

**Report on the Study of the Commodity Exchange Act and the
Commission's Rules and Orders Governing the Conduct of
Registrants Under the Act**

**Pursuant to Section 125 of the
Commodity Futures Modernization Act of 2000**



Commodity Futures Trading Commission

June 2002

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I. INTRODUCTION

The Commodity Futures Modernization Act of 2000 ("CFMA")¹ requires the Commodity Futures Trading Commission ("CFTC" or "Commission") to conduct a study of the Commodity Exchange Act ("Act")² and the Commission's rules³ and orders governing the conduct of registrants under the Act.⁴ This report responds to the CFMA's requirement that the Commission submit a report on the results of its study to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition and Forestry of the Senate. Pursuant to the CFMA, the study was to be completed by December 21, 2001 (one year from the date of enactment of the CFMA). In response to requests from industry groups, the Commission petitioned Congress to extend the statutory deadline for the study. Congressional leaders responded by extending the deadline to June 21, 2002, stating that "[t]he volume and complexity of recent regulatory initiatives have greatly strained the varied resources that are necessary to complete a meaningful study."⁵

The study must address: (1) the core principles and interpretations of acceptable business practices that the Commission has adopted or intends to adopt to replace provisions of the Act and rules thereunder, and the extent to which these changes have been or may be made pursuant to the Commission's exemptive authority under Section 4(c) of the Act; (2) the rules that the Commission has determined must be retained and the reasons therefor; and (3) the regulatory functions that the Commission performs that can be delegated to a registered futures association and the regulatory functions that the Commission has determined must be retained and the reasons therefor. The CFMA directed the Commission to solicit the views of the public as well as Commission registrants, registered entities,⁶ and registered futures associations in conducting its study.

The Commission published a request for comment in the Federal Register on June 22, 2001.⁷ The Commission received two comment letters.⁸ In addition, Commission staff

¹ Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 – Appendix E, §125, 114 Stat. 2763A-365 (2000).

² 7 U.S.C. § 1 *et seq.* (2000).

³ Commission rules referred to herein are found at 17 C.F.R. Ch I (2002).

⁴ Persons required to register under the Act include futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors, associated persons of any of the foregoing, floor brokers and floor traders, as defined in Sections 1a(20), 1a(23), 1a(5), 1a(6), 4k, 1a(16) and 1a(17), respectively, of the Act.

⁵ Letter from the Honorable Tom Harkin, Chairman, and the Honorable Richard Lugar, Ranking Member, Senate Committee on Agriculture, Nutrition and Forestry, to the Honorable James E. Newsome, Acting Chairman, Commodity Futures Trading Commission (Oct. 30, 2001).

⁶ The term "registered entities" is defined in Section 1a(29) of the Act to include designated contract markets, registered derivatives transaction execution facilities, and registered derivatives clearing organizations.

⁷ 66 Fed. Reg. 33531 (June 22, 2001).

⁸ In response to the *Federal Register* release, the Commission received comment letters from the Futures Industry

interviewed representatives of futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs"), commodity trading advisors ("CTAs"), exchanges, clearing organizations, and self-regulatory organizations, as well as attorneys and accountants practicing in the futures industry. Interviews were conducted in Chicago, New York, Washington, and by telephone. The Commission also held a public hearing in Washington on June 6, 2002.⁹ A list of commenters, interviewees, and hearing participants is included as an Appendix.¹⁰

Section II of this report discusses regulatory reforms the Commission has undertaken to date. Section III discusses proposals that were raised by participants in the course of the study. The Commission's overall conclusions and plans for future action are set forth in Section IV.

A common theme running through many of the comment letters, interviews, and presentations was a desire that the Commission provide additional flexibility to registrants in meeting their obligations under the Act. None of the commenters, however, advocated that the existing rules be deleted wholesale and replaced by a defined set of core principles. Some commenters indicated that such an approach would be unworkable in areas such as financial requirements, while others expressed concern about the legal uncertainty that might result. The commenters focused instead on specific rules or sets of rules within the existing framework that they believed should be modified or eliminated. With regard to delegation of functions to a registered futures association, two potential candidates were identified. They are discussed below.

Commenters, particularly the hearing participants, indicated that their overriding concerns with the futures industry could not necessarily be addressed by changes to the Commission's rules, although they identified particular areas where rule changes would be beneficial. Commenters instead noted that their greatest concerns involved market structure issues and the effect they have on promoting competition within the markets. It was noted by more than one commenter that the competition at the exchange and clearing organization level expected as a result of the CFMA has not yet materialized. While these same commenters noted that it might be too soon after the enactment of the CFMA to state definitively why the expected competition did not occur, two particular characteristics of the market structure of the futures industry were identified as possible causes: the lack of fungibility of products across exchanges and the lack of common clearing. These issues are discussed more fully below in Section III C.

Association and Phillip McBride Johnson.

⁹ Comment letters and written statements from the hearing participants are contained in CFTC Public Comment File 01-013, which is available at http://www.cftc.gov/foia/comment01/foi01--013_1.htm. A transcript of the public hearing will be placed in the comment file as soon as it is available.

¹⁰ To the extent that comments to Commission staff were received only through interviews, and therefore are not reflected in the public comment file referenced in note 9 above, the report refers to those offering such comments as interviewees. Where comments or suggestions were made in comment letters or the public hearing, as well as during interviews with Commission staff, the report refers to those offering such comments or suggestions as commenters.

During the conduct of the study, numerous issues worthy of further analysis were raised. In this regard, the Commission has determined to hold a series of roundtable meetings with futures industry representatives to discuss further, in detail, upcoming Commission rule proposals and the Commission's role in addressing the issues facing the futures industry. In the coming months, the Commission will have a roundtable to discuss its intended proposal to change Commission rules regarding the allocation of bunched orders. The Commission will also hold a roundtable to discuss the effects of overlapping Commission, Securities and Exchange Commission ("SEC"), and state jurisdiction faced by members of the managed funds industry. Finally, the Commission will soon be organizing a roundtable on clearing issues to discuss the elements of an appropriate oversight program with respect to Derivatives Clearing Organizations, a new registration category. At this roundtable, the Commission also wants to discuss common clearing and fungibility of products, their role in encouraging competition in the futures market, and the Commission's function in helping to facilitate greater competition.

II. RECENT REGULATORY REFORM

In recognition of the rapidly changing nature of the futures industry, the Commission is engaged in a continuous process of reviewing its regulations to identify areas in which it can lessen the burden on registrants and promote competition and market efficiency, while continuing to meet its regulatory mandates to ensure the financial integrity of the futures and options markets, and to protect market participants and the public. In this regard, concurrent with the development and implementation of the CFMA, the Commission has proposed and adopted amendments to numerous provisions of its regulations that affect intermediaries.

A. General Reforms

1. Revised Regulatory Framework

In October 2001, as part of a revised regulatory framework, the Commission adopted a number of rule changes relating to intermediaries. These changes provided for, among other things: (a) elimination of the required submission of a certified financial report as part of IB registration procedures; (b) replacement of the specific ethics training rule for Commission registrants with a Statement of Acceptable Practices; (c) amendment of the definition of "principal" to exclude certain officers of firms from otherwise applicable listing and fingerprinting requirements; (d) simplification of account opening procedures by permitting a single signature for all documents; (e) codification of a previous interpretation permitting electronic transmission of account statements; and (f) greater customer choice concerning the close-out of offsetting positions.¹¹

2. Online Registration

In May 2002, the Commission adopted amendments to Part 3 of its rules, which governs

¹¹ 66 Fed. Reg. 53510 (Oct. 23, 2001). Many of these changes had been previously adopted in December 2000 as part of the Commission's new regulatory framework, but were subsequently withdrawn following passage of the CFMA.

the registration of intermediaries in the futures industry. These amendments were adopted to facilitate the implementation of an online registration system.¹² The online registration system should provide applicants with a more streamlined process for registering, resulting in less redundancy and quicker processing of applications by the National Futures Association ("NFA").¹³ Through the online registration system, registrants and applicants should be able to provide NFA with required information more quickly and easily and enable NFA to process this information more efficiently, while maintaining most of the features of the previous, paper-based system. Additionally, information on registrants should be more readily accessible by the Commission, NFA, and the public.

