Act and from Commission regulation any such transaction that is not conducted on a board of trade. See also note 38, *infra*. The Association has vigorously and consistently supported in the courts and in the Congress the relief afforded to government securities dealers by the Treasury Amendment. See Briefs Amicus Curiae of the Public Securities Association in *Dunn v. Commodity Futures Trading Comm'n*, 117 S. Ct. 913 (1997) and *Commodity Futures Trading Comm'n v. Frankwell Bullion Limited*, 99 F.3d 299 (9th Cir. 1996); Statement of PSA The Bond Market Trade Association before the Senate Committee on Agriculture, Nutrition and Forestry, *Hearing on the Commodity Exchange Act Amendments of 1997* (February 13, 1997); Statement of PSA The Bond Market Trade Association before the House Subcommittee on Risk Management and Specialty Crops, House Committee on Agriculture, *Hearings on the Commodity Exchange Act Amendments of 1997* (April 16, 1997). The Association was formerly known as the Public Securities Association and PSA The Bond Market Trade Association. Any analysis of EFPs involving those instruments must take into account and must conform with the Treasury Amendment.



administered by other authorities to monitor cash market activity;⁵ and (iii) the untenable enforcement burden and devastating budgetary impact that would result;

3. The Association urges *against* codification of the REPORT OF THE DIVISION OF TRADING AND MARKETS: EXCHANGES OF FUTURES FOR PHYSICALS (October 1987) (hereinafter the "EFP Report"). The EFP Report has provided valuable and yet flexible, adaptable guidance to market participants for over a decade. Codification would rigidify the process and, at a minimum, could not adapt to innovation or change except through a slow rulemaking process;⁶

4. The Association urges *against* regulating entities that assist in pairing a cash transaction with a futures contract to form a proposed EFP. These facilitators increase the efficiency and transparency of the EFP process but cannot "execute" anything; the validity and enforceability of the futures "side" of an EFP is decided ultimately and exclusively by the Commission-regulated contract market where that contract is traded; and

5. The Association *favors* liberalization of noncompetitive trading procedures to accommodate large order/block trading, exchanges-of-futures-for-swaps ("EFSs"), and exchanges-of-options-for-physicals ("EOPs"). In the case of EFSs and EOPs, these transactions simply effectuate a different way of "delivering" the underlying commodity and should be subject to the same EFP practices currently governing "cash" deliverables. Moreover, each of these steps enhances the ability of market

⁵ For a very recent exercise of that oversight authority, see the *Joint Report* at note 8, *infra*.

⁶ Rulemaking at the Commission is subject to the Administrative Procedure Act, 5 U.S.C. §553 as well as the Commission's own Regulations §§13.1 - 13.6, 17 C.F.R. §§13.1 - 13.6 calling for publication of a proposed rule in the *Federal Register* and a period for public comment prior to adoption. Rulemaking at the contract markets is subject to Commodity Exchange Act §5a(a)(12), 7 U.S.C. §7a(12), and the Commission's own Regulation §1.41, 17 C.F.R. §1.41, which can entail an extended period of Commission review and a call for public comment on exchange rules that are deemed to be of "major economic significance."



participants to meet their requirements regarding transaction size and adds flexibility in the management of market exposures and price risks.

II. THE ASSOCIATION REPRESENTS THE INTERESTS OF DEALERS IN SECURITIES ISSUED BY GOVERNMENTS AND PUBLIC AGENCIES.

The market for government securities is dynamic, responding to changing public financing needs, innovative financial products, international competition, and general economic trends. To remain effective, dealers must enjoy in their operations the maximum degree of flexibility consistent with prudent and ethical business practices, under the supervision of several federal regulatory agencies other than the Commission. The issues raised by the Commission's Concept Release present a risk that the dealers' ability to adapt to changing economic or competitive stresses could be undermined by rigid articulation and application of hard-to-change "standards" and qualification requirements where, based on many years of experience, less formal guidance has worked very successfully.

1. The Over-The-Counter Government Securities Market Is A Highly Regulated, Efficient Market That Is Not Subject To CFTC Regulation.

