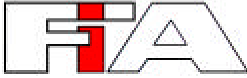

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April 5, 2002

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

Re: Study of the Commodity Exchange Act and the Rules Thereunder, 66 *Fed. Reg.* 33531 (June 22, 2001)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit these comments in connection with the

regulation of Commission registrants. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 50 of the largest futures commission merchants ("FCMs") in the United States, the majority of which are also registered broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

At the outset, we want to thank the Commission for extending the comment period in order to permit the industry to focus its energies on working with the Commission and the Securities and Exchange Commission ("SEC") in resolving the many issues that have arisen in connection with the development of a regulatory structure governing security futures products. As we all have learned, melding these two regulatory programs into a comprehensive and coherent scheme has been far more difficult than originally contemplated. Certain of our recommendations discussed below are designed, in part, to address other conflicting requirements that could adversely affect the offer and sale of security futures products.

Core Principles for Intermediaries

As the Commission is aware, FIA strongly supported the Commission's regulatory reform recommendations as well as the provisions of the Commodity Futures Modernization Act of 2000, each of which were designed to replace the prescriptive regulations that restricted an exchange's conduct with a set of core principles against which the exchange's activities would be measured. In particular, we endorsed the Commission's goal of developing a regulatory program for multilateral transaction execution facilities that would be "tailored to match the degree and manner of regulation to the varying

nature of the products traded thereon, and to the sophistication of the customer."[1] As the Commission is also aware, however, we were troubled that the Commission was unable to include in its reform proposal comparable relief for market intermediaries. Therefore, we welcome the Commission's study as an essential step in a process that will afford market intermediaries the same flexibility that it has offered to the markets themselves.

FIA understands that, to a certain extent, the regulatory relief the Commission has provided the exchanges and self-regulatory organizations generally may redound to the benefit of intermediaries that are subject to their jurisdiction. In particular, more recent exchange rules governing block trades, pre-execution discussions and permissible cross trades by and large have addressed FIA's previous concerns with respect to the Commission's interpretation of Commission rules 1.38 and 1.39.

However, we believe that the Commission's decision to retain the provisions of these rules in their entirety may have the unintended consequence of appearing to hold intermediaries to these standards and the body of Commission interpretations and case law that support them when, in fact, their provisions are essentially superceded by exchange rules that the Commission either has approved or has allowed to go into effect. Secondarily, the failure to rewrite these rules could inhibit the exchanges as they continue to revise their rules "to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer."

Commission Rule 1.35 and the Allocation of Bunched Orders

Commission rule 1.35 is perhaps the poster child of the unintended consequences that result from the Commission's decision to grant the exchanges general exemptions from its rules rather than rewriting the rules to reflect more accurately the Commission's intent. A substantial portion of that rule is simply not applicable. Even those provisions of the rules that apply to FCMs and introducing brokers are less meaningful, since the core principles with which exchanges must comply would likely require these registrants to prepare and maintain comparable records. Consequently, FIA recommends that the provisions of Commission rule 1.35 be removed and replaced with a core principle that would require FCMs and introducing brokers to prepare such records of transactions as are appropriate to their respective businesses or as may be required by exchange or other self-regulatory organization rule or regulation. This principle would be consistent with the comparable core principle applicable to recognized futures exchanges.[2]

The adoption of this core principle would indirectly address a regulatory issue that has vexed both the FCM and the commodity trading advisor communities for more than a decade—the appropriate procedures for the execution and allocation of bunched orders. As the Commission is aware, rule 1.35 and an Interpretative Statement issued by NFA and approved by the Commission in 1997, generally

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[1] 65 *Fed. Reg*. 38986, June 22, 2000.

[2] Core Principle 9: Audit Trail, requires a recognized futures exchange to have procedures to ensure the recording of full data entry and trade details sufficient to reconstruct trading, the quality of such data captured, and the safe storage of such information, and to have systems to enable information to be used in assisting in detecting and deterring customer and market abuse.

require FCMs to have information that identifies the accounts included in the bunched order and the number of contracts to be allotted to each account at or before the time a bunched order is placed. Post-execution allocation procedures set forth in rule 1.35(a-1)(5), as added by the Commission in 1998,[3] are available only with respect to accounts of defined eligible customers. Moreover, responsibility for complying with these requirements and for assuring appropriate allocations of trades is placed primarily on the FCMs that carry these accounts.