3. *Electronic Signatures*

In March 2000, the Commission adopted new Rule 1.4, permitting the use of electronic signatures in lieu of handwritten signatures where the Act or Commission rules require a customer's signature.¹⁴

B. FCMs and IBs

1. *Investment of Customer Funds*

In December 2000, the Commission adopted amendments to Rule 1.25, expanding the permitted investments of customer funds by FCMs and clearing organizations.¹⁵ Previously, FCMs and clearing organizations were limited to investing in U.S. and municipal government-guaranteed debt securities. The expanded list of permitted investments includes highly-rated commercial paper, corporate notes, foreign sovereign debt, and U.S. government sponsored agency debt, as well as money market mutual funds regulated by the SEC. This rule change significantly increased potential earnings for FCMs, clearing organizations, and customers.

2. *Secured Amount Depositories*

In October 2000, the Commission clarified its interpretation of the foreign futures or foreign options secured amount requirement of Rule 30.7.¹⁶ The Commission previously interpreted that rule to require FCMs, and firms exempt from FCM registration under Rule 30.10

¹² 67 Fed. Reg. 38869 (June 6, 2002).

¹³ The Commission has previously delegated the authority to process applications for registration of intermediaries and floor traders under the Act to NFA. See 58 Fed. Reg. 19657 (Apr. 15, 1993) (floor traders); 51 Fed. Reg. 34490 (Sep. 29, 1986) (floor brokers); 49 Fed. Reg. 39593 (Oct. 9, 1984) (futures commission merchants, commodity pool operators, commodity trading advisors, and associated persons thereof); 48 Fed. Reg. 35158 (Aug. 3, 1983) (introducing brokers and associated persons thereof).

¹⁴ 65 Fed. Reg. 12466 (Mar. 9, 2000).

¹⁵ 65 Fed. Reg. 77993 (Dec. 13, 2000); 65 Fed. Reg. 82270 (Dec. 28, 2000).

¹⁶ 65 Fed. Reg. 60557 (Oct. 11, 2000).

("Rule 30.10 firms"), to perform an inquiry with respect to the treatment of secured amount funds by any depository holding such funds. If this inquiry revealed that a depository beyond the initial depository would not hold secured amount funds in a manner consistent with Rule 30.7, the FCM or Rule 30.10 firm would have to set aside funds in an acceptable depository, i.e., a "mirror" account. The Commission revised its interpretation so that firms need not perform the inquiry referred to above if they obtain the acknowledgement required by Rule 30.7 from the initial depository of secured amount funds and provide disclosure to customers concerning the risks of transactions and funds deposited in other jurisdictions.

3. *NYMEX OTC Clearing Arrangement*

In May 2002, the Commission issued an order permitting the New York Mercantile Exchange ("NYMEX") and its clearing members to commingle in a single account funds received from customers trading on designated contract markets with funds received in connection with NYMEX's clearing of certain over-the-counter energy contracts.¹⁷

4. *Offsetting Deficits with Readily Marketable Securities*

In August 2001, the Commission amended its rules to provide that an FCM, when computing its segregation requirements, may offset deficits in customer accounts with readily marketable securities deposited by customers to margin their futures and options positions. The amount of the offset is limited to the market value of the securities, less the applicable haircuts set forth in the rules of the SEC.¹⁸

5. *Foreign Order Transmittal*

In August 2000, the Commission adopted new Rule 30.12 that permits certain foreign firms acting in the capacity of FCMs and IBs to accept and execute foreign futures and options orders received directly from certain sophisticated U.S. customers without being required to register with the Commission.¹⁹

6. *CME-MEFF Clearing Arrangement*

In June 2001, the Commission issued an order permitting the Chicago Mercantile Exchange ("CME") and its clearing members to commingle in a single account the funds received from customers trading on designated contract markets with the funds received in connection with the CME's clearing of certain products traded on or through the MEFF Sociedad Recotra de Productos Financieros Derivados de Renta Variable ("MEFF"), a board of trade located in Spain.²⁰

¹⁷ A copy of the order may be viewed on the Commission's web site at: <http://www.cftc.gov/tm/tmnymexotcorder.htm>.

¹⁸ 66 Fed. Reg. 41131 (Aug. 7, 2001).

¹⁹ 65 Fed. Reg. 47275 (Aug. 2, 2000).

²⁰ 66 Fed. Reg. 34110 (June 27, 2001).

7. *Capital Charge for Foreign Broker Receivables*

In November 2000, the Commission amended its minimum financial requirements for FCMs and IBs by increasing the amount eligible for exclusion from the capital charge against unsecured receivables due from foreign brokers.²¹

8. *Review of Subordination Agreements*

In August 2000, the Commission adopted amendments to its minimum financial requirements for FCMs and IBs by modifying the treatment of subordination agreements, to permit a futures industry self-regulatory organization ("SRO") to rely on a securities industry designated examining authority's review and approval of a proposed subordination agreement and related transactions.²² Previously, FCMs and IBs were required to get the approval of both the futures industry SRO and the securities industry designated examining authority.

9. *Withdrawal of Equity Capital*

In April 2000, the Commission amended Rule 1.17 to ease the restrictions on withdrawal of equity capital from an FCM.²³ Previously, the withdrawal of equity capital from an FCM for certain purposes was prohibited if, after giving effect to the withdrawal, the FCM's adjusted net capital would be less than seven percent of the customer funds required to be segregated. The amendment reduced the limit to six percent.

10. *Average Price Calculation*

In February 2000, the Commission issued an Advisory permitting an FCM to calculate and confirm to its customers an average price when multiple prices are received on an order or series of orders involving contracts traded on domestic as well as non-domestic exchanges, provided that certain criteria were met.²⁴

C. CPOs and CTAs

1. *Exemption from Registration for CTAs Providing Standardized Advice*

In March 2000, the Commission adopted Rule 4.14(a)(9). This rule exempts from registration CTAs who do not direct client accounts or provide advice based on, or tailored to, their clients' circumstances.²⁵

²¹ 65 Fed. Reg. 66618 (Nov. 7, 2000).

²² 65 Fed. Reg. 51529 (Aug. 24, 2000).

²³ 65 Fed. Reg. 21309 (Apr. 21, 2000).

²⁴ 65 Fed. Reg. 4807 (Feb. 1, 2000).

²⁵ 65 Fed. Reg. 12938 (Mar. 10, 2000).

2. *Expansion of the Definition of QEP*

Commission Rule 4.7 provides an exemption from certain disclosure, reporting, and recordkeeping requirements for CPOs whose participants meet specified eligibility criteria and are defined as qualified eligible persons ("QEPs"), and for CTAs who direct or guide the commodity interest accounts of clients who are QEPs. In August 2000, the Commission expanded the scope of persons included within the definition of a QEP, to include: (a) principals of registered investment professionals who themselves are defined as QEPs; (b) certain registered securities investment advisers and their principals; (c) "qualified purchasers" and "knowledgeable employees" as those terms are defined under the federal securities laws; (d) certain employees and agents of pools, CPOs, and CTAs, as well as certain of those employees' and agents' immediate family members; (e) trusts whose advisors and settlors are QEPs; and (f) "non-United States persons." In addition, the revisions make it easier for certain charitable organizations, trusts, and collective investment vehicles to be classified as QEPs.²⁶

3. *Fund of Funds Annual Reports*

In December 2000, the Commission adopted rule amendments to permit CPOs to submit a claim for an extension of time to file a pool's annual report where the pool invests in other collective investment vehicles, and the CPO cannot obtain the information that its accountant requires about the collective investment vehicles in time for the pool's annual report to be prepared, audited, and distributed by the due date.²⁷

4. *Profile Disclosures for CPOs*

In October 2000, the Commission adopted rule amendments to permit CPOs to deliver to prospective participants a summary "profile" document containing only key information about a pool prior to providing them with the pool's disclosure document.²⁸ These amendments accommodated a rule submitted by NFA for Commission approval concerning the use of profile documents.