The Bond Market Association represents approximately 180 securities firms and banks that underwrite, trade and sell fixed-income securities, domestically and internationally. These comments relate primarily to the Association's representation of members' activities in the markets for debt securities that are issued or guaranteed by the United States government and federal agencies, including agency-issued mortgage-backed securities (hereinafter "government securities") as well as financial instruments related to, or involving, government securities. In this respect, the Association represents all thirty-seven (37) primary dealers in government securities.⁷

⁷ More information about the Association can be obtained at www.bondmarkets.com, our website. The Association also represents dealers active in the corporate bond and municipal bond markets as well. Any action the CFTC takes concerning

(continued...)



The government securities market in the United States is the most liquid and efficient securities market in the world.⁸ The value of outstanding marketable U.S. Treasury securities (bonds, notes, and bills) is approximately \$3.5 trillion, with average daily turn-over about \$210 billion. Agency-issued debt securities (*e.g.*, "Fannie Mae" or "Freddie Mac" securities with which the Commission is familiar) have an outstanding market value of more than \$970 billion. In addition to routine purchases and sales, government securities are also frequently made the subject of "repurchase agreements"; in 1997, primary dealers' financing activity conducted through repurchase transactions involving Treasury, agency and agency-mortgage-related securities averaged \$2 trillion on a daily basis.⁹ Indeed, the Federal Reserve Bank of New York uses repos as its primary tool for implementation of federal monetary policy.

Activity in government securities, of course, services the funding needs of the Federal Government and various agencies. But it also acts regularly as a benchmark for lending generally, such as for interest rates on home mortgages, student loans and business financings. Moreover, many agency securities actually enlarge the pool of capital available for such uses by issuing, for instance, mortgage pass-through certificates. In addition, this market is characterized by use of derivatives such as forwards, options, futures, swaps and structured securities.

⁷ (...continued)
government securities should be reviewed in light of the benchmark status of Treasury securities relative to the global credit markets.

⁸ See *Joint Report of the Regulatory System For Government Securities* dated March 26, 1998 issued by the U.S. Department of the Treasury, the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System (report concludes that "the [U.S. government securities] market continues to function smoothly, and . . . is not flawed in any fundamental sense.")

⁹ The data represent financing activities by the primary U.S. government securities dealers reporting to the Federal Reserve Bank of New York. The figure represents the average of the amount outstanding as of the close of each Wednesday in the calendar year.



The government securities markets are among the most heavily regulated sectors of the U.S. economy. These activities are subject to standards set by the Securities and Exchange Commission (and the National Association of Securities Dealers, Inc.), the Department of the Treasury, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and state banking authorities. Government securities dealers operate under antifraud rules and registration requirements imposed by Congress in the federal securities laws beginning in 1934 and updated as recently as 1993. The Association has worked closely with these federal regulators in developing and implementing rules, regulations, and policies.

2. EFPs Involving Interest Rate Futures Are Critical To the Efficient Functioning of the Government Securities Markets.

EFPs have been congressionally recognized as a valuable and important resource for the business community since 1936 when §4c(a) of the Commodity Exchange Act¹⁰ made clear that the Act's prohibition against certain privately-negotiated transactions does not "prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities . . . if made in accordance with board of trade rules applying to such transactions and such rules shall have been approved by the Commission." The historical roots of EFPs can be found in the agricultural sector where they have often been used by hedgers to close out their futures positions simultaneously with the settlement of the underlying cash transactions.¹¹

EFPs contribute significantly to the liquidity and efficiency of the government securities market and, as a result, dealers in government securities engage in EFPs on

¹⁰ 7 U.S.C. §6c(a).

¹¹ The use of EFPs has remained especially pronounced in the agricultural sector where, according to the Commission's figures, futures associated with EFPs reached nearly 25% of one farm commodity's futures volume in 1986 and continue today to account for 10-15% of total grain futures volume on certain markets. See note 2, *supra*, at 3711 or CCH ¶27,211 at 45,846.



