

March 27, 2000

Mr. William J. Rainer
Chairman
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Chairman Rainer:

The Executive Committee of the FIA has asked me to forward to you its recent policy recommendations titled "Recommendations for Legislation and Regulatory Reform Under the Commodity Exchange Act." As we have explained in the document, the purpose of the recommendations is to permit more consistency and efficiency in the trading of cash market positions, OTC derivatives and exchange-traded derivatives for the benefit of market participants and the markets themselves.

We are requesting that to the extent that the recommendations contained in the memorandum do not require amendments to the Act, that the Commission incorporate such recommendations in developing its proposal for new regulatory framework to be published for comment in the *Federal Register*.

We are also sending the recommendations to the Senate and House Agriculture Committees. Some of the FIA recommendations would entail legislative changes. In that regard, we have asked the leadership of the Agriculture Committees to consider including our recommendations for amendments to the CEA in the CFTC reauthorization bill. I would be pleased to discuss the recommendations with you and your staff and to answer any questions you may have about them.

I look forward to continuing to work with you and the other commissioners and staff on the CFTC regulatory reform and CFTC reauthorization. Thank you in advance for your consideration of our request.

Sincerely,

John M. Damgard
President

cc: Commissioner Thomas Erickson
Commissioner Barbara Pedersen Holum
Commissioner James E. Newsome
Commissioner David D. Spears
Mr. Robert Paul
Mr. John Lawton
Ms. Phyllis Cela
Mr. John Mielke
Mr. Paul Architzel
Mr. Andrew S. Lowenthal
Mr. Beau Greenwood

**RECOMMENDATIONS FOR LEGISLATIVE AND REGULATORY REFORM
UNDER THE COMMODITY EXCHANGE ACT (“ACT”)**

In November 1999, the President’s Working Group on Financial Markets issued a report entitled *Over the Counter Derivative Markets and the Commodity Exchange Act* (“PWG Report”). More recently, the Commodity Futures Trading Commission (“Commission”) issued a staff report entitled *A New Regulatory Framework* (“CFTC Report”). Both reports reflect a recognition of the increasing convergence between the exchange-traded derivatives markets and the OTC derivatives markets and the important role that each of these markets plays in managing the risks of large institutions, commercial enterprises and other investors.

The recommendations contained in the PWG Report are designed to facilitate participation of securities broker-dealers, banks and other financial institutions in the OTC derivatives markets by excluding such transactions from regulation under the Act, thereby reducing the legal uncertainty that surrounds many types of transactions that are effected in these markets. The recommendations contained in the CFTC Report, on the other hand, are designed to facilitate transactions on organized exchanges by eliminating unnecessary regulatory burdens that reduce the efficiency of these markets.

The Futures Industry Association (“FIA”) has prepared this memorandum recommending the adoption of certain amendments to the Act and the Commission’s regulations. These recommendations are entirely consistent with the positions advanced in both Reports and recognize the need to permit more consistency and efficiency in the trading of cash market positions, OTC derivatives and exchange-traded derivatives for the benefit of market participants and the markets themselves. Our recommendations focus on two key areas:

- Futures commission merchants (“FCMs”) should be permitted to participate in exchange-traded derivatives markets as both a dealer and an agent, acting for its own account as well as on behalf of institutional and other market participants. The expansion into dealing activity in exchange-traded derivatives would bring these markets in line with all other traded markets.
- The Act and Commission regulations should be modified to recognize that market participants are trading and have positions in all markets and, where customers elect, FCMs should be able to carry cash, OTC and exchange-traded positions in one account, provide margin credit and receive capital credit for offsetting risks, and allow customers to clear all positions at one futures clearinghouse.

To the extent that the recommendations contained in this memorandum do not require amendments to the Act, FIA respectfully requests that the Commission incorporate such recommendations in developing its proposal for new regulatory framework to be published for comment in the *Federal Register*.

FIA understands that, in several instances, its recommendations may not be able to be implemented fully without the cooperation of, and coordination with, the Securities and Exchange Commission. However, to facilitate this process, it is imperative that Congress and the Commission move forward now to remove impediments under the Act and regulations.

This memorandum does not address the recent legislative proposals recently advanced by the US Treasury and Congressman Leach to implement the recommendations in the PWG Report.