5. *Exclusion from Definition of CPO for Church Plans*

Commission Rule 4.5 excludes from the definition of CPO certain persons that are otherwise regulated with respect to the operation of enumerated qualifying entities. Additionally, under Rule 4.5, certain employee benefit plans are not commodity pools. In April 2000, the Commission adopted amendments to Rule 4.5 to include a plan defined as a "church plan" in Section 3(33) of Title I of the Employee Retirement Income Security Act of 1974²⁹ as a

²⁶ 65 Fed. Reg. 47848 (Aug. 4, 2000).

²⁷ 65 Fed. Reg. 81333 (Dec. 26, 2000).

²⁸ 65 Fed. Reg. 58648 (Oct. 2, 2000).

²⁹ 29 U.S.C. § 1002(33) (1994).

type of plan that is not a commodity pool.³⁰

D. Proposed Regulatory Reforms

In addition to the regulatory reforms the Commission has already adopted, as discussed above, the Commission has pending proposed reforms that will provide relief to futures intermediaries.

1. Notional Funds

In July 1999, the Commission proposed rule amendments to provide that the rate of return for partially-funded, or "notionally funded," accounts of CTAs be computed by dividing net performance by the nominal account size agreed upon between the CTA and the client to establish the client's level of trading in the CTA's program.³¹ The Commission expects staff recommendations concerning this proposal in the near future.

2. Foreign Futures Broker Registration

In August 1999, the Commission proposed to codify some of the interpretations and positions that its staff has taken regarding registration requirements under Part 30 of its rules.³² The Commission proposed to modify Rule 30.4(a) by clarifying that foreign futures and options brokers, including those with U.S. bank branches, are not required to register as FCMs pursuant to Rule 30.4, or seek Rule 30.10 relief, if they fall generally into the following categories: (a) those that carry customer omnibus accounts for U.S. FCMs; (b) those that carry U.S. affiliate accounts that are proprietary to the foreign futures and options broker; and (c) those that carry U.S. accounts that are proprietary to a U.S. FCM. In addition, proposed Rule 30.10(a) would specify representations that must be made by a foreign futures and options broker that has U.S. bank branches in order to obtain Rule 30.10 relief or to come within the registration exception of Rule 30.4. Staff expects to make recommendations to the Commission concerning this proposal in the near future.

III. SUMMARY OF COMMENTS, INTERVIEWS, AND PUBLIC HEARING COMMENTS

A. FCMs and IBs

1. Bunched Orders

By far the suggestion most often raised by commenters was to change Commission Rule 1.35, regarding the allocation of bunched orders. In particular, commenters indicated that the

³⁰ 65 Fed. Reg. 24127 (Apr. 25, 2000).

³¹ 64 Fed. Reg. 41843 (Aug. 2, 1999).

³² 64 Fed. Reg. 46613 (Aug. 26, 1999).

procedures for post-execution allocation of bunched orders are cumbersome and the recordkeeping requirements imposed on FCMs result in unnecessary delays. It was also noted that with the increased use of electronic order routing and execution systems, which permit account managers to place orders for execution directly, FCMs do not have the ability to monitor these transactions prior to execution and clearing. Indeed, FCMs have frequently noted that many account managers place orders through multiple FCMs, rendering it impossible for any one FCM to assess the overall fairness of allocations. Many commenters indicated that the burden of allocating bunched orders and maintaining required records should be placed solely on the account managers, as opposed to FCMs.

The Commission understands this issue is a high priority of the futures industry. Changes in order placement and execution caused by the increased use of electronic systems and the impact these changes have on the capability of FCMs to make and/or monitor allocations are issues which must be examined in considering changes to the currently available methodologies for the placement and allocation of bunched orders, or in considering whether to shift certain responsibilities from FCMs to account managers. In addition, any proposed changes in this area will require increased monitoring by NFA. The Commission also believes that any proposed changes to this rule must be considered in light of concerns regarding the possibilities of fraud and money laundering.

In the near future, the Commission will be organizing a roundtable with industry representatives to discuss proposed rule changes in this regard. At that time, the Commission intends to be able to provide a more complete picture of the form these rule changes might take and to discuss more fully any resulting responsibilities that will attach to the respective intermediaries.

2. *Denomination of Customer Funds and Location of Depositories*

In 1988, the Commission issued Financial and Segregation Interpretation No. 12 ("Interp. 12"),³³ which provides that, under certain conditions, an FCM may deposit segregated funds of customers domiciled in the U.S. in foreign depositories. Under Interp. 12, before an FCM may deposit a customer's funds offshore, it must obtain a subordination agreement from the customer that becomes operative in the event the FCM is placed in bankruptcy or receivership and there are insufficient funds available for distribution from the funds held in the particular currency to satisfy all customer claims against those funds.³⁴

In conducting the study, one of the requests the Commission heard most often was that the requirements of Interp. 12 be revised. In particular, commenters indicated that the requirement to obtain a subordination agreement should be eliminated.

³³ Financial and Segregation Interpretation No. 12 -- Deposit of Customer Funds in Foreign Depositories, 53 Fed. Reg. 46911 (Nov. 21, 1988). The document was published in the Federal Register as a Statement of Agency Interpretation. It was also published in the Commodity Futures Law Reporter at ¶ 7122 together with a series of Financial and Segregation Interpretations issued by the Commission's Division of Trading and Markets.

³⁴ 53 Fed. Reg. at 46913.

Commission staff have worked closely with the Futures Industry Association ("FIA") and the exchanges' Joint Audit Committee ("JAC") to develop rules that would address these concerns while continuing to address financial integrity and customer protection concerns identified in Interp. 12.³⁵ In the very near future, the Commission expects to consider staff recommendations that the Commission propose rules that would modify the conditions under which FCMs and derivatives clearing organizations may deposit customer funds in foreign depositories and in certain currencies other than U.S. dollars and would address the subordination requirement and the bankruptcy distribution issues.

3. *Minimum Capital Requirements*

Many commenters stated that they would like the Commission to adopt risk-based capital requirements for FCMs. In January 1998, several commodity exchanges in the U.S. adopted a risk-based component to their minimum adjusted net capital requirement for members. In October 2000, NFA also adopted a risk-based capital requirement. Therefore, virtually all FCMs required to be registered with the Commission are subject to risk-based minimum adjusted net capital requirements.

In April 2001, the Division of Trading and Markets of the Commission issued a report comparing the risk-based capital requirements of the SROs and the Commission's minimum adjusted net capital requirements.³⁶ The report recommended that the Commission replace its current minimum capital requirement, based on four percent of the amount of funds required to be segregated or set aside for customers, with a risk-based capital requirement proportionate to the risk to an FCM of the positions it carries for its customers' and non-customers' accounts. The Commission expects to consider proposed rules to implement this concept in the near future.

One interviewee suggested that FCMs that do not clear trades should be subject to reduced minimum capital requirements. Additionally, another interviewee suggested that the Commission expand the definition of the term "cover", under Rule 1.17(j), to include the circumstances where a person owns the securities underlying a futures contract on a securities index. The Commission may consider these items in connection with the rule proposal regarding risk-based capital.

Commission Rule 1.10(b)(2)(iii) requires that financial statements required to be certified by a public accountant must be filed in paper form. NFA has indicated its belief that this rule should be amended to permit certified statements to be filed electronically. Under Commission rules, certain financial reports, requests, and notices must be filed with both the Commission and the registrant's designated self-regulatory organization ("DSRO"). NFA has recommended that the Commission amend its rules so as to require such reports be filed only with the DSRO. NFA noted that the Commission could obtain copies of any report it needed from the DSRO. NFA

³⁵ In December 1997, the Commission requested comments from the public on how to address risks related to holding segregated funds offshore or in foreign currencies. 62 Fed. Reg. 67841 (Dec. 30, 1997).