When the Commission first promulgated the amendments to rule 1.35, authorizing post-execution allocation procedures for eligible clients, FCMs generally believed that the procedures would provide significant relief. In practice, however, FCMs and money managers have found that the current procedures are unnecessarily cumbersome. We have concluded that these requirements actually inhibit the fair and efficient execution of orders, without adding customer protections that otherwise could be realized through equally effective, less costly procedures.

In particular, the limitation on the type of clients that may take advantage of the procedures as set forth in subparagraph (ii) as well as the recordkeeping requirements in subparagraph (v) cause unacceptable processing delays.[4] Further, account managers have objected to the requirement that they make the disclosures set forth in rule 1.35(a-1)(5)(iii). As otherwise regulated entities, they believe that the laws and regulations to which they are subject adequately govern their disclosure and other fiduciary obligations to their clients. Their conduct should not be subject to indirect regulation by the Commission through the imposition of recordkeeping requirements on the FCMs that carry the accounts of their clients. We agree and note, in addition, that the procedures in rule 1.35(a-1)(5) unnecessarily force FCMs to interfere in the contractual relationship between the account manager and its clients.

We encourage the Commission, therefore, to acknowledge that the responsibility for allocation of bunched orders rests with the account manager, the originator of the allocation methodology. The account manager, not the FCM, is the person who knows and must keep records detailing the totality of each of its customers' positions, which may be held at several FCMs. The increased use of electronic order routing and execution systems, which permit account managers to place orders directly for execution, while denying FCMs the ability to monitor such transactions prior to execution and clearing, emphasizes this point and makes relief in this area all the more urgent.[5]

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[3] 63 *Fed.Reg.* 45699, August 27, 1998.

[4] Moreover, clients that presently are not eligible to be included in a post-execution allocation scheme may be unfairly disadvantaged in the quality of the timing and execution of their orders.

[5] The following excerpts (with minor, non-substantive changes) from the National Futures Association and Futures Industry Institute *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions*, released on March 15, 2001 ("Recommendations"), reflect the views of the participants in that study regarding the responsibilities account managers with respect to the allocation of bunched orders:

- To assure that an account manager's bunched order allocation procedures are fair and equitable, such processes must be sufficiently objective and specific to permit independent review of any trade or series of trades that involves bunched orders. An account manager responsible for the post-execution allocation of a

Adoption of the recommended core principle, effectively authorizing the post-execution allocation of bunched orders of both US and foreign futures and options on futures contracts, is of critical importance to FIA's member firms generally. Moreover, this core principle would conform the Commission's procedures with those in place in the securities markets.[6] In this regard, we understand that the goal of the Commission and the SEC in developing the regulatory program for security futures products is to assure that the markets of one regulator are not favored over the markets of the other. We respectfully suggest that, consistent with this goal, it is essential that futures market intermediaries and securities market intermediaries be subject to the same procedures relating to bunched orders.

Pre-Dispute Arbitration

Regulatory parity in the offer and sale of security futures products also supports FIA's recommendation that the Commission amend its rules governing the use of pre-dispute arbitration agreements. FIA is pleased that the Commission's recent amendments removed from the requirements governing the use of pre-dispute arbitration agreements customers that fall within the definition of eligible contract participants.[7] Nonetheless, we continue to believe that the Commission should remove this prohibition entirely.

As we have previously argued, the provisions of the Commission's rules, which 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, inhibit the ability of FCMs that are also broker-dealers to enter into a single agreement with their customers. The SEC does not prohibit the use of mandatory pre-dispute

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bunched order should develop internal procedures pursuant to which the account manager analyzes its trading programs at regular intervals. The results of such reviews should be documented and made available to appropriate regulatory or self-regulatory authorities upon request and/or to the account manager's own auditors.

- If there is evidence of divergent performance among client accounts over time, the account manager must be able to demonstrate to the appropriate authorities that such results are attributable to factors other than the account manager's trade allocation or execution procedures. In this context, self-regulatory organizations should undertake periodic reviews or audits of such registrants to assure that their actual trade allocations are equitable.

- In addition, account managers should allocate all transactions among their customers no later than the end of the trade date. To minimize the potential for end-of-day congestion related to trade allocations, intermediaries carrying such accounts may require account managers to provide allocation information earlier in the trading day, for example within specified time-periods after trades have been executed.

Recommendations, pp. 25-26.