A. The Act Should Be Amended to Clarify That FCMs May Act as Dealers in Exchange-Traded Contracts.

The Act does not prohibit an FCM, among others, from acting as a dealer in OTC derivatives products and in cash market transactions. FIA believes that the Act should be amended to clarify that FCMs may act pursuant to exchange rules as dealers in exchange-traded contracts as well. Such clarification would expand upon the Commission's recent initiatives to permit "block trading" of futures and would provide important benefits to market users. In this connection, section 4b(b) and section 4c(a)(A) of the Act should be revised to clarify that FCMs may cross orders of their customers away from the exchange or take the other side of a customer order, provided the transaction is reported, recorded and cleared in accordance with the rules of a contract market.

As amended, section 4b(b) would read as follows:

Nothing in this section or in any other section of this Act shall be construed to prevent a futures commission merchant or a floor broker who shall have in hand, simultaneously, buying and selling orders ~~[at the market]~~ for different principals for a like quantity of a commodity for future delivery in the same month from executing such buying and selling orders ~~[at the market price]~~; *Provided*, That any such execution ~~[shall take place on the floor of the exchange where such orders are to be executed at public outcry across the ring and]~~ shall be duly reported, recorded and cleared in the same manner as other orders executed on the exchange; *And provided further*, That such transactions shall be made in accordance with such rules and regulations as the Commission may promulgate regarding the manner of the execution of such transactions.

Similarly, section 4c(a) would be amended to add at the end thereof the following sentence:

Further, nothing in this section or in any other section of this Act shall be construed to prevent a futures commission merchant, as a dealer, from entering into, executing and confirming the execution of a contract with a counterparty for the purchase or sale of a commodity for future delivery; *provided*, That such contract shall be duly reported, recorded and cleared in accordance with the rules of a contract market.

B. The Act Should Be Amended to Confirm That a Clearing Organization, Which Clears Exchange-Traded Futures and Options on Futures Contracts, May Clear Multiple Types of Products, Including OTC Derivatives Products, Equity Securities and Other Cash Market Products.

In contrast to the provisions of the Securities Exchange Act of 1934, which specifically authorizes the Securities and Exchange Commission to regulate securities clearing agencies, no provision of the Commodity Exchange Act separately authorizes the comprehensive regulation of clearing organizations. FIA believes that, consistent with the CFTC Report's recommendation, Congress should confirm the Commission's ability to authorize and regulate clearing organizations separate from its authority to regulate designated contract markets.

In doing so, Congress should also confirm that clearing organizations that clear exchange-traded futures and options on futures contracts may clear OTC derivatives products, equity securities and other cash market products in a single account. Concurrently, the Commission should amend its rules governing the treatment of customer funds, securities and property, Commission rules 1.20-1.30, to permit a clearing organization to carry the funds related to such contracts and products in a single account. Implementation of these recommendations will afford FCMs and their customers the ability to manage more efficiently and more effectively their cross-market risks through cross-margining or cross collateralization of obligations.¹

Implementation of this recommendation also will extend to futures clearing organizations the same benefits that the PWG Report has endorsed for securities and bank clearing agencies. Futures clearing organizations, therefore, will be able to compete with securities and bank clearing agencies on a more level playing field and, no less important, market participants will have a greater choice in selecting where they will clear multiple types of products.

C. The Commission's Regulations Should Be Amended to Permit FCMs to Carry Customer OTC Derivatives, Equity Securities and Other Cash Market Positions—and the Funds Deposited to Margin or Secure Such Products and Positions— in a Single Account.

If futures clearing organizations are authorized to clear multiple products as described above, the Commission's regulations governing the treatment of customer funds, securities and property held by an FCM must also be amended. Commission rules 1.20-1.30 prohibit an FCM from depositing in the customer segregated account funds and other property of such customers that the FCM holds to margin or secure OTC derivatives, equity securities or cash market positions. These rules should be modified both to permit non-futures position margin and other security to be held in the customer segregated account and to permit, pursuant to specified rules with respect to categories of institutional investors, futures margin and other security to be held outside of a segregated account.

¹ Separately, the Commission should encourage and, where necessary, facilitate cross margining relationships among futures clearing organizations and between futures clearing organizations and securities clearing agencies.