³⁶ A copy of the report may be viewed on the Commission's web site at: <http://www.cftc.gov/files/tm/tmriskbasedcapitalreview42701.pdf>.

also indicated that the Commission should permit these reports and notifications to be submitted electronically. The Commission already permits quarterly financial reports to be filed electronically.

Pursuant to Commission Rule 1.12, if an FCM's adjusted net capital falls below early warning levels, it must file monthly financial statements. NFA indicated that, in light of the fact that NFA and the designated contract markets require FCMs for which they are the DSRO to file financial statements for each month end, virtually all FCMs are required to file monthly financial statements regardless of financial condition. NFA suggested that the monthly filing component of the early warning requirements of Rule 1.12 is no longer needed and should be eliminated. NFA also recommended that it be delegated authority to approve changes in a registrant's fiscal year-end, and to grant extensions of time to file financial and annual reports. As part of the rule proposal regarding risk-based capital, the Commission will consider the changes suggested by NFA.

4. *Foreign Futures and Options*

The Commission staff has discussed with commenters and interviewees many issues related to the trading of foreign futures and options. Some of these issues also involve the SEC.

Pursuant to Section 2(a)(1)(E) of the Act, the Commission and the SEC have been granted authority to issue rules jointly to permit the offer and sale to U.S. persons of security futures products ("SFPs") traded on or subject to the rules of a foreign board of trade. Commenters have encouraged the Commission to adopt a regulatory standard defining a broad-based security index, pursuant to the authority granted under this section of the Act. On May 31, 2002, the Commission and the SEC issued a joint order excluding from the definition of the term "narrow-based security index" those security indexes that qualified for the "grandfather" exclusion from that definition under Section 1a(25)(B)(v) of the Act. The order is effective as of June 21, 2002.

Additionally, Section 2(a)(1)(F)(ii) of the Act provides that the Act is not intended to prohibit an eligible contract participant³⁷ located in the U.S. from purchasing SFPs traded on or subject to the rules of a foreign board of trade to the same extent that such persons may be authorized to purchase other securities traded on a foreign board of trade. Some commenters indicated that the Commission should confirm the right of eligible contract participants located in the U.S. to take advantage of this section of the Act. As this issue involves the sale of securities, it must be addressed not only by the Commission, but also by the SEC. The Commission will continue to work with the SEC to provide U.S. customers with access to foreign SFPs.

Commenters have also encouraged the Commission to work with the SEC to implement Section 2(a)(1)(F)(i) of the Act. Section 2(a)(1)(F)(i) permits FCMs to carry SFPs traded on or subject to the rules of a foreign board of trade in the accounts of persons located outside the U.S. FIA, in particular, noted that it has discussed this matter with the SEC, but has been unsuccessful

³⁷ An eligible contract participant is defined in Section 1a(12) of the Act.

in having this section implemented. The Commission has also been working with the SEC on this issue, among many others involving SFPs, and is hopeful that an agreement will be reached to implement this section of the Act.

Another issue raised relates to the use of non-U.S. exchange terminals located in the U.S. Through a series of no-action letters, the Commission's Division of Trading and Markets has authorized certain foreign futures exchanges to locate terminals for the execution of transactions on those exchanges in the U.S. These no-action positions were subject to the condition that, among other things, only transactions in futures contracts that had been approved for trading by or on behalf of U.S. customers could be executed through these terminals. Commenters have indicated their desire to be permitted to execute transactions through these terminals on behalf of non-U.S. customers for non-approved contracts. Because these contracts generally involve security index contracts, their trading on these terminals might raise issues that must be jointly resolved with the SEC. The Commission intends to work with the SEC to address any such issues.

Some commenters expressed concern about the length of time required under current procedures for the approval of broad-based security index products on foreign markets for trading by U.S. persons. The Commission endeavors to approve such requests as quickly as possible. However, these requests involve issues that are, by their nature, complex and often Commission staff require additional information from the requester. The Commission will continue to work with requesters to act as efficiently as possible in approving these requests.

Pursuant to Rule 30.10, the Commission permits persons located outside the U.S. and subject to a comparable regulatory structure in the jurisdiction in which they are principally located to seek an exemption from certain of the requirements under Part 30 of the Commission's rules jurisdiction based upon substituted compliance with the regulatory requirements of the foreign. Appendix A to Part 30, "Interpretative Statement With Respect to the Commission's Exemptive Authority Under § 30.10 of Its Rules" ("Appendix A"), generally sets forth the elements the Commission will evaluate in determining whether a particular regulatory program may be found to be comparable for purposes of exemptive relief pursuant to Rule 30.10.³⁸ During the conduct of this study, it was suggested by some commenters that the requirement that a country's regulatory system be comparable to the Commission's is no longer relevant and impedes the ability of U.S. customers to conduct business on these markets. Additionally, commenters noted that regulation of the significant overseas markets has vastly improved since implementation of the Commission's policy.

The Commission, in determining whether to provide exemptive relief pursuant to Rule 30.10, must balance the desire to permit U.S. customers access to the opportunities of non-U.S. markets with its mandate under the Act to protect market participants. While the Commission requires a regulatory system to be comparable, it does not require it to be identical. However, there are certain protections that must be in place, such as the protection of customer funds from misapplication, sales practice standards, procedures to audit for compliance with, and to take action against those persons who violate, the requirements of the regulatory program, and an

³⁸ 52 Fed. Reg. 28990, 29001 (Aug. 5, 1987).

information sharing arrangement between the foreign regulator and the Commission to ensure access to information as necessary. The Commission believes that these types of protections are essential to fulfilling its regulatory mandate of protecting market participants. Accordingly, the Commission will continue to look at every application submitted pursuant to Rule 30.10 on a case-by-case basis and will grant an exemption where the foreign regulatory scheme adequately protects market participants.

Pursuant to Rule 30.12, an FCM may permit certain authorized customers (generally "eligible swap participants" as that term is defined in Commission Rule 35.1(b)(2)) to place orders directly with a foreign broker for execution in the FCM's foreign futures and options customer omnibus account. Commenters encouraged the Commission to expand the definition of customers permitted to directly place orders under Rule 30.12 to include eligible contract participants. The Commission will consider making this change.

Pursuant to Rule 30.8, FCMs registered for purposes of offering foreign futures or options must file with NFA quarterly reports containing information as to the number and type of foreign futures and options transactions effected. NFA has indicated that it does not use these records for any regulatory purpose and that the reports present a recordkeeping burden for it and, accordingly, NFA has suggested that the Commission remove the Rule. The Commission will consider making the suggested change, along with other appropriate amendments to Part 30, in the near future.

Finally, interviewees requested that the Commission define the permitted investments of customer funds held by firms offering trading in foreign futures and options as is done under Rule 1.25 regarding domestic futures and options. The Commission is studying the types of investments that firms offering this type of trading use, and expects to develop a proposal to amend Part 30 to clearly define the permitted investment of customer funds.

5. *Permitting FCMs to Carry Multiple Products in Customer Segregated Accounts*

The Commission has also heard from some commenters that they would like to be permitted to hold collateral for non-futures positions along with collateral for futures positions in a single customer segregated account. Currently, under Commission rules, an FCM may not deposit in the customer segregated account funds and other property of the customer that the FCM holds for purposes other than trading in commodity futures or options. As noted in Section II, however, the Commission has issued orders that permit customer funds relating to OTC derivatives cleared by NYMEX and certain foreign futures cleared by CME to be carried in segregation subject to specified safeguards. The Commission recognizes that certain efficiencies can be achieved by holding collateral for other types of instruments in the customer segregated account. The Commission stands ready to consult with the industry to take additional steps to attain these efficiencies in a manner that will not impair the financial integrity of the markets, the protection of customer funds, or, in the unlikely event of bankruptcy, the equitable distribution of funds. In pursuit of these goals, the Commission will also endeavor to confer with other financial regulators, such as the SEC, and other interested parties, such as the Securities Investor Protection Corporation.