[6] As the Commission is aware, procedures for the post-execution allocation of bunched securities transactions are governed by the securities self-regulatory organizations. See, *e.g.*, New York Stock Exchange Interpretation 88-3.

[7] Commission rule 166.5, effective October 9, 2001.

arbitration agreements, provided a broker-dealer furnishes a customer with the uniform disclosure regarding pre-dispute arbitration agreements adopted by the several securities self-regulatory organizations. Moreover, neither the SEC nor the applicable securities self-regulatory organizations distinguish between institutional investors and retail customers. The same procedures apply without regard to the type of customer.

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, unless the customer is an eligible contract participant. FIA believes that the uniform pre-dispute arbitration agreement disclosure statement that all securities self-regulatory organizations require broker-dealers to provide customers is effective in advising customers of the rights they may be foregoing in agreeing to arbitration. Therefore, the Commission's rules should be further amended to remove its current procedures relating to the use of pre-dispute arbitration agreement and authorize FCMs to use the securities disclosure in lieu of the Commission's statement.

We do not intend to imply by the preceding discussion that the relief we are requesting should be limited only to those FCMs that are also registered as broker-dealers. Although the relief certainly would facilitate the activities of FCM/broker-dealers, the more important point is that we see no reason why the Commission could not adopt the same procedures that have been successfully employed in the securities industry. In this regard, the disclosure statement currently incorporated in many broker-dealer customer account agreements could be easily modified as appropriate for use by FCMs that are not also registered broker-dealers.

Single Customer Account

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. FIA believes that the Commission should modify these rules both to permit non-futures position margin and other property to be held in the customer segregated account and to permit futures margin and other property on behalf of eligible contract participants to be held outside of a segregated account.

FIA believes that the Commission has sufficient regulatory authority, pursuant to section 4(c) or otherwise, to adopt rules permitting the single account to be held outside of segregation.[8] Allowing both of these alternatives would maximize flexibility and serve market participants' needs to operate through a single account.

We recognize that the practical and regulatory issues that would arise under this proposal may be complex, particularly if securities and futures positions are to be held in a single account. However, we

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[8] This recommendation expands upon the provisions of Commission rule 1.68, which currently authorizes a registered derivatives transaction execution facility to adopt rules permitting eligible contract participants to "opt out" of segregation.

also note that the Commission and the SEC have previously agreed on an approach by which professional traders have been authorized to carry futures on stock indices and related options on stock indices in a single "cross-margin" account. The cross-margin accounts authorized are limited both with respect to the nature of the participants permitted to take advantage of them and the positions that could be carried. Therefore, they do not constitute a perfect example of the structure that such accounts could take.

We further recognize that, in connection with the adoption of regulations to implement these recommendations, 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. FIA will be pleased to work with the Commission as it sorts through these issues.

Minimum Financial Requirements

FIA continues to urge the Commission to move forward with the adoption of risk-based capital requirements for FCMs. Risk-based requirements should facilitate the ability of FCMs to engage in OTC derivatives and cash market transactions on behalf of their clients. At a minimum, however, FIA encourages the Commission to adopt the following amendments to its regulations:

First, the Commission must revise rule 1.17(c), defining the term "adjusted net capital," 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.

Second, 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.

Agricultural Trade Options

The Commission has previously proposed to amend Commission rule 32.13(g) to remove subparagraphs (i) and (ii) of that paragraph. 65 *Fed.Reg.* 77838 (December 13, 2000.) If adopted, the exemption from the agricultural trade option rule set forth in paragraph (g) would be based only on the net worth requirement currently contained in subparagraph (iii) of the paragraph. As such, the exemption would be "consistent with the broader exemption of part 35." *Id.*

The Commission received only one comment on the proposed amendment, which strongly endorsed the Commission's proposal.[9] As noted in the comment letter, "opening up the market for agricultural trade options to entities that satisfy the net worth test will expand market liquidity, which will allow hedgers

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[9] Letter from Robert S. Mancini, Deputy General Counsel, Goldman Sachs & Co., to Jean A. Webb, Secretary to the Commission, dated December 27, 2000.

and others to trade in a more efficient and cost effective manner." FIA agrees with this comment, and we urge the Commission to adopt a final rule promptly.

