Emerging
Markets
Traders
Association

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BY FAX

January 21, 1999

Ms. Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St., NW
Washington, DC 20581
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COMMENT

RE: CFTC's Request for Comment on Federal Register Notice 98-33354, dated December 16, 1998, regarding the Chicago Mercantile Exchange's Proposed Amendments to Cash Settlement Provisions of the CME Brazilian Real Futures Contract

Dear Ms. Webb:

With respect to the above-captioned request, the Emerging Markets Traders Association ("EMTA") welcomes the opportunity to comment. We also appreciate the brief extension of the comment period for the benefit of our members.

EMTA supports the Chicago Mercantile Exchange's (the "CME") proposed amendments to its cash settlement procedures for the CME Brazilian Real Futures Contract, which were revised and re-submitted to you on January 15, 1999 (the "January 15 Methodology"; capitalized terms not defined herein are used as defined in the January 15 Methodology).

Background

On January 12, 1999, market participants from the over-the-counter ("OTC") non-deliverable forward ("NDF") Brazilian real/U.S. dollar market participated in a telephone conference call with the CME and us to discuss the CME's proposed back-up cash settlement procedures for its Brazilian Real Futures Contract. Currently, OTC market participants settle their NDF contracts to the PTAX Commercial Rate[1] published by the Central Bank of Brazil. This is the same rate used

[1] The PTAX Commercial Rate is based on the weighted average price of all U.S. dollar/Brazilian real transactions in Brazil's foreign exchange market as reported to the Central Bank of Brazil through the SISBACEN network, as adjusted by the Central Bank pursuant to its methodology to represent the "offered" side of the market (currently by adding .0004 Brazilian real per U.S. dollar).

by the CME to close its Brazilian Real Futures Contracts on the termination of trading day, which permits NDF market participants to effectively hedge their NDF exposure by using the CME futures contracts. This ability to hedge exposure becomes even more essential in the event of a market disruption, which could cause the Central Bank of Brazil to suspend publication of the PTAX Commercial Rate.

Based upon the recent experience of the Russian Ruble crisis, market participants were interested in exploring the possibility of extending to the Brazil context the model of the CME/EMTA RUB/USD Reference Rate. In the Russian context, the CME and EMTA jointly developed a methodology for determining a Ruble/Dollar exchange rate based upon a dealer survey, which has been published daily since suspension of the MICEXFRX Rate. The CME and the financial industry have adopted the CME/EMTA RUB/USD Reference Rate as the primary rate source for settling both the CME Ruble Futures Contract and NDFs since publication of the MICEXFRX Rate was suspended, thereby creating certainty in the marketplace and reducing overall basis risk.

Recognizing the value of developing a common back-up rate for the CME Brazilian Real Futures Contract that the NDF marketplace could also adopt, EMTA members were very interested in reviewing the CME back-up procedures and discussing certain issues relating to those procedures with the CME. The January 15 Methodology reflects the recommendations of EMTA members.

In general, EMTA members fully support the CME's approach to determining the back-up settlement rate for the Brazilian Real by mirroring to the greatest extent possible the methodology used by the Central Bank of Brazil in determining the PTAX Commercial Rate. EMTA members had two recommendations for refining the methodology described in the Federal Register Notice 98-33354 dated 12/16 (the "<u>December 16 Methodology</u>"), which resulted in the January 15 Methodology. These issues related to: (1) clarifying that, in the first instance, actual quotes (rather than quotes based upon a market participant's view or perception of market rates ("perceived market rates")) should be requested of survey participants; and (2) prioritizing the use of actual quotes over perceived market rates. These issues are analyzed below.

<u>The Survey Question: Actual Quotes vs. Perceived Market Rates</u>

Market practice in the NDF markets is still evolving; however, there is consensus among market participants that, when it is impossible to obtain a primary rate source for settlement of the NDF (i.e., a "Price Source Disruption" has occurred), market participants should settle to a fallback reference rate. Generally, the first fallback reference rate is determined on a bilateral basis through a polling of (usually three or four) reference currency dealers. These dealers are generally asked to provide quotations for actual transactions, or quotations representing prices at which that firm would be willing to transact. These three or four actual quotes are then averaged to determine a rate for settlement of the NDF. It has not been market practice in the NDF market to poll dealers for their view or perception of market rates, or to accept these perceived market rates for purposes of settling their NDFs[2].

[2] The development of the CME/EMTA RUB/USD Reference Rate was prompted by the inability of NDF market participants to obtain actual dealer quotes immediately after the suspension of publication of the MICEXFRX rate.

In the December 16 Methodology, the CME proposed to ask randomly selected survey participants for their "perception of the average dollar offered rate at which spot transactions for Brazilian reais per U.S. dollar occurred during the trading day". EMTA members recommended that the survey participants provide quotes based upon their <u>actual</u> transactions, rather than their market perception, for a number of important reasons.