6. *Recordkeeping*

Recordkeeping requirements are necessary to ensure compliance with the Act and Commission rules. Recordkeeping also can be important in resolving disputes between customers and futures intermediaries. The Commission has always attempted to balance the regulatory needs for recordkeeping with the needs of intermediaries to operate with minimal constraints. To this end, Commission rules permit intermediaries to maintain such records in electronic form. Rule 1.31(b) provides certain requirements for maintaining records in electronic form, including, among other things, that the system preserves records exclusively in a non-rewritable, non-erasable format and automatically verifies the quality and accuracy of the storage media recording process. To the extent that certain records are handwritten, they must be maintained in hardcopy format.

Some commenters suggested that recordkeeping requirements imposed by Commission rules should be reduced. NFA has indicated that these requirements should be replaced with general reliability and accessibility standards requiring intermediaries to "adopt and enforce reasonable procedures to keep the books and records from being altered or destroyed."³⁹ The Commission will continue to explore ways in which it can meet its regulatory needs for readily available records while imposing the least amount of burden on intermediaries. The Commission has sought to conform its recordkeeping requirements with those of the SEC to minimize burdens on firms dually registered with the Commission and the SEC. With the large number of dual registrants and the advent of SFPs, the Commission will continue to work with the SEC in this regard.

7. *Pre-Dispute Arbitration*

In August 2001, the Commission adopted new Rule 166.5 permitting intermediaries to enter into pre-dispute arbitration agreements with customers that are eligible contract participants or QEPs. However, while an eligible contract participant may waive the right to seek reparations and may be required to sign the agreement as a condition of opening an account, a QEP may not waive the right to seek reparations and signing the agreement may not be made a condition to opening an account. Some commenters have suggested that the Commission broaden this rule to permit intermediaries to enter into pre-dispute arbitration agreements with customers that are not eligible contract participants or QEPs. The Commission is considering this issue.

In a comment letter in response to a joint proposed rulemaking with the SEC regarding the treatment of customer funds for purposes of trading SFPs,⁴⁰ NFA stated that security futures positions carried in securities accounts should be exempted from Commission Rule 166.5. NFA noted that, absent such an exemption, a securities broker-dealer would have to either apply Rule 166.5 to all transactions in the account, including traditional securities products, or be required to

³⁹ Letter from Thomas W. Sexton, Vice President and General Counsel, NFA, to John C. Lawton, Acting Director, Division of Trading and Markets, Commodity Futures Trading Commission (May 29, 2002).

⁴⁰ 66 Fed. Reg. 50786 (Oct. 4, 2001).

have an agreement that treated the transactions in the account differently depending on whether they are SFPs or traditional securities transactions. The Commission is considering the NFA's comment.

8. *Reparations Program*

NFA and several interviewees indicated that the Commission's reparations program should be eliminated because it was unnecessary and redundant in light of NFA's arbitration program. NFA has indicated that, if the reparations program is not eliminated, the Commission should delegate administration of the program to NFA. NFA noted that the reparations proceedings could continue to be governed by the Commission's Part 12 rules and presided over by the current administrative law judges and hearing officers, but Commission staff would not need to administer the program. NFA further noted that the infrastructure NFA has developed for its arbitration program could be adapted to administer the reparations program.

The reparations program is specifically provided for under Section 14 of the Act and, thus, its elimination would require action by Congress. The Commission may, however, be able to use its authority under Section 4(c) of the Act to exempt certain classes of persons or types of claims from reparations jurisdiction. In addition, the Commission has authority under Sections 14(a)(2) and (b) of the Act to modify the scope of the program. The Commission is committed to examining the public policy implications of any changes to the reparations program.

9. *Registration*

NFA suggested that the Commission remove its Part 3 registration rules in light of the fact that the Commission has delegated registration processing to NFA. NFA noted that when it wishes to change its registration processing rules, in addition to NFA submitting the rules for Commission approval, the Commission must also amend its rules. NFA also indicated its support for simplified registration for FCMs and IBs who are currently registered with another financial regulator and trade solely for institutional customers.⁴¹ NFA also suggested that questions on Form 8-R regarding the employment, residential, and educational background of applicants be eliminated. NFA noted that it does not use this information to determine an applicant's fitness for registration. The delegation of the registration processing functions to NFA has been very beneficial in making Commission resources available to be used in other areas of the Commission's regulatory mission. Moreover, the Commission has found NFA to be very proficient in its implementation of the registration process and feels confident in NFA's ability to ensure that registrants meet the appropriate fitness standards. The Commission looks forward to working with NFA in the future and continuing to discuss ways in which the registration process can be made more efficient, including the possibility of amending or removing some of the Commission's registration processing regulations.

NFA has also proposed that Commission Rule 166.4, regarding the name used by a

⁴¹ The CFMA provides for notice-registration of broker-dealers registered with the SEC as an FCM or IB solely for purposes of trading security futures products. *See*, Section 252(b) of the CFMA (codified at Section 4f(a) of the Act); *see also*, Rule 3.10(a)(3).

branch office of a registrant, be amended. Currently, Rule 166.4 requires that each branch office of a Commission registrant use the name of the firm of which it is a branch. This requirement is meant to ensure that customers are fully aware of the firm with which they are dealing. NFA has indicated that it will submit a proposed rulemaking that would permit the use of a name other than the registrant's, but does not mislead customers as to the branch office's identity and affiliation. The Commission looks forward to receiving NFA's proposal.

10. Unsubstantiated Claims

One interviewee suggested that greater regulation might be necessary in some areas. This interviewee stated that the CFTC or NFA should ensure that firms do not make claims that they cannot or will not fulfill, but that permit them to take business from more conscientious firms. These actions tend to bring disrepute on the entire industry. The Commission's staff is considering, for example, working with NFA to publicize those firms that are registered as FCMs, yet claim not to handle customer funds. The intention would be to discourage persons from sending funds to such firms that may not be equipped to handle customer funds.

11. Disclosure Statements

The Commission heard from some interviewees that the disclosure statements required under Commission rules should be shortened and simplified. Commission rules require that FCMs and IBs, when soliciting retail futures customers, provide a prescribed one-page risk disclosure statement about the futures markets and the risks involved in trading in these markets. The Commission also permits the use of a generic risk disclosure statement that has also been approved for use in the U.K., Ireland, and Singapore. Where the customer is an eligible contract participant, a risk disclosure statement is not required before opening an account.

In a comment letter, NFA indicated its belief that Commission rules should not dictate the manner in which disclosures and consents are delivered and acknowledged.⁴² The National Introducing Brokers Association ("NIBA") expressed its agreement with NFA's comment letter in this respect. NFA offered to draft a statement of acceptable practices in this area, which the Commission will consider. Additionally, the Commission is prepared to work with industry representatives on these issues.

12. Large Trader Reports

Some interviewees indicated their belief that the large trader reporting levels are too low, resulting in the collection of substantial amounts of unnecessary information. In March 2000, the Commission adopted amendments to its large trader reporting rules.⁴³ The Commission, among other things: (a) raised the reporting levels at which a firm and traders must file large trader reports in several commodities; (b) removed the requirement that a firm identify the number and name of other accounts that the trader controlled or owned that were not included in

⁴² See, 66 Fed. Reg. at 53513.

⁴³ 65 Fed. Reg. 14452 (Mar. 17, 2000).

the special account; and (c) removed the requirement that exchanges provide weekly option trader data directly to the Commission. The Commission closely monitors the information that is required to be collected as a result of its large trader reporting rules. When the reporting levels result in large amounts of information being filed with the Commission that do not enhance the Commission's market monitoring responsibilities, the Commission has in the past, and will in the future, amend its rules accordingly.