International Issues

Since at least 1986, when the Commission first undertook to adopt regulations governing the offer and sale of futures and options on futures contracts, FIA has worked closely with the Commission in an effort to assure that US FCMs would be able to provide their customers access to non-US markets. Although we have not always agreed, FIA commends the Commission's willingness to consult with FIA and other industry representatives on these critical matters. The issues discussed below are not new to the Commission. We raise them here to reconfirm our strong interest in their successful resolution.

Foreign Security Futures Products

By letter dated July 18, 2001, FIA encouraged the Commission and the SEC to exercise the rulemaking authority that Congress granted specifically to address foreign security index contracts and adopt a regulatory standard defining a broad-based security index that takes into appropriate account "the nature and size of the markets that the securities underlying the security futures product reflects."[10] The standard recommended by FIA was set forth in Appendix A to that letter. FIA again urges the Commission to adopt its proposal.

FIA further encourages the Commission to continue to work with the SEC to implement the provisions of section 2(a)(1)(F)(i) and (ii). Subparagraph (i) is intended to extend the terms of a no-action position adopted by the Commission, after consultation with the SEC, which authorizes US FCMs to carry on behalf of non-US customers foreign stock index contracts that have not been approved for trading by US customers. Subparagraph (i) grants this same right to FCMs carrying foreign security futures products on behalf of their non-US customers.

Subparagraph (ii) simply provides that eligible contract participants may purchase security futures products traded on a non-US exchange to the same extent that such person may be authorized to purchase or carry other securities traded on a foreign exchange or market. These provisions of the Act were adopted after substantial discussion with Commission and SEC staff. There is no reason why the Commission should not confirm the right of US FCMs to take advantage of them.

Financial and Segregation Interpretation No. 12

As the Commission is aware, FIA, along with other industry representatives, has long opposed certain provisions of Financial and Segregation Interpretation No. 12 governing the deposit of customer funds outside of the US. In particular, FIA has objected to the requirements that (1) an FCM obtain specific

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[10] Letter from John M. Damgard, President, Futures Industry Association, to Jean A. Webb, Secretary to the Commission, Commodity Futures Trading Commission, and Jonathan G. Katz, Secretary to the Commission, Securities and Exchange Commission, July 18, 2001.

written authorization from a customer to maintain funds offshore in that customer's segregated account and (2) before placing a customer's funds overseas (or holding a foreign customer's funds overseas) an FCM obtain from the customer a signed subordination agreement in the form set forth in the interpretation. In this latter connection, FIA has expressed its strong belief that the subordination agreement is unnecessary and should be eliminated. In its place, the Commission should amend Appendix B of the Commission's Part 190 rules to establish distribution procedures for FCMs that hold customer funds offshore.

Separately, FIA has objected to the requirement that customer funds be deposited only in those banks that are rated in one of the two highest ratings categories by Standard & Poors Corporation or Moody's Investor Services. As FIA has previously advised the Commission, the ratings test is impractical. Many foreign banks, including foreign subsidiaries of US banks, simply are not rated.[11]

FIA has worked with the Commission's staff in the past to revise the interpretation to address these and other concerns. Whenever it appears that we have made progress, another issue arises and steps taken to revise the interpretation are set aside. We respectfully request the Commission to proceed promptly to address this issue. In light of the amount of effort both sides have expended to date, we are confident that we will be able to craft an acceptable alternative to the current interpretation with little difficulty.

Use of Non-US Exchange Terminals

In a series of no-action letters issued in 1999, the Commission's Division of Trading and Markets authorized certain foreign futures exchanges to locate terminals for the execution of transactions on those exchanges in the US. Each no-action letter was subject to a number of conditions, including a requirement that specifically identified the contracts that could be executed through those terminals. The purpose of this restriction was to assure that US FCMs did not engage in transactions in futures contracts that had not been approved for trading by or on behalf of US customers, *i.e.*, futures on certain security index contracts. The Commission reaffirmed this restriction in its Statement of Policy Regarding the Listing of New Futures and Options on Futures Contracts by Foreign Boards of Trade. 65 *Fed.Reg.* 41641 (July 6, 2000).

Although FIA appreciates the rationale behind this restriction, it fails to take account of the fact that, in a twenty-four hour trading environment, these terminals could be used to transmit orders for non-US customers of either the US FCM or the FCM's non-US affiliates. Non-US customers are not prohibited from trading in these products.

