COMMODITY FUTURES TRADING COMMISSION

Hearing on Self-Regulation and Self-Regulatory Organizations in the U.S. Futures Industry

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COMMISSION PRESENT:

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COMMISSIONER SHARON BROWN-HRUSKA

COMMISSIONER FRED HATFIELD

COMMISSIONER MICHAEL V. DUNN

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Panel I:

Board Composition in an Evolving Futures Industry

John M. Damgard, President, Futures Industry Association

Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange

Jeffrey Jennings, Managing Director and Global Head of Futures, Lehman Brothers

Roberta S. Karmel, Centennial Professor of Law, Brooklyn Law School

James E. Newsome, President, New York Mercantile Exchange

Panel II:

Alternative Regulatory Structures - Regulatory Oversight Committees and Third-Party Regulatory Providers

John M. Damgard, President, Futures Industry Association

Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange

Christopher K. Hehmeyer, Co-Chairman, Goldenberg Hehmeyer & Company

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Panel III:

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Mark G. Bagan, President and Chief Executive Officer, Minneapolis Grain Exchange

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Michael Schaefer, Managing Director, Citigroup Global Markets

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James E. Newsome, President, New York Mercantile Exchange

Panel IV:

Balancing Expertise and Impartiality on SRO Disciplinary Committees

Bernard W. Dan, President and Chief Executive Officer, Chicago Board of Trade

Jeffrey Jennings, Managing Director and Global Head of Futures, Lehman Brothers

Audrey R. Hirschfeld, Senior Vice President and General Counsel, New York Board of Trade

Joseph W. Ott, Vice President-Compliance, Kansas City Board of Trade

Daniel J. Roth, President, National Futures Association

P R O C E E D I N G S

CHAIRMAN JEFFERY: Good morning, everybody. If you happen to be here for the Bernanke testimony, you're in the wrong place. If you happen to be here to hear Secretary Chertoff on homeland security, you're probably in the wrong place. But if you're here for the state of the futures industry self-regulatory organization hearing, you're in the right place, and we welcome all of you today, and in particular our distinguished panelists, those who are before us now and those we will see over the course of the day, our visitors from the industry, from the public, and from the media.

I think this is a special occasion for any number of reasons:

One is that it's probably the first time in some time that the Commission has had the opportunity to have an open hearing on a matter of such broad industry import and significance, and so we are really looking forward to today's discussion and hoping we can foster a really open and candid dialogue on the issues at hand.

Now with that, I would like to get into the substance. We will have opening statements from each of the five Commissioners and then turn to our panelists, who each will make their own remarks, and then the Commissioners will ask questions of the panelists, and then we will go back to the panelists, lest you thought you were off the hook, and give them the opportunity to ask each other questions. And if there are questions from the audience and time permits, we are certainly prepared to entertain those.

So without further ado, let me say that few issues are more vital and fundamental to the United States futures industry than the structure of our self-regulatory system. Ours is a model of regulation that is premised on the notion that the industry is uniquely situated to define, monitor, and enforce rules of conduct governing its members. With proper checks and balances, self-regulation can fulfill its ultimate role of promoting market integrity and customer protection.

Self-regulation, however, as we all know, and have experienced, is not a static concept. To continue to work properly, the self-regulatory model must adapt, as appropriate, to reflect the realities of the marketplace.

In this, it is incumbent upon all of us -- the SROs, the Commission, the industry -- to remain open to changes necessary to ensure that self-regulation continues to play a vital role in the futures industry, but at the same time preserve the essential strength and vitality of the self-regulatory system that we have.

The changes unfolding in the industry have brought to the fore questions about the current state of self-regulation and in particular the adequacy of the SRO governance structure to manage heightened potential -- and I underline potential -- conflicts of interest arising from those changes.

As reflected in the various comment letters that many of you submitted and we have had a chance to review, there are strongly held and differing views as to whether and how the existing self-

regulatory model can effectively respond to the changing marketplace.

That said, the dynamism and vigorous competition are hallmarks of the futures industry today and that is a real affirmation that self-regulation has been a great success in this industry. But if our markets are to continue to flourish, we cannot give short shrift to this most fundamental component of our regulatory framework.

Ultimately, self-regulation becomes irrelevant unless it fosters public confidence that the SROs are fair and impartial, notwithstanding pressures that could potentially compromise, or call into question, the fair execution of their self-regulatory responsibilities.

With that, we look forward to hearing from all of our distinguished panelists, and I turn it over to Commissioner Lukken for his opening remarks.

COMMISSIONER LUKKEN: Thank you, Mr. Chairman.

I want to thank you for holding this important hearing and welcome our distinguished guests who are testifying today.

Self-regulation is an integral part of our regulatory fabric here in the United States and serves as a healthy complement to the CFTC's oversight mandate. Today, we will discuss whether the system is in need of modification, given recent trends in the industry, including the transformation of exchanges from mutually-owned to publicly-traded companies.

As we study this question, it is important to remember that self-regulation long predates the CFTC's involvement in these markets. It was 1859 when the Chicago Board of Trade first formalized its self-regulatory powers and its founding charters, and it wasn't until the early 1920s, some 60 years later, that the Federal government began to directly regulate the futures markets.

Understanding why self-regulation came to be and would exist independent of any statutory mandate is fundamental to our discussion today.

Self-regulation brings value to the exchange model because it is in the best interest of an exchange to protect its reputation, brand, and product. Market discipline, swift and unrelenting, makes this even more true for publicly-listed exchanges.

