

**Securities Industry Association**

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April 27, 1998

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

**Re: Concept Release Regarding Regulation of Non-Competitive
Transactions Executed on or Subject to the Rules of a Contract
Market**

Dear Ms. Webb:

The OTC Derivative Products Committee (the "Committee") of the Securities Industry Association (the "SIA")¹ is submitting this letter in response to the Commodity Futures Trading Commission's (the "Commission" or "CFTC") request for comments on the captioned concept release ("Concept Release").²

The Committee welcomes the Commission's review of many of the issues addressed in the concept release and encourages the Commission to utilize this initiative as a vehicle for affording greater flexibility to the futures exchanges to accommodate the needs of institutional traders and for broadening and strengthening the complementary relationship between the exchange markets in futures contracts and the over-the-counter markets that utilize the exchange markets for hedging and as a price source.

1. Exchanges of Futures for Swaps and Options

The Commission has requested comment as to whether it should approve exchange rules permitting, among other transactions, exchanges of futures for swaps. The Committee strongly endorses the implementation by exchanges of rules permitting the execution of exchanges of futures contracts for swaps and encourages the Commission to approve exchange rules authorizing such transactions.³ The Committee acknowledges that

certain of these transactions may not qualify as "exchanges of futures for physicals" within the meaning of CEA section 4c(a). The Committee accordingly encourages the Commission to utilize its general exemptive authority under CEA section 4(c), where necessary, to authorize the adoption by exchanges of rules permitting the execution of such transactions.

As noted by the Commission, EFPs are unique in that they represent the single statutory exception to the requirement that futures transactions be executed by unrelated parties at prices discovered in the competitive auction process. This exception finds its roots in the fundamental objective of the CEA to foster the use of exchange markets for hedging and as a price source for transactions in commodities in interstate commerce. The contract market designation process (through the economic purpose test) seeks to ensure that contracts are designed in a manner consistent with their use as a price source for the cash market and for hedging. The EFP exception furthers this objective and fosters the use of futures markets for hedging by eliminating the execution risk associated with the initiation or liquidation of a futures position to hedge a physical position.

Individually negotiated swap transactions and "off-exchange" options are analogous to physical transactions in the sense that they too may be executed at negotiated prices. By permitting counterparties to these transactions to execute exchanges for futures positions, exchanges will promote the use of the futures markets as a price source for such transactions and, concomitantly, will promote the use of futures markets to hedge these transactions. This will occur because, by using the futures markets as a price source, ⁴ counterparties to these transactions may mitigate correlation risk and, through an exchange for futures transaction, the execution risk associated with legging into or out of a hedging position in the related futures contract. The Committee believes that this would contribute to liquidity and enhance the price discovery function of the relevant contract market. In this regard, the Committee endorses the conclusion of the New York Mercantile Exchange that such a development would be beneficial both to the futures markets and to the parties to these off-exchange transactions and would promote fundamental objectives of the CEA.

2. Execution facilities and EFP basis trading

The Commission has also requested comment as to whether additional regulatory review or other measures are warranted by the evolution of trading systems for the execution of EFPs. The Committee is unaware of any electronic system on which participants can currently "execute" transactions in EFPs (or in the futures leg of an EFP), although a number of interdealer brokerage systems provide actionable basis quotations to which parties may commit on a separate bilateral telephone conversation.

The Committee does not believe that such systems constitute execution facilities or that such systems constitute "boards of trade" under the CEA.

If a system for the electronic execution of EFPs evolved, the Committee believes that, so long as an EFP transaction is conducted in accordance with rules adopted by the listing futures exchange, it would not be appropriate to regard (or regulate) the system on which the parties establish the pricing basis for the EFP as a board of trade. This conclusion follows from the fact that the futures leg of the transaction is itself executed subject to the rules of the listing futures exchange. The futures leg is not, however, executed on the facility on which the EFP basis is agreed. Because a basis trade is itself only an agreement to enter into a physical transaction and a futures contract at an agreed price relationship, it would be factually incorrect to characterize the facility through which the basis is agreed as the facility on which (or through which) the futures leg is executed. That occurs only on the listing futures exchange. Indeed, in a basis trade, the price at which the futures leg is to be executed is not even agreed -- only the relationship between the cash and futures price is agreed. As a result, it would be incorrect, as a factual matter, to characterize a facility through which parties agree to the basis relationship between the futures and cash leg of an EFP as a "board of trade" or "execution facility" on which the futures leg is executed.

Even if the facts were different and one could reasonably analyze the basis transaction as involving a futures transaction conducted on an execution facility, the Committee does not believe it would be either appropriate or necessary to regulate both the basis execution facility and the listing exchange in connection with the execution of a single futures transaction that is regulated under the rules of the listing futures exchange. Any necessary limitations on such activity can be effectively imposed through the rules of the listing exchange.

So long as any EFP executed on an electronic facility does not conflict with the rules of the listing futures exchange applicable to EFPs generally, the Committee sees no reason to impose or require the imposition of additional regulatory oversight or limitations. The development of such facilities would not, in the Committee's view, present the need for the Commission to employ contract market designation criteria different than or additional to those currently used by the Commission to evaluate whether exchange EFPs rules are contrary to the public interest. To the extent that existing EFP rules are consistent with the public interest, the Committee does not believe that any evolution of systems to execute such transactions consistent with such rules would become contrary to the public interest as a result of evolution in the environment in which such transactions are conducted.