FIA notes that the second proviso of section 4d(2) of the Act, which generally requires the segregation of customer funds, authorizes the Commission to require an FCM to deposit into the segregated account other funds, securities and property belonging to its exchanged-traded futures and options customers. Specifically, this proviso states:

Provided, further, That, in accordance with such terms and conditions as the Commission may prescribe by rule, regulation or order, such money, securities and property of the customers of such futures commission merchant may be commingled and deposited as provided in this section with any other money, securities or property received by such futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to the customers of such futures commission merchant.

FIA believes that this provision of section 4d(2) vests the Commission with sufficient authority to require any FCM that wishes to carry a customer's cash, OTC derivatives, securities and futures positions in a single account to maintain that account as a customer segregated account under section 4d(2).² Correspondingly, FIA believes that the Commission has regulatory authority, pursuant to section 4(c) or otherwise, to adopt rules permitting the single account to be held outside of segregation. Allowing both of these alternatives would maximize flexibility and serve market participants' needs to operate through a single account. We recognize that, in connection with the adoption of regulations to implement this recommendation, the Commission will be required to revise its regulations relating to commodity broker liquidations to assure appropriate treatment of customer cash and OTC derivatives positions, as well as securities, that the FCM holds.

In the event it is determined that section 4d(2) does not currently provide authority to permit the Commission to implement this recommendation, we would be pleased to assist in developing an appropriate legislative proposal.³

D. The Commission's Minimum Financial Requirements Should be Amended to Permit FCMs to Effect Transactions in a Full Range of Products.

As discussed above, nothing in the Act prohibits an FCM from engaging in OTC derivatives or cash market transactions on behalf of its customers. However, the Commission's minimum financial and related requirements constrain FCMs from participating in the OTC derivatives markets in a meaningful way, as either dealer or agent. In the CFTC Report, the staff recommends that the Commission consider adopting

² FIA believes this same provision also vests the Commission with authority to permit a futures clearing organization to commingle in a single customer segregated account funds of customers deposited to clear multiple types of products, including products traded on the recognized futures exchanges, derivatives trading facilities and exempt multilateral transaction execution facilities proposed in the CFTC Report.

³ Separately, FIA endorses the CFTC Report recommendation that would expand the types of instruments in which FCMs may invest customer funds.

a risk-based capital rule for FCMs. FIA endorses this concept. At the very least, however, FIA believes the Commission must adopt the following amendments to its regulations:

- Commission rule 1.17(c), defining the term “adjusted net capital” must be revised to recognize that futures contracts may reduce the risk of holding certain other futures contracts and OTC derivatives products. Consequently, such futures contracts and derivatives products should be considered “inventory”, which is covered by a futures contract. This amendment will enhance the efficiency of both the OTC and exchange markets.
- Commission rule 1.19, which generally prohibits an FCM from assuming financial responsibility for OTC options except in defined circumstances, should be removed. Subject to appropriate haircuts, FCMs should not be prohibited from assuming responsibility for any OTC commodity option.

E. The Act Should Be Amended to Eliminate the Commission’s Reparations Program. Further, the Commission Should Amend its Arbitration Regulations to Facilitate the Use of a Uniform Account Agreement for Customers of a Broker-Dealer/FCM.

FIA recommends that Congress amend the Act to eliminate the reparations program entirely. Reparations served a useful purpose during the early years of the Commission and before the development of an effective arbitration program at the National Futures Association. The need for and expense of a separate federal dispute resolution forum, which has no parallel in the securities or banking laws, can no longer be justified. Alternative dispute resolution forums, provide fair and equitable hearings for customer disputes against Commission registrants.

Separately, the Commission’s rules relating to pre-dispute arbitration agreements, in particular rule 180.3, inhibit the ability of FCMs that are also broker-dealers to enter into a single agreement with their customers. The Commission’s rules provide that an FCM may not require a customer to sign a pre-dispute arbitration agreement as a condition to opening an account with the FCM. In addition, in signing a pre-dispute arbitration agreement, the customer does not waive the right to have any complaint heard under the Commission’s reparations program. Provided a broker-dealer furnishes a customer with the uniform disclosure regarding the a pre-dispute arbitration agreements adopted by the several securities SROs, the Securities and Exchange Commission does not prohibit the use of mandatory pre-dispute arbitration agreements. The SEC, of course, does not have reparations program.