a regular basis.¹² Government securities dealers use futures contracts to hedge their transaction positions and firm portfolios as well as to unwind hedge positions.¹³ Basis trading using EFPs permits primary dealers to better manage the risk of distributing auctioned securities and allows investment managers to better manage the risk associated with buying these securities. In addition, using EFPs to hedge a position is particularly crucial to a dealer's ability to make a market in securities which have low trading volumes such as "off the run securities."¹⁴ For example, if a customer desires to buy a sizable amount of "off the run securities" from a dealer, the dealer would be very hesitant to assume a short position to accommodate the customer because it would be unlikely that the dealer could satisfy the short by buying the securities in the cash market at a reasonable price. However, dealers are comfortable accepting orders for "off the run securities" only because they are able to hedge their positions by purchasing futures contracts and, thereafter, unwinding their hedge positions using EFPs. Using EFPs to unwind a hedge position is preferred over executing a trade in the cash markets and then in the futures market, or vice versa, because (1) most importantly, the dealer can preserve the relationship between the price of the cash commodity and of the futures contracts without market risk exposure since the cash and futures transactions are entered into simultaneously, (2) EFPs provide an efficient and price neutral impact vehicle to facilitate these transactions, and (3) EFPs can be entered into even when the futures market is closed. The consensus among Association members is that without the EFP mechanism, primary dealers would be less able to participate in the current Treasury auction process, and the liquidity of "off the run securities" would be substantially diminished resulting in an increase in price volatility for those securities.

¹² While EFPs play an important role in the operations of government securities dealers, their contribution to exchange volumes nevertheless remains modest. By the Commission's own statistics, EFPs involving Treasury security futures accounted in 1996 for only 4-5% of total CBOT volume in those contracts.

¹³ To a lesser extent, government securities dealers also enter into futures transactions if they believe there is a favorable difference between the cash market and futures bond contract market.

¹⁴ "Off the run securities" are defined as those securities which are neither benchmarks nor current issues.



EFP transactions in the government securities market have a high level of transparency. The basis, which is the key component of an EFP that market participants seek to preserve, is derived by multiplying the futures contract price by the Chicago Board of Trade (CBOT) futures conversion factor and then subtracting the calculated cash price. Both the futures contract price and the CBOT futures conversion factor are publicly disseminated by the CBOT. The calculated cash price usually tracks the actual cash market and there are numerous sources for obtaining the actual cash market price such as individual inter-dealer brokers or GovPx Inc. which provides real-time access to prices of government securities traded among all primary dealers as reported through five inter-dealer brokers. Lastly, GovPx Inc. provides real-time best bid/best offer basis prices in the market. Since the components of an EFP are determinable, prior trades can be readily analyzed by market participants. As a result, instituting formalized procedures to ensure transparency would be unnecessary and would only rigidify a well-functioning process.

III. THE ASSOCIATION'S POSITIONS ON THE CONCEPT RELEASE.

1. The Commission's Existing Jurisdiction Over The Futures Markets Eliminates Any Need To Impose Regulation On The Physical Component of EFPs or On The Operations of Firms That Assist In Assembling EFPs.

The starting point of any regulatory policy analysis should be a finding of necessity. When that threshold standard is applied to the issues raised by the Concept Release, most of the suggested outcomes¹⁵ including codification of the EFP Report or formal regulation of EFP assembly services, the lack of need for regulatory action is readily evident.

The Concept Release itself provides ample confirmation that no additional regulatory steps are required for EFPs or for EFP facilitators. The Commission, first, has summarized the regulatory control that exists today over EFPs:

¹⁵ An exception may be the Commission's suggestion to liberalize the use of EFSs, EOPs, and large order/block trading.



EFP transactions are currently subject to oversight through a variety of sources, including: (i) the Commission's review of contract market rules governing such transactions; (ii) the Commission's reporting and recordkeeping requirements; (iii) the contract markets' enforcement of their own rules; (iv) the Commission's rule enforcement review program; and (v) the Commission's own enforcement program.¹⁶

In addition, the Commission has the ability through means such as the EFP Report to provide valuable but flexible guidance to market participants on acceptable EFP practices.

Through the tools described above, the Commission has the authority to assure that EFP activity remains consistent with the congressional intent embodied in Act §4c(a). But the controls go well beyond the Commission's own authority in this area. As the Commission has also noted in the Concept Release, the futures contract component of an EFP is always subject to acceptance by the contract market where that contract is traded:

Of course, if the Commission were to revise its regulatory structure relating to noncompetitive transactions, the choice of whether to permit these types of transactions on a particular contract market would remain, in the first instance, with that contract market (emphasis added).¹⁷

This is not to suggest, however, that a contract market may arbitrarily narrow or prohibit EFPs. Such action would clearly contravene the congressional objective of Act §4c(a) in which, as the EFP Report (p. 25) indicates, "Congress intended to preserve an established commercial practice in enacting the EFP exception."

¹⁶ See note 2, *supra*, at 3711 or CCH ¶27,211 at 45,847.