FIA understands that both Commission staff and SEC staff have indicated informally that they would not object if terminals located in the US were used to transmit orders for execution in non-approved contracts on behalf of non-US customers. However, this position has not been adopted formally. We

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[11] For this same reason, FIA also recommends that the Commission eliminate the ratings test as it is applied to customer funds deposited offshore to margin, guarantee or secure foreign futures and foreign options transactions, as set forth in Commission Advisory 87-5. [1987-1990 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶23,997 (December 3, 1987).

respectfully request that the Commission work with the SEC to clarify this issue at its earliest convenience.

Greater Deference to Home Country Regulation

Under the provisions of rule 30.10, the Commission has established a procedure pursuant to which non-US entities may be authorized to solicit orders from US customers for execution on non-US exchanges and to carry such trades on a fully disclosed basis without being registered with the Commission. Specifically, the Commission must find that the regulatory structure of the entity's home country is "comparable" to the Commission's own regulatory scheme. FIA respectfully suggests that the requirement that a country's regulatory system be comparable to the Commission's before granting an exemption from regulation is no longer essential and unnecessarily impedes the ability of US customers, in particular, those customers meeting the definition of eligible contract participants, to conduct business on these markets.[12]

Although the comparability requirement may have had relevance in 1987, when the Commission promulgated the foreign futures and options regulations, the regulation of the more significant overseas markets by their home regulators has improved dramatically. For example, Germany, Hong Kong and Japan have well-developed regulatory programs but either have not applied for or have not received an exemption under Commission rule 30.10. Yet, in the exercise of its authority under former section 2(a)(1)(B)(v) of the Act, the Commission staff has granted a no-action position to exchanges located in each country, authorizing US customers to enter into transactions in broad-based stock index futures contracts listed for trading on such exchanges. Further, Eurex has been authorized to place terminals in the US for the purpose of receiving and transmitting orders for execution on that exchange.

We recognize that the Commission does not undertake the same analysis in authorizing a stock index contract to be offered to US customers as it does in granting an exemption under rule 30.10. Nonetheless, the Commission does review the regulatory structure governing transactions on the applicable exchange and certainly would not have granted the referenced no-action positions if the Commission were at all concerned about the integrity of those markets.

If US customers may effect transactions on exchanges located in jurisdictions that have not received an exemption under Commission rule 30.10, we see no reason why the Commission cannot authorize US customers in certain circumstances to enter into direct customer relationships with intermediaries located in such jurisdictions. This is particularly true in the case of institutional customers, which dominate—and demand access to—the international markets. Such customers, many of which conduct a global business, may well conclude that they are able to conduct business more efficiently if their accounts are carried by an intermediary in a jurisdiction that has not received an exemption under rule 30.10.

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[12] Further, the Commission's position contrasts sharply with its domestic policy of granting greater flexibility to the self-regulatory organizations under its jurisdiction.

In sum, we submit that the Commission must be more flexible in its approach toward the international markets. FIA would welcome the opportunity to work with the Commission to develop a policy pursuant to which qualified US customers would be permitted to become customers of, and place orders for execution directly with, intermediaries that are affiliates of US registrants and that are subject to appropriate regulation in their home country, even if the regulatory structure of such country may not be "comparable" to the US regulatory structure.

Direct Foreign Order Transmittal

Commission rule 30.12 establishes the procedures by which an FCM may permit certain authorized customers to place orders directly with a foreign broker for execution in the FCM's foreign futures and options customer omnibus account. Pursuant to the provisions of rule 30.12(a)(2)(ii), such authorized customers include eligible swap participants as defined in Commission rule 35.1(b)(2). FIA recommends that rule 30.12(a)(2)(ii) be amended to define an authorized customer to include "eligible contract participants" as defined in section 1a(12) of the Act.

Use of the Internet

As the Commission knows, the Internet facilitates the conduct of a global business from a single location. Although we appreciate the concerns that US and other regulatory authorities have in deterring fraudulent conduct though the Internet, the lack of uniform international standards is also inhibiting the conduct of legitimate business and exposing firms to unnecessary regulatory risk. FIA encourages the Commission to work with its international counterparts in developing uniform standards governing the use of the Internet.

Conclusion

The Futures Industry Association appreciates the opportunity to submit these comments in connection with the Commission's study of the Commodity Exchange Act and the regulations thereunder. If you have any questions regarding this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard

cc: Honorable James E. Newsome, Chairman
Honorable Barbara Pedersen Holum
Honorable Thomas J. Erickson
Lawrence B. Patent
Barbara S. Gold