13. *Block Orders*

In June 1999, the Commission issued an *Advisory on Alternative Execution, or Block Trading, Procedures for the Futures Industry*.⁴⁴ In the Advisory, the Commission announced its intention to consider contract market proposals to adopt alternative execution, or block trading, procedures for large size or other types of orders on a case-by-case basis under a flexible approach to the requirements of the Act and the rules thereunder. The Commission recognized that such procedures could use any combination of competitive and “noncompetitive” (that is, negotiated) trading practices. Under the Commission’s approach, each contract market retains the discretion to permit alternative execution procedures and is able to develop procedures that reflect the particular characteristics and needs of its individual markets and market participants. At least one interviewee noted that, pursuant to Commission rules, an executable customer order must be submitted before any order in the same commodity for a proprietary account.⁴⁵ In this manner, the grouping of proprietary and customer orders in block orders is effectively prohibited. It was suggested by the interviewee that the Commission amend its rules so as to permit the grouping of proprietary and customer orders for purposes of block orders and require that the proprietary trades receive the least desirable fill price. The Commission will consider proposing changes to its trading standard rules.

14. *Internalization of Order Flow*

One interviewee suggested that FCMs be permitted to execute customer orders internally, matching a customer order with the order of another customer, rather than submitting the order to an exchange. It was noted that sending an order to an exchange for execution increases the cost of trading, which is passed on to customers. However, another interviewee indicated that internalization of order flow would run contrary to the goal of a transparent marketplace and provide a disincentive to market makers to participate in the markets, reducing liquidity. Section 5(b)(3) of the Act, as amended by the CFMA, permits FCMs to internalize order flow in accordance with contract market rules. The Commission would consider any such rules in the context of the contract market's price discovery and transparency obligations.

15. *Transmittal of Orders by Introducing Brokers*

Rule 1.57 requires that an IB transmit customer orders to a carrying FCM or a floor broker (“FB”) if the IB's carrying FCM is the clearing member with respect to the customer

⁴⁴ 64 Fed. Reg. 31195 (June 10, 1999); 64 Fed. Reg. 34851 (June 29, 1999) (corrections).

⁴⁵ See, Commission Rule 155.3.

order. NFA noted that the rule would not permit an IB to transmit an order directly to an exchange using a terminal or an automated order-routing system ("AORS") provided by the exchange or to transmit an order to an FB through an AORS if the carrying FCM is not a clearing member of the exchange. NFA suggested that the rule be amended to permit an IB to transmit a customer order directly to an FB, executing FCM, or electronic trading system if the IB's carrying FCM has authorized the IB to transmit orders in this manner and the carrying FCM has systems or procedures to monitor those orders promptly after they are transmitted. The Commission will consider this proposal.

16. *Trading Standards*

The Commission's rules pertaining to trading standards require that, among other things, if an individual is employed by an FCM or IB, copies of all statements and order tickets must be sent to the individual's employer. Commenters suggested that it is unnecessary to require copies of the order tickets be provided to the employer, and that copies of the order tickets should be provided only if requested by the employer. It is important that an FCM or IB be aware of futures trading by its employees to ensure that employees are not trading ahead of customer orders or engaging in any other inappropriate activity. To this end, an FCM or IB must be aware not only of what trades have been made by its employees, but also of information about these trades, such as when they were placed. The Commission will review trading standards and consider what procedures would provide sufficient information to alert an FCM or IB to any inappropriate trading by its employees.

In a comment letter submitted regarding the Commission's adoption of rule amendments relating to intermediaries, NFA indicated its belief that the Commission's existing rules relating to trading standards should be extended to trading on DTEFs regardless of the type of customer. NIBA, as part of this study, indicated its agreement with these sentiments. NIBA noted that abusive trading practices could occur just as easily on a DTEF as on a designated contract market. Commission Rule 155.6(b), adopted in October 2001, sets forth a general standard of practice regarding the intermediation of trades by institutional customers at DTEFs. As noted at the time the Commission adopted this rule, this approach was taken to strike a balance between preserving rules that have been successful in curbing abusive trading practices, and relaxing certain specific provisions of existing rules in regard to trading on DTEFs by more sophisticated customers.⁴⁶ As the Commission gains experience with trading standards for trading on DTEFs, it may consider changes in this area.

17. *FCM Liability for Guaranteed IBs*

An IB may comply with the minimum financial requirements under the Commission's rules by entering into a guarantee agreement with a registered FCM. It has been suggested by some interviewees that the liability of an FCM for the activities of an IB that it guarantees be limited. The purpose of permitting an IB to satisfy the minimum financial requirements by way of a guarantee agreement is to provide IBs with an alternative to meeting the adjusted net capital requirements and to protect the customers of an IB. Customers are protected through a guarantee

⁴⁶ 66 Fed. Reg. at 53514.

agreement by ensuring that the IB is not judgment proof and by providing coverage for the potential liability of the IB arising from its business operations and customer relations.⁴⁷ In the *Federal Register* release adopting the final rules, the Commission indicated that an FCM entering into a guarantee agreement with an IB is not precluded from entering into a separate indemnification agreement with the IB.⁴⁸ Additionally, the Commission notes that the United States Court of Appeals for the District of Columbia Circuit, in affirming an order of the Commission holding an FCM jointly and severally liable for violations of Commission rules committed by an IB guaranteed by the FCM, found that the regulation permitting the use of guarantee agreements to satisfy minimum financial requirements was valid and not subject to customer waiver.⁴⁹

18. *Investment of Customer Funds*

As noted above, in December 2000, amendments to Rule 1.25 were adopted that expanded the permitted investments of customer funds by FCMs and clearing organizations.⁵⁰ Among other things, the permitted investments were expanded to include certain money market mutual funds. Some interviewees suggested that Rule 1.25 be modified again so as to permit investments in bank money market funds. Commission staff is currently considering a proposal from an FCM to permit this type of investment of customer funds. Some interviewees stated that the two percent haircut on investments in money market mutual funds, which is established by the SEC and incorporated by reference in the Commission's rules, is excessive. Commission staff is continuing to discuss this issue with SEC staff.

19. *Loans to Customers*

Some interviewees indicated that FCMs should be permitted to lend funds to customers, at least non-retail customers. Commission Rule 1.30 explicitly permits an FCM to lend its own funds to a customer on a secured basis. Commission rules are silent as to lending funds to customers on an unsecured basis. However, the FCM must appropriately account for unsecured loans to customers under Commission Rule 1.17 when calculating its adjusted net capital and take a 100% charge.

20. *Opting Out of Segregation*

Section 5a(f) of the Act provides that a registered DTEF may authorize an FCM to offer its customers that are eligible contract participants the right not to have separate accounting and segregation for their funds that are carried by the FCM for purposes of trading on a registered DTEF. In April 2001, as required by the Act, the Commission approved final rules permitting eligible contract participants to opt out of having their funds segregated by an FCM for trades on

⁴⁷ 48 Fed. Reg. 35248, 35264 (Aug. 3, 1983).

⁴⁸ *Id.*

⁴⁹ *First American Discount Corp. v. Commodity Futures Trading Commission*, 22 F.3d 1008 (D.C. Cir. 2000).

⁵⁰ 65 Fed. Reg. 77993 (Dec. 13, 2000); 65 Fed. Reg. 82270 (Dec. 28, 2000).

or through a registered DTEF.⁵¹ In conducting this study, the Commission heard from some commenters the suggestion that the Commission permit eligible contract participants to opt out of having their funds segregated by an FCM for trades on any board of trade, not just DTEFs. As noted above, the Act only provides for permitting eligible contract participants to opt out of having their funds segregated for trades on or through a registered DTEF. The Commission will consider this issue.