¹⁷ See note 2, *supra*, at 3710 or CCH ¶27,211 at 45,845.



Accordingly, neither the parties to an EFP nor any dealer who provides EFP facilitation services can assemble a legally binding futures contract in support of an EFP unless it already meets all of the following tests:

- (1) It is consistent with the EFP rules of a designated contract market which must be diligently enforced by such market;¹⁸
- (2) Those EFP rules (and any amendments thereto) have been submitted to and approved by the Commission;¹⁹
- (3) The EFP satisfies all mandated reporting and recordkeeping requirements;
- (4) The particular EFP conforms with the host contract market's own reasonable interpretation of its EFP rules with which the Commission concurs;
- (5) The EFP is not otherwise deemed by the Commission to violate the Act or Commission regulations; and
- (6) The contract market causes its clearinghouse to accept, recognize and record the futures side of the tendered EFP.

It is difficult to imagine any greater checks-and-balances against inappropriate EFP activity than the legal requirements that are already in place. The Association strongly believes that further regulatory action is clearly unnecessary.

¹⁸ Act §5a(a)(8), 7 U.S.C. §7a(8).

¹⁹ Act §4c(a), 7 U.S.C. §6c(a).



2. Certain Potential Outcomes From The Concept Release Would Expand the Commission's Statutory Authority And Reverse the Commission's Historical Policy Against Regulation of the Cash Markets in Commodities On Which Futures Contracts Exist.

It is beyond dispute that the Commission already possesses plenary and comprehensive authority over a formative EFP through its controls over the futures "leg" as well as over the contract markets which must decide whether or not to recognize the EFPs that are tendered to them; no further rulemaking, registration or other action is required in that regard. Accordingly, the only regulatory expansion considered in the Concept Release pertains to the *cash transaction* which is paired with a fully-regulated futures contract to assemble an EFP for submission to the relevant contract market for its acceptance and rejection.

Were the Commission to codify the EFP Report (or to adopt similar measures), or to undertake regulation of the dealers that have become facilitators for assembling the components of an EFP (subject, in all cases, to contract market acceptance), it would embark on a *substantial* and *unprecedented* incursion into the cash markets with the attendant costs and responsibilities that accompany that step. It would also enter a territory already occupied by other regulators that have far greater knowledge and experience in monitoring the physicals markets, including the vast markets for government securities.

Under the Commodity Exchange Act, the role of the Commission in respect of cash market operations has been confined traditionally to two functions: (A) civil proceedings (Act §§6(c)-(d), 6c)²⁰ or criminal referral to the Department of Justice (Act §9(a)(2))²¹ in the event of a suspected manipulation of the cash market in a commodity that is the subject of futures trading; or (B) various recording, recordkeeping, informational, and verification rules (see, *e.g.*, Act §§4i, 5a(a)(7), 8(d), 16(a) and Commission Regulation §§1.35(a-2) and 1.38).

²⁰ 7 U.S.C. §§9, 13b, 13a-1.

²¹ 7 U.S.C. §13(a).



Shortly after creation of the Commission, an issue arose whether the rules of contract markets which related solely to cash commodity transactions were subject to the agency's new prior-review authority. At that time, certain contract markets also operated "cash tables" where merchants could review samples of a cash commodity and negotiate its sale. In a no-action letter, the Commission's Division of Trading and Markets waived review of such rules for the time being.²² And, when the Commission determined subsequently to require prior submission of *all* contract market rules in order that their reviewability could be assessed on a case-by-case basis, the Commission continued to honor the prior no-action letter's waiver of pre-filing for cash market rules.²³ Since that time it appears that the Commission has undertaken a formal review of cash market rules on only one occasion involving the activities of certain Spot Cash Quotation Committees on contract markets.²⁴

Were the Commission to venture into cash market regulation simply because of a connection with futures trading, it might not be possible to confine that step to EFPs and related noncompetitive trading procedures. After all, the Commission's review of each new futures contract entails a "public interest" examination²⁵ designed to confirm that cash market benefits by way of hedging opportunities or price discovery are likely to result. To date, the Commission has not cited this requirement of nexus with the cash market as sufficient reason to impose cash market standards or constraints; rather, the cash markets have been left largely to operate according to their own commercial norms. Similarly, the Commission recognizes that futures trading is used extensively to hedge cash market price exposures but has not engaged

²² CFTC Interpretative Letter No. 76-2 (Approval of Cash Market Rules Pursuant to Sec. 5a(12) of the Commodity Exchange Act), [1975-77 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,133 (February 13, 1976).