FCMs want to know that, in the event a customer has a complaint against the firm, all of the elements of the complaint will be heard in a single forum. Under the Commission’s arbitration rules, FCMs that are also broker-dealers do not have this confidence. FIA believes that the uniform pre-dispute arbitration agreement disclosure statement that all securities SROs require broker-dealers to provide customers is effective in advising customers of the rights they may be foregoing in agreeing to arbitration. Therefore, we believe that the Commission’s rules should permit FCMs to use the securities disclosure in lieu of the Commission’s statement.

F. The Commission Should Revise its Interpretation of its Regulations Governing the Foreign Futures and Options Secured Amount.

FIA has consistently expressed concern with the Commission's efforts to extend the benefits of the segregation requirements to US customers that trade on foreign markets, even if those markets do not offer similar protections. In this regard, the Commission has interpreted the provisions of Commission rule 30.7 to require FCMs to assure "that funds provided by US customers for foreign futures and options transactions . . . receive equivalent protection at all intermediaries and clearing organizations." As a result of the legal uncertainties that surround the treatment of customer funds in many foreign jurisdictions, the Commission's interpretation effectively prohibits the use of customer assets to margin the positions of those customers on many foreign exchanges. Rather, US FCMs must establish "mirror" accounts in the US to hold customer assets and use their own assets to margin customer positions.

This interpretation imposes a significant financial burden on FCMs with institutional customers and must be revised. FCMs should not be required to provide financial protection to institutional customers that demand access to international markets that may not offer protections with respect to customer funds that are comparable to the Commission's own financial protection rules. In this regard, the Commission should be encouraged to adopt the policy followed in the United Kingdom and other jurisdictions. These authorities do not attempt to protect market participants that elect to trade in other jurisdictions by extending the reach of their regulatory programs, including regulations designed to protect customer funds, beyond their respective borders.

G. The Act Should Be Amended to Exclude From Registration and Regulation as Commodity Pool Operators Investment Vehicles Whose Futures-Related Activities Are *De Minimis*.

The Commission has generally interpreted the Act to require the manager of any investment vehicle that engages in transactions in exchange-traded futures and options on futures contracts to register with the Commission as a commodity pool operator. Registration is required even if the investment vehicle's participation in these markets is *de minimis*. FIA believes that this requirement imposes unnecessary burdens on the managers of investment vehicles and causes other managers to avoid the futures markets entirely. We, therefore, recommend that Congress amend section 4m of the Act to provide an exclusion from registration and regulation for certain investment vehicle managers.

Specifically, section 4m of the Act would be amended to add at the end thereof:

Provided further, That the provisions of this section shall not apply to a commodity pool operator that operates one or more investment vehicles with respect to which the aggregate initial margin and premiums required to establish positions in commodity futures and commodity options contracts does not exceed five percent of the liquidation value of each such vehicle's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

H. The Commission’s Definition of an Institutional Customer Should Be Amended to Include Any Person Whose Account Is Managed by a Commodity Trading Advisor, Registered Investment Adviser, or a Foreign Person Subject to Comparable Regulation in a Foreign Jurisdiction That Manages Accounts in the Aggregate Amount of \$25 Million.

Because an advisor is a fiduciary to the customer, FIA believes it is more appropriate to look only to the sophistication of the advisor in determining whether a customer should be considered an institutional customer. The net worth of the underlying customer or the aggregate value of the individual customer’s assets should be irrelevant. Requiring an advisor to have a minimum amount of assets under management is a measure of the expertise of the advisor and the level of confidence that a significant number of market participants have placed in the advisor. FIA believes \$25 million is an appropriate amount of assets to require an advisor to have under management. We note that, under the Investment Advisers Act of 1940, advisors with \$25 million or more under management are registered only with the Securities and Exchange Commission, while advisors with lesser amounts under management are registered only with the states.

I. As Exchanges Move Toward Demutualization and Privatization, It May Be Appropriate to Separate Certain of the Self-Regulatory Functions of the Exchanges and Transfer Them to an Unaffiliated Self-Regulatory Organization. FIA Understands That This Same Issue is Being Examined by the SEC and the Securities Exchanges. FIA Recommends That, in Publishing Its Recommendations for Comment, the Commission Request Comment on This Issue.