The Commission has specifically requested comment as to whether

additional regulation is appropriate in the context of basis trading in government securities EFPs. In this connection the Commission expressly raises the questions whether additional protection against manipulation is warranted, whether there is adequate price transparency and whether competitive execution requirements should be imposed. The Committee believes that, in the context of basis trading in government securities EFPs, no additional regulatory protections are necessary because the circumstances under which such transactions are executed provide even greater market and regulatory protective mechanisms⁵ than are applicable to conventional EFPs involving other asset classes.

The Committee notes that government securities basis transactions (and basis transactions in stock index EFPs) are executed by regulated securities brokers or dealers or government securities brokers or dealers subject to extensive recordkeeping and other regulatory requirements. These transactions also necessarily involve cash leg transactions that (unlike other physicals transactions underlying EFPs) are subject to a comprehensive scheme of federal regulation, including anti-manipulation and anti-fraud provisions. The fact that EFPs do not by their nature have any directional price bias, further mitigates the potential for such transactions to raise additional regulatory concerns. Accordingly, the Committee believes that these transactions provide the least compelling case for additional regulation or restrictions.

The Commission has also requested comment on the adequacy of the transparency of government securities systems, such as the interdealer brokerage systems, and whether a lack of transparency raises the need for additional regulation. EFPs generally are, by their nature, executed individually, and not in transparent markets. If anything, systems such as interdealer brokerage systems create a degree of transparency that is otherwise absent in the context of these transactions and therefore enhance transparency.

The Commission has also asked whether competitive execution should be required in the context of government securities EFPs entered into on execution facilities. Any such requirement would be plainly contrary to the CEA. As noted above, EFPs are the sole express statutory exception to the CEA's competitive execution requirement. In light of the unambiguous statement of Congress's intent that EFPs be permitted to be effected without competitive execution, it would be difficult to imagine a policy justification under the CEA for the Commission to impose any such requirement.

Finally, in the case of basis trades involving government securities (and other products enumerated in CEA section 2(a)(1)(A)(ii)), the Committee questions the CFTC's authority to impose an additional layer of regulation -- particularly in the case of a facility that is not an organized exchange.

For the foregoing reasons, the Committee believes that developments in the execution of EFPs do not present any heightened need for Commission intervention (or further codification) generally and that basis trading in government securities EFPs (and stock index EFPs), in particular, present the least compelling case for additional regulatory intervention by the Commission.

3. Transitory EFPs

The Commission has requested comment as to whether the Commission should codify criteria for transitory EFPs.

The Committee agrees with the Commission that the question presented by transitory EFPs transactions is whether the cash leg of the EFP is in reality a sham and, therefore, whether the transaction constitutes a bona fide EFP within the meaning of CEA section 4c(a). The Committee does not believe, however, that any additional initiatives are required by the Commission to define an impermissible "transitory" EFP. In the Committee's view, the relevant inquiry in this context is whether the parties have executed the EFP either (i) without any cash leg at all or (ii) as part of a broader binding contractual obligation which obligates the parties in addition to execution of the EFP, to execute an offsetting cash market transaction at an agreed price without any transfer of the physical or the incidents of ownership of the physical or any market exposure. Absent such an obligation, the parties' EFP should be respected as bona fide.

The Commission has identified a number of criteria for consideration in connection with the proposed codification that would define impermissible transitory EFPs.⁶ However, the Committee does not regard the criteria identified by the Commission as appropriate for inclusion in a definition. Instead, the criteria identified by the Commission are circumstantial considerations which may be evidence of the actual agreement(s) of the parties to an EFP but are not in themselves dispositive or defining characteristics. As a result, the Committee does not regard codification of these considerations as appropriate.

4. Large Order Execution

The Commission has also requested comment on a regulatory approach to the execution of large transactions other than in accordance with customary auction market procedures. The Committee supports the development of exchange rules permitting the execution of large orders. The Committee believes that many approaches to this issue have merit. However, the individual characteristics of markets will influence the success of a particular approach. For that reason, the Committee does not believe that the Commission should attempt, in the abstract, to define one or more specific approaches. Instead, the Commission should exercise its rule approval authority by affording exchanges greater flexibility in

developing and implementing, on a trial or other basis, specific approaches to large order execution.

If you have any questions or would like further information regarding this letter, please feel free to contact Gerard J. Quinn, Staff Adviser to the Committee, at 212-618-0507 or Edward J. Rosen, of Cleary, Gottlieb, Steen & Hamilton, counsel to the Committee, at 212-225-2820.

Very truly yours,

Zachary Snow, Chairman
OTC Derivative Products Committee

Footnotes

¹ SIA is the leading proponent of capital markets, bringing together the shared interests of nearly 800 securities firms throughout North America. SIA members -- including investment banks, brokers-dealers, specialists, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90%, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans.

² 63 Fed. Reg. 3709, January 26, 1998.

³ The Committee would similarly endorse transactions in the nature of exchanges of options for physicals ("EOPs") and exchanges of futures for options ("EFOs"). The Committee recognizes that, as a result of the price structure of options, such transactions raise additional quantitative considerations that would need to be addressed by a listing futures exchange in establishing the parameters for permitted EFOs or EOPs.

⁴ Unlike the agricultural markets, the price discovery function for many other markets, including the financial markets, is performed by the cash rather than the futures market.

⁵ Similar considerations would apply in the case of EFPs involving stock index baskets.

⁶ 63 Fed. Reg. at 3713.