²³ 41 Fed. Reg. 40091 (September 17, 1976), reprinted at [1975-77 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,208.

²⁴ 42 Fed. Reg. 6726 (February 3, 1977), reprinted at [1975-77 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,262. That review, moreover, was confined largely to antitrust issues under Act §15, 7 U.S.C. §19.

²⁵ Act §5(7), 7 U.S.C. §7(g).



(beyond documentation and verification)²⁶ in directing how the cash market component of a hedge must be executed nor has it otherwise sought to set minimum standards in that area. Undertaking such a task, which would be a logical but legally and jurisdictionally questionable consequence of concluding (as with EFPs) that an association with futures contracts necessitates regulating a cash market, would impose impossible strains on the Commission's resources and burden it with vast enforcement obligations that cannot realistically be met.

3. Codifying the EFP Report Would Defeat Its Long-Standing Value as a Flexible, Adaptable Tool for Market Participants.

A great strength of the EFP Report is that it does not attempt to freeze EFP practices into any rigid framework. Rather, it speaks of "indicia" for evaluating particular EFPs and of "guidance" to the exchanges and market participants.²⁷ Above all, the approach of the EFP Report is recognized as "flexible".

This flexible approach, which recognizes the variety of uses for EFPs across the different markets, will enable the exchanges to adapt the Division's analysis to the particular circumstances of their markets, either by rule or through their affirmative surveillance programs. The Division recognizes that EFP practices continue to evolve to accomplish a variety of trading strategies and industry needs as the nature of the futures market changes. The frequent references in this Report to standard cash market practices and commercial appropriateness are designed to address those evolving needs.²⁸

²⁶ See, e.g., Commission Regulation §§ 1.47 - 1.48, 17 C.F.R. §§1.47 - 1.48.

²⁷ See, e.g., EFP Report at 259-60.

²⁸ EFP Report, p. 260.



Indeed, the EFP Report suggested no substantive action by the Commission other than to assure the timely existence of verifying records and reports, and sensitivity by clearing members toward creditworthiness of EFP parties.

Codification of the EFP Report (or of its standards, or of any updated criteria for EFPs) implicates immediately the federal procedures for rulemaking which retard the pace of change in a variety of ways. First, the Administrative Procedure Act and implementing Commission regulations²⁹ dictate a protracted process of developing and explaining proposals, receiving and reviewing comments, deliberating and acting to codify the new regulatory policy. In addition, various provisions of the Act require or encourage the Commission to consult other federal departments and agencies when matters affecting their responsibilities are involved.³⁰ In light of the fact that EFP transactions currently take place in a wide variety of physical assets or instruments falling within the responsibility of potentially many federal departments and agencies, the consultation process alone could consume many months during which time all needed change would be blocked and the ability of American business to upgrade its products and services, as well as to compete effectively on the global markets, would suffer.

It is for this reason that the Association firmly believes that sound regulatory policy, as noted earlier, is always based on a finding of compelling necessity that outweighs the disruptions that inevitably accompany the rulemaking and consultation processes. There is no evidence that such a need exists; indeed, the observation below from the EFP Report appears to be as accurate today as it was then:

The Division began its study of EFPs in part because of concerns about potential abuses of the EFP mechanism for noncompetitive futures trading without a corresponding bona fide cash transfer. Although the

²⁹ See note 6, *supra*.

³⁰ See, e.g., Act §§2(a)(1)(B)(iv)(Securities and Exchange Commission), 2(a)(8)(A)(Department of Agriculture), 2(a)(8)(B)-(C)(Federal Reserve System and Department of the Treasury), 15 (Department of Justice).



potential for abuse is clearly present, most notably with EFPs involving transitory ownership of the cash commodity (such as those which take place in the gold and currency markets),³¹ *the Division's study did not indicate that widespread abuses of the EFP exception are currently taking place. Moreover, most of the EFPs now used to facilitate trading strategies, for instance arbitrage trading, appear to involve both cash and futures transactions and to be appropriate to the business purpose to be achieved* (emphasis added).³²

In light of the Commission's and the contract markets' existing authority to act as gatekeepers of EFPs; the paucity of abuses found by the Division of Trading and Markets in its comprehensive 1987 review of EFP practices; and the benefits of flexibility "to adapt . . . to the particular circumstances of their markets"³³ as highlighted in the EFP Report, the Association urges against codification of the EFP Report or of its guidelines or of any updated criteria for EFP activity.