First, it is the understanding of market participants that the PTAX Commercial Rate is based upon the weighted average of <u>actual</u> foreign exchange transactions for a given day, which are entered into an electronic database. At the end of the trading day, the Central Bank of Brazil determines the weighted average of all transactions entered into the database that day, and then adjusts that rate, by adding .0004 Brazilian Real per U.S. Dollar, to obtain the average dollar offer rate. Because the PTAX Commercial Rate is based upon actual trades occurring in a trading day, whenever possible, the CME back-up rate should also be based upon actual quotes.

The emphasis on obtaining <u>actual</u> quotes over perceived market rates lies at the core of the NDF market. An NDF's value is based upon the difference between a forward rate agreed on the trade date and the spot rate on the valuation or settlement date. When entering into an NDF transaction, the parties to a trade must indicate the source from which they will obtain the spot rate on the valuation or settlement date for settlement of the NDF. The perception of the parties when entering into the trade and agreeing to the forward rate is based upon their understanding of, and reliance on, this primary rate source. The rate source must provide a real rate—a rate at which currencies are actually being exchanged in the local market.

For a market participant to settle its NDF contract to a rate provided by a rate source other than the one agreed to on the trade date, such market participant (and, by implication, the market as a whole) must have confidence that the back-up rate is one at which currencies are actually being exchanged in the local market. This is why, in current market practice, the reference dealer survey is conducted on the basis of obtaining either actual quotes, or quotations representing prices at which that firm would be willing to transact. A survey based upon actual quotes is viewed as more reliable (and less subject to manipulation) because the participant providing the rate implies that he is willing to execute (or has executed) a foreign exchange transaction at that rate. The integrity of the rate is called into question if a market participant provides a quote based upon its perception or view of where the market is, rather than a rate based on actual exchanges of real currencies.

This modification of the methodology from perceived market rates to actual rates also occurred in the context of the CME/EMTA RUB/USD Reference Rate. In the first methodology, dated August 28, 1998, survey participants were asked to provide "their view of the current prevailing bid and offer for typically sized Russian Ruble per U.S. dollar spot transactions in the Moscow marketplace." The methodology was revised on October 14, 1998 based upon EMTA member recommendations, and survey participants are now asked to provide "both the bid and offer at which the participant could currently execute a minimum-sized transaction ($100,000)...in the Moscow marketplace."

Therefore, in the Brazil back-up procedures, EMTA members recommended that the CME ask each survey participant to provide the average dollar offered rate based upon its <u>actual</u> spot transactions (consistent with the current PTAX methodology). If the participant were not able to provide a quote based upon its actual spot transactions, then the CME would request that survey participant to provide its best estimate of the overall market's average dollar offered rate. The objective in refining the survey question is to obtain actual quotes, whenever possible.

Five Actual Quotes vs. Eight Perceived Market Rates

Market participants also recommended that the CME limit the survey to actual quotes to the extent they were able to obtain actual quotes. Therefore, if eight actual quotes were provided, these would be the starting points for determining the Final Settlement Price. If less than eight actual quotes were provided, market participants agreed that they would rather use a smaller pool of actual quotes (down to five) than introduce perceived market rates, to comprise the Final Settlement Price. Moreover, using a minimum of five actual quotes results in a broader polling than the currently accepted market practice in the NDF market of polling only three of four reference dealers.

Market participants have generally accepted that only in a situation of extremely limited liquidity, where the survey results in less than five actual quotes, would the introduction of perceived market rates into the formula for determining the Final Settlement Price be necessary. It is agreed among market participants that once such perceived market rates are being used, it is best to use a larger pool of survey participants, so that anomalous rates are weeded out. Therefore, EMTA members recommended that, in the event the survey resulted in fewer than five actual quotes, the CME should broaden the pool to eight perceived market rates in order to determine the Final Settlement Price.

Finally, consistent with the methodology for the CME/EMTA RUB/USD Reference Rate, as a final fallback, market participants would prefer for the CME to determine a rate based upon perceived market rates even if less than eight participants responded to the survey (down to five) rather than invoke the Emergency Provisions. This view is based upon the understanding that if less than eight market participants are able to provide perceived market rates, the market situation will have become very deteriorated; therefore a rate based upon five perceived market rates is better than no rate at all or a rate based upon a methodology evoked under the Emergency Provisions that was unknown to market participants.

We hope that you find these comments helpful in your analysis of the CME proposed back-up cash settlement procedures for the Brazilian Real Futures Contract. If you have any questions, please do not hesitate to contact Michael Chamberlin, EMTA's Executive Director, or me at (212) 908-5000.

Very truly yours,

Starla Cohen

Starla Cohen
Legal Counsel

cc: Mr. Michael A. Penick, Division of Economic Affairs