21. *Agricultural Trade Options*

In December 2000, the Commission proposed to amend Rule 32.13(g) so as to make the exemption from its trade option rule consistent with a broader exemption that was separately proposed for adoption regarding certain bilateral transactions.⁵² Commenters encouraged the Commission to adopt the proposed amendments to Rule 32.13(g). The Commission notes, however, that the amendment was proposed in light of amendments to Part 35 that were subsequently withdrawn upon passage of the CFMA.⁵³ Accordingly, the proposed amendments to Rule 32.13(g) were never adopted. The Commission will consider whether similar amendments should be proposed in light of amendments to the Act by the CFMA.

B. CPOs and CTAs

1. CPO Registration

The Managed Funds Association ("MFA") has proposed that the Commission adopt an exemption from CPO registration for operators of funds offered solely to certain QEPs or accredited investors in private transactions exempt from registration under the Securities Act of 1933. The proposed exemption is intended, in part, to address the reluctance of operators of collective investment vehicles to use futures products due to the perceived burden of registration and regulation by NFA and the Commission. Concerns about registration included: testing requirements; fingerprinting; oversight by NFA; prescriptive requirements for financial reports; and the possibility that existing regulations that currently may not be seen as burdensome may be changed in the future.

Commenters were generally in favor of such an exemption. Current Rule 4.7, as noted above, provides an exemption from certain disclosure, reporting, and recordkeeping requirements for CPOs whose participants are defined as QEPs. Some interviewees suggested that CPOs currently operating pools pursuant to Rule 4.7 were likely to remain in that status and not claim the exemption from registration proposed by MFA. There are alternatives that would address some of the same concerns, such as: (a) exemption from CPO registration based on a de minimis level of futures trading; (b) expanding the relief available under Rule 4.7; and (c) providing relief from some or all of the testing requirements for operators of entities whose

⁵¹ 66 Fed. Reg. 20740 (Apr. 25, 2001).

⁵² 65 Fed. Reg. 77838 (Dec. 13, 2000).

⁵³ See, 65 Fed. Reg. 82272 (Dec. 28, 2000).

futures activities are limited. NFA has previously proposed that the Commission adopt an exemption from CPO registration for operators of pools engaging in a de minimis amount of futures trading and an exemption from registration as a CTA to persons who provide advice solely to these pools. The Commission expects to review staff recommendations in this area.

2. *Disclosure, Reporting, and Recordkeeping Requirements*

Some of the interviewees stated that many of the specific disclosure requirements under Part 4 are overly prescriptive, and that they supported moving toward more of a materiality standard. They expressed concern that literal compliance with the rules creates a safe harbor and may mitigate any incentive for qualitative efforts to provide information that is important to clients. There was some agreement, however, that performance standards should remain, as they permit comparability over time among firms. Moreover, other interviewees expressed a belief that specific disclosure requirements and concrete guidance are helpful, especially for smaller firms. Most supported elimination of boilerplate statements that Commission rules currently require to be presented in capital letters and boldface type. The Commission will consider amendments to these rules.

Some interviewees noted a discrepancy between the periodic reporting requirements applicable to different types of pools. Pools exempt under Rule 4.7 that do not issue units do not have the option that exists in Rule 4.22(a) to disclose, as an alternative, the value of the participant's interest in the pool. A rule change to address this issue could be included as part of a related rulemaking, mentioned above.

Another suggestion by commenters was to eliminate from the recordkeeping provisions in Rule 4.23 for CPOs, and Rule 4.33 for CTAs, the requirement that books and records be maintained at the firm's main business office, with appropriate alternate means of permitting Commission and SRO access for auditing and investigative purposes. In addition, a recommendation was made to amend Rule 4.2 to permit electronic filing of notices of eligibility for various exemptions available under Part 4. The Commission will consider amendments to these rules.

3. *Timing of Disclosure Document Delivery*

Pursuant to Commission rules, a CPO or CTA must provide a disclosure document to a prospective participant or client before directly or indirectly soliciting such prospective participant or client. Several commenters expressed concern that Commission requirements regarding when a disclosure document must be given are too restrictive. CPOs and CTAs may want to give out some preliminary information to determine whether there is interest in an offering before going forward with a disclosure document. Commenters suggested that the Part 4 rules dealing with provision of a disclosure document (Rule 4.21 for CPOs and Rule 4.31 for CTAs) might be relaxed to permit some information or materials to be disseminated prior to distributing the disclosure document. The disclosure document would continue to be provided prior to accepting any funds from a participant or entering into an agreement with a client. As mentioned in Section II above, the Commission provided some relief in this regard when it issued the profile disclosure rules. The Commission will consider additional steps.

4. *Interpretation of "Person" under Section 4m(1) of the Act*

Section 4m(1) of the Act provides that the registration requirements do not apply to a CTA who has not advised more than 15 persons in the past 12 months and does not hold himself out generally to the public as a CTA. For the purpose of calculating the total number of clients a CTA advises, where the client is other than a natural person, the staff has generally “looked through” the client and counted the individual participants therein. Two interviewees felt that the Commission should conform its interpretation with that of the SEC, which, in applying a similar provision of the Investment Advisers Act, counts each collective entity as one person. Commission staff understands that there has been discussion in the securities industry that SEC may reconsider this interpretation. The Commission will consider changing the current interpretation.

5. *Codification of Disclosure and Reporting Relief for Master-Feeder Funds*

Commenters also noted that codification of relief may be warranted due to the number of virtually identical requests for relief from disclosure and reporting requirements for situations, known as “master-feeder funds,” in which a CPO operates a “master fund” whose only participants are one or more “feeder fund(s).” Rules 4.21 and 4.22 require that a CPO provide participants with certain disclosure documents and periodic and annual reports. Therefore, the CPO of the master fund would be required to provide disclosure documents, periodic reports, and an annual report to itself as the CPO of the feeder fund(s), absent the relief that the Division has generally provided in response to CPOs’ requests. The Commission will consider amendments to address these issues.

6. *Schedule of Investments in Commodity Pool Annual Reports*

Since 1995, non-public investment entities have been required to include a schedule of investments in their annual reports as specified by AICPA Statement of Position (SOP) 95-2, *Financial Reporting by Nonpublic Investment Partnerships (the Guide)*. Investment partnerships that were commodity pools subject to regulation under the Act were exempted from this requirement. A recent amendment to SOP 95-2 has revoked that exemption.⁵⁴ The amended SOP 95-2 is effective for commodity pools’ financial statements issued for periods ending after December 15, 2001. SOP 95-2 provides that investments in the securities of a single issuer should be disclosed if they exceed five percent of a pool’s net asset value. CPOs have objected to this requirement for a number of reasons, primarily on the grounds that it results in providing trading strategies to competitors and compromising the private nature of investee funds. Any changes regarding SOP 95-2 would have to be made by AICPA, and Commission will work with AICPA and registrants to this end.

⁵⁴ AICPA SOP 01-1, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships*.

7. *Application of Anti-Money Laundering Requirements to CPOs and CTAs*

Interviewees had some questions about the manner in which anti-money laundering provisions of the USA PATRIOT Act would be applied to CPOs and CTAs. On April 24, 2002, the Treasury Department deferred the application of section 352 of the USA PATRIOT Act (requiring anti-money laundering programs) to CPOs and CTAs for up to six months. The Commission will continue to address these issues with other federal financial regulatory agencies and through its participation in the President's Working Group on Financial Markets.

8. *Coordination Among Agencies*

Some commenters indicated a desire for more coordination between the Commission and the SEC on issues such as definitions of sophisticated persons, disclosure documents and reports for public pools, and oversight of firms' operations. With respect to publicly offered commodity pools, an additional concern was raised regarding regulation by the states, which may act as an entry barrier for public pools. One commenter suggested certain legislative changes that he believed Congress should adopt. In particular, in noting the often overlapping regulatory schemes of the Commission, the SEC, and the states where CPOs and CTAs operate, the commenter suggested that Congress amend the Securities Exchange Act of 1933 to provide that securities issued by commodity pools be subjected to review by a single regulator.