4. The Commission Misapprehends the Nature and Function of EFP Facilitators, Which Do Not Operate as "Markets" or "Execute" Any Futures Contracts, and Therefore Should Not Be Viewed As Equivalent to Contract Markets.

EFP facilitators are incorrectly characterized in the Concept Release as having a "formal market environment" where "transactions . . . are executed off-exchange and reported to contract markets as EFPs."³⁴ The Concept Release also refers inaccurately to the basis trading facilities operated by major inter-dealer brokers in the U.S.

³¹ This practice was not identified with the government securities area where the Association's members conduct business.

³² EFP Report, pp. 257-258.

³³ See note 28, *supra*.

³⁴ 63 Fed. Reg. at 3719 or CCH ¶27,211 at p. 45,859.



Treasury securities markets as permitting "the simultaneous acquisition of positions in actual Treasury securities and in offsetting futures contracts." As a consequence, the Commission offers a plainly invalid assessment that these dealers might be viewed as "functionally the equivalent of designated contract markets."³⁵

The fundamental error of the Commission's analysis of EFP facilitators is that no futures transactions are "executed" there, and that futures contracts are not (and cannot be) acquired through them. As recognized elsewhere in the Concept Release (and noted repeatedly in these comments), "whether to permit these types of transactions on a particular contract market would remain, in the first instance, with that contract market."³⁶ Thus, while it may be possible for EFP facilitators to arrange a binding transaction in the *physical* commodity or security, no futures contract comes into existence until the host contract market and its clearinghouse acknowledge and accept the futures component of the EFP. In other words, the contract market continues to be the exclusive point of execution of the *futures contracts* and the EFP facilitators can do no more than assist the parties in assembling a proposed EFP for ultimate acceptance or rejection of the futures contract component by the pertinent contract market.

Under these circumstances, no weakness (as the Commission mistakenly infers) arises from the fact that "Basis trades executed [sic] through these facilities currently are subject to the same regulatory requirements as any other EFP transaction" or that "The Commission's oversight of these facilities does not differ in any way from its oversight of the EFP markets generally."³⁷ EFP facilities raise no new issues; like the traditional ad hoc arrangements for assembling EFPs, the dealers simply make it possible for parties to provisionally identify a specific physicals transaction to be paired with a futures contract when and if the latter is acknowledged and accepted by the clearinghouse of the host contract market. Far from being "functionally the

³⁵ 63 Fed. Reg. at 3720 or CCH ¶27,211 at p. 45,861.

³⁶ See note 17, *supra*.

³⁷ 63 Fed. Reg. at 3720 or CCH ¶27,211 at p. 45,860.



equivalent of designated contract markets,"³⁸ the efforts of an EFP facilitator are secondary and subordinate to the ultimate decision of a Commission-regulated contract market whether to deem a futures contract to have been created.

Because an EFP facilitator is incapable of creating a futures position for any of its clients, the Association urges against any expansion of Commission jurisdiction over those dealers.³⁹ Where the Commission's (and the contract markets') control is most needed - over the futures transaction - it is already pervasive and final.

5. The Commission Should Authorize Use of Other Off-Exchange Procedures Involving Instruments Over Which It Has Comprehensive Authority.

In its Concept Release, the Commission has requested comment on the efficacy of permitting certain new uses of off-exchange procedures beyond traditional EFPs, including block trading of futures, exchanges-of-futures-for-swaps ("EFSs"), and exchanges-of-options-for-physicals ("EOPs"). For the reasons given above and, most notably, the vast scope of authority enjoyed by the Commission and the contract markets over the futures (or options) component of each such procedure, the Association supports an expansion in these areas.

The rationale for allowing these initiatives is fundamentally the same as for EFPs. In their commercial and financial operations, many market users now utilize a variety of techniques including swaps and options as risk-management tools and for other forward-planning purposes. The Commission itself has acted to recognize the role of swaps⁴⁰ and of options⁴¹ in modern commercial life. No evident purpose would be

³⁸ See note 35, *supra*. For the same reason, a dealer engaged in EFP facilitation does not constitute a "board of trade" within the meaning of the Act (§1a(1)). That term is equated with an organized futures exchange (see, *e.g.*, *Commodity Futures Trading Comm'n v. Frankwell Bullion Limited*, 99 F.3d 299 (9th Cir. 1996), reprinted at [1994-96 Transfer Binder] *Comm. Fut. L. Rep. (CCH)* ¶26,807) where futures contracts are actually formed. See also *Dunn v. Commodity Futures Trading Comm'n*, 117 S. Ct. 913 (1997), reprinted at 2 *Comm. Fut. L. Rep. (CCH)* ¶26,955, where the Supreme Court implicitly held that the appellee options dealer was not a board of trade by absolving it under the Treasury Amendment while ruling that options conducted on a "board of trade" would not qualify for such relief.

³⁹ See also note 4, *supra*.

⁴⁰ See, *e.g.*, Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694
(continued...)



served by rendering these instruments any less useful as management tools than classical EFPs.

Similarly, as the futures markets have become predominantly institutional and must be responsive to demands for futures in volumes not contemplated when the Act first mandated the on-exchange requirement, steps to permit block trading should improve efficiency at every level: end user, futures commission merchant, exchange and clearinghouse. From time to time, for example, cash transactions in government securities may reach sizes that would severely tax the liquidity of a futures pit or ring if associated futures orders were to be placed in equal volume. The ability to arrange an inter-institutional futures transaction in the first instance to complement a large cash securities transaction would relieve much of that pressure without compromising the contract markets' right to accept or to reject the trade or impairing the transparency of market activity. While the Association is aware that block trading is not universally welcomed among the membership of some contract markets, and while the Association supports a solution that accommodates the interests of all key market professionals to the extent possible, we urge the Commission to seek suitable means to accommodate institutional needs in this regard.

IV. CONCLUSION.

The Association supports and commends the Commission for its initiatives with respect to EFSs, EOPs and block trading where greater flexibility of use would be widely welcomed by the financial community. On the other hand, the Association wishes to emphasize that any formal Commission action in the EFP area, whether to codify the EFP Report (or similar standards), to set other standards, or to regulate dealers that facilitate assembly of EFP components, is unnecessary and potentially counterproductive as overly rigid in light of the Commission's existing flexible oversight of EFP activity. That oversight is further augmented by the separate

⁴⁰ (...continued)
(July 21, 1989), reprinted at [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) 24,494; and Commission Regulations §§35.1 - 35.2, 17 C.F.R. §§35.1 - 35.2.

⁴¹ See, e.g., Commission Regulations §§32.4(a), 33.1 - 33.11, 17 C.F.R. §§33.1 - 33.11; and Trade Options on Enumerated Agricultural Commodities, 62 Fed. Reg. 59624 (November 4, 1997), reprinted at 2 Comm. Fut. L. Rep. (CCH) ¶27,178.



contract markets where the validity and enforceability of the futures contract component of all EFPs are ultimately decided even today. Rather, any such initiative would simply bog down the Commission in the minutiae of *cash market* regulation, a role that it cannot perform without enhanced statutory authority and that it has historically declined to assume and which, in any event, is already performed effectively by a variety of other federal departments and agencies.

We would be pleased to discuss our views in greater depth at your convenience and, for that purpose, please feel free to contact the undersigned at 212.440.9459, or Paula H. Simpkins, Esq., at 212.440.9431 with any questions or comments.

Sincerely,

A handwritten signature in cursive script that reads "Paul Saltzman".

Paul Saltzman, Esq.

Senior Vice President and General Counsel

- cc: The Honorable Brooksley Born, Esq.
The Honorable John E. Tull, Jr.
The Honorable Barbara Petersen Holum
The Honorable David D. Spears
Daniel R. Waldman, Esq., General Counsel
I. Michael Greenberger, Esq., Director, Division of Trading and Markets
Geoffrey Aronow, Esq., Director, Division of Enforcement
Steven Manaster, Ph.D., Director, Division of Economic Analysis
U.S. Commodity Futures Trading Commission
Richard Lindsey, Director, Division of Market Regulation
Catherine McGuire, Division of Market Regulation
U.S. Securities and Exchange Commission
Roger Anderson, Deputy Assistant Secretary for Federal Finance
United States Department of the Treasury
Oliver Ireland, Associate General Counsel
Board of Governors of the Federal Reserve System