Regarding the overlapping jurisdictions of the Commission and the SEC over CPOs and CTAs, the Commission will soon host a roundtable that includes representatives from the managed funds industry, as well as representatives of the SEC, to discuss, among other things, ways in which this regulatory environment may be made less confusing and burdensome. Possible topics of discussion might include further conforming the rules of the Commission and the SEC and exempting certain persons from agency rules if they are otherwise regulated.

C. Other Issues

In addition to the issues noted above, many commenters also raised issues that, although perhaps outside the scope of the study required by the CFMA, are important to maintaining and increasing the competitiveness of the futures markets and industry. In particular, commenters noted three issues: fungibility of products, common clearing, and technology.

Fungibility of products across exchanges would permit a market participant to enter into a contract on one exchange and offset the position on another exchange. Fungibility could help to promote liquidity in specific futures products. It was noted that this liquidity might alleviate some of the hesitancy of market participants to enter into a contract on a new exchange because they would have some expectation that the contract could be offset without difficulty. On the other hand, the development of new products can require a significant expenditure of capital. The current system tends to reward those who create successful new products. Mandating fungibility could decrease the potential reward and therefore decrease the incentive for innovation.

Another topic that has been raised is the concept of common clearing. Common clearing

would provide for clearing organizations to be independent of the exchanges whose contracts they clear. In this regard, for example, a futures contract purchased on the Chicago Mercantile Exchange could be cleared through the Board of Trade Clearing Corporation, instead of only being permitted to clear through the Chicago Mercantile Exchange Clearing House, as is currently required. It was noted that common clearing could reduce the costs to FCMs and their customers and permit them to better manage their risks across exchanges. Commenters suggested that common clearing could work to heighten competition between exchanges and clearing organizations. However, mandating common clearing would have the effect of subjecting clearing organizations to one another's credit risk involuntarily.

The Act and Commission rules do not prevent the adoption of fungibility or common clearing. Nor do they require that the Commission mandate them. As stated in Section 3(b) of the Act, one of the purposes of the Act, and by extension one of the functions of the Commission, is to promote competition among boards of trade, markets, and market participants. As it always has in the past, the Commission will continue to work with the entire futures industry to promote and facilitate a competitive environment that will best serve the public interest. In this regard, the Commission will organize a roundtable to discuss the elements of an appropriate oversight program in respect of derivatives clearing organizations, a new registration category. At this roundtable, the Commission also intends to discuss common clearing and fungibility of products, their role in encouraging competition in the futures market, and the Commission's function in helping to facilitate greater competition.

The Commission's Technology Advisory Committee -- a committee composed of industry participants -- recently forwarded to the Commission for its consideration a report entitled *Recommendations for Standardization of Protocol and Content of Order Flow Data*.⁵⁵ The report recommended standardization of content by June 30, 2003, and the voluntary development of best practices for protocol at about the same time. NFA endorsed the recommendations and encouraged the Commission to adopt them within the report's suggested timeframes. It was noted by FIA that, while it supports the development of technology protocols, it believes that mandating a specific date as called for in the report will impose significant costs on intermediaries. Additionally, FIA noted that this comes at a time when the futures industry is already under significant financial challenges due to the costs involved in increased technology infrastructure requirements, the implementation of SFP trading, and the increased concerns over disaster recovery and business continuity procedures in the wake of the terrorist attacks of September 11. The Commission has always encouraged and attempted to facilitate the use of technological advancements in the futures industry so as to increase the efficiency and competitiveness of the markets, while maintaining essential participant and public protections. The Commission will continue to work with the industry to ensure that the latest technologies are used in a manner that is beneficial to the markets and intermediaries while imposing minimal burdens, yet maintaining the necessary protections for the public and market participants.

It was also suggested that the Commission work to establish uniform international

⁵⁵ A copy of the report may be viewed on the Commission's web site at: <http://www.cftc.gov/files/ac/acrecommstandardreport.pdf>.

standards regarding the use of the Internet by futures intermediaries. The Commission has a long history of working with foreign regulators to help foster the growing internationalization of the futures and options industry and will continue to do so.

IV. CONCLUSIONS

A. Core Principles

As noted above, the commenters and interviewees generally were not in favor of replacing the provisions of the Act and rules thereunder with core principles. Commenters noted that such an approach is not viable in some areas, particularly rules regarding financial requirements. Additionally, commenters indicated that this approach might result in legal uncertainty, making it more difficult for registrants to identify what steps are necessary to remain in compliance with the Act.

B. Commission Rules

While commenters did not advocate the wholesale replacement of existing Commission rules with core principles, they did note specific rules or sets of rules that they believed should be modified or eliminated. The Commission will consider changes to rules in the specific areas indicated by commenters. As noted at various places in the report, the Commission has begun work in a number of these areas.

C. Delegation of Regulatory Functions to a Registered Futures Association

The Commission has had a long and mutually beneficial relationship with NFA, currently the only registered futures association. The Commission has delegated to NFA many regulatory functions, such as the registration of futures intermediaries and the review of CPO and CTA disclosure documents. The Commission has found that NFA exercises its authority pursuant to these delegations in a proficient manner and the Commission remains confident that it will continue to do so in the future. The Commission will examine the appropriate role for a registered futures association in reviewing allocation of bunched orders, developing an option disclosure statement, and possibly in the administration of reparations proceedings. In addition to the administration of reparations proceedings, NFA also suggested a delegation of authority to approve changes in fiscal year-end and to grant extensions of time to file financial and annual reports.

D. Moving Forward

The Commission appreciates the assistance of the many individuals who contributed to the study. They provided many valuable insights and raised a number of issues worthy of further analysis. The Commission considers this report to be a first step in identifying areas of the futures regulatory framework that must be reassessed in light of the current realities of the futures industry. To further the process of implementing some of the changes discussed in this report, the Commission will be organizing and hosting a series of roundtables with industry representatives. Specifically, the Commission will, in the coming months, hold three roundtables

to discuss: (1) Rule changes regarding the allocation of bunched orders; (2) the issue of overlapping jurisdiction faced by members of the managed funds industry; and (3) the elements of an appropriate oversight program in respect of derivatives clearing organizations, a new registration category, as well as common clearing, fungibility of products, and the Commission's function in helping to facilitate greater competition. The Commission will provide intermediaries with the flexibility they need to meet their customer and business needs while maintaining the mandate of the Act to promote competition, to ensure the integrity of the markets, and to protect market participants and the public.

The Commission, along with the futures industry, must move forward in not only considering the changes suggested through the study, but in continually reassessing the applicability of the Commission's rules and its regulatory role to permit continued growth and expansion of the industry in a fair and competitive manner.

Appendix
List of Interviewees, Commenters, and Hearing Participants

FCMs and IBs

ADM Investor Services, Inc.
Cargill Investor Services, Inc.
Gelber Group, LLC
Goldman Sachs & Co.
Infinity Brokerage
J.P. Morgan Futures Inc.
Man Financial, Inc.
Marquette Electronic Brokerage, LLC
Zaner and Company
Morgan Stanley Dean Witter & Co., Inc.
Refco, LLC

CPOs and CTAs

Caxton Corporation
Commonfund Asset Management Company, Inc
John W. Henry & Company Inc.
MLIM Alternative Strategies, LLC
Millburn Ridgefield Corporation
Renaissance Technologies Corp.

Industry Organizations

Futures Industry Association
Managed Funds Association
National Futures Association
National Introducing Brokers Association

Attorneys and Accountants

The Association of the Bar of New York City, Committee on Futures Regulation

Arthur F. Bell, Jr., Arthur F. Bell, Jr. & Associates

Phillip McBride Johnson, Esq.

Leo Melamed, Melamed and Associates

Paul B. Uhlenhop, Esq., Lawrence, Saunders, Kamin & Uhlenhop

Emily M. Zeigler, Esq., Willkie Farr & Gallagher

Exchanges and Clearing Organizations

Board of Trade Clearing Corporation

Chicago Board of Trade

Chicago Mercantile Exchange

New York Board of Trade

New York Clearing Corporation

New York Mercantile Exchange