Many today will cite the reasons behind the success of the U.S. futures regulatory model, including the fact that SRO decision-making is enhanced by its proximity and access to the exchanges, its participants, and market information. Self-regulators frequently enjoy better understanding of the business and its relationships than those of us in Washington.

That said, still others will cite these same reasons as the basis of its potential weakness. If not properly overseen, exchanges can use this control of information and access to disadvantage competitors. Although the Commodity Futures Modernization Act of 2000 reaffirmed in statute our "system of effective self-regulation," it also recognized the tension inherent in this regime with the inclusion of core principle 15, which requires

exchanges to “minimize conflicts of interest in decision-making and establish a process for resolving such conflicts of interest.”

This is the challenge we face today: determining the best manner in which to identify, minimize, and resolve potential conflicts of interest that may arise between the quasi-governmental functions of an exchange and its core business.

This will undoubtedly involve striking a careful balance between the need to insulate regulatory decision-making with the desire to preserve the advantages of the SRO model that result from its intimacy with the market. Where and how we place this fulcrum will determine whether the system is perceived in the public as fair and balanced or one-sided and unworkable.

Today's testimony will greatly aid our Commission as we strive to reach this equilibrium, and I look forward to the testimony we are about to receive.

Thank you very much.

CHAIRMAN JEFFERY: Commissioner Brown-Hruska.

COMMISSIONER BROWN-HRUSKA: Thank you. Good morning. I would like to thank the panelists who have agreed to testify today, some familiar faces, and the chairman for agreeing to convene this hearing on self-regulation in the futures industry.

Self-regulation in the futures industry has long served the market well, as has been demonstrated by the success of the industry as well as I believe the relative lack of serious regulatory breaches in the industry. Yet I am old enough to remember the FBI sting of the late 1980s and I recall that it raised some significant questions regarding self-regulation of the markets, but I believe that the industry learned a serious lesson from those events, as did the CFTC in that time, and we have all sort of stepped up to the regulatory plate, as it were, and have moved well beyond the problems that the sting exposed.

Today the SRO model of regulation in the futures industry seems to be working well, but with

any regulatory program, I believe it is important that we periodically review its efficacy to ensure that the program has the right incentives built into it to effectively serve the market and public interest.

In recent years, the futures industry has experienced a sea change of innovation. Whereas the trading floor once served as the mechanism to bring traders and those for whom they traded together in the markets, today computer networks serve that purpose. The technology that has enabled this has had a profound effect on the global nature of markets, the ownership structure of exchanges, and the ability of competitors to enter the markets.

New competitors no longer need to construct large trading floors or limit membership to grant access to the floor. As a result, there is the potential for many more competitors to enter the markets.

Moreover, many of these potential competitors are currently members of the exchange and subject to the rules of those exchanges. And

just as this technology has enabled members to become competitors, so too has the technology enabled exchanges to bypass the traditional member.

Self-regulation is vitally important to the U.S. futures industry, and we must ensure that the regulatory model continues to serve us well in light of the dramatic changes taking place in the marketplace.

These changes, many of which are very recent in origin, have challenged some of the assumptions that underlie the SRO model. The fundamental rationale underlying self-regulation is ironically self-interest. That is, in the rational self-interest of exchanges to police their members so as to prevent abuses.

Equally important is the notion that organized exchanges have strong incentives to adopt rules that benefit investors since their long-run profitability is a function of how well they serve their customers.

But this fundamental alignment of interests, which underlies the SRO model, breaks

down somewhat when exchanges switch from member cooperative to public corporations. Changes in industry corporate structure, to give one example, now permit exchanges to issue rules that affect their competitors. These changes have led to a paradoxical situation where those who are in charge of self-regulation may be regulated by or are regulating their competitors.

We all know that when incentives change, so does behavior. Our task is to identify those specific areas where the incentives are such that self-regulation may be compromised in serving the public interest and to come up with fixes carefully tailored to allow this form of regulation to work better.

As a result of the changes that we have seen and we have discussed, conflicts that once did not exist in this marketplace now do. As the oversight regulator of the futures industry, it is important that we focus on the well-being of these markets. We must be confident that the conflicts that exist and steps taken by SROs to deal with them

work to the good of the marketplace over the self-interest of the SROs. At times these interests may be aligned, but at other times they may not.

I look forward to a robust discussion of the issues today. I would ask that as you develop your responses to the questions, you keep in mind that as we consider SRO structures, what we are really focusing on are the incentives that particular structure creates to achieve a particular public interest outcome.

What we look forward to is an explanation from the panelists as to how the particular structures they advocate create the proper incentives and the proper balance to best serve the public interest.

Thank you.

CHAIRMAN JEFFERY: Commissioner Hatfield.

COMMISSIONER HATFIELD: Thank you, Mr. Chairman, and thank you very much for calling the hearing today. It's an issue that is not new to us. We have been looking at it for quite some time. In fact, we have been looking at it since Chairman

Newsome, now Dr. Newsome, began this quest in 2003, and we have built up actually quite a paper trail. This is the briefing book for today's hearing. I tried to read through this last night. By the time I got done, I was a little confused, but I'm hopeful that with all of you here today that we can get some specific answers.

I think that when you get to bottom of reading through all of this, what you end up with is an essential difference. There are those here today who believe that the existing self-regulatory structure is in fact working quite well, and there are those here today who believe that changes need to be made in the self-regulatory structure. So what I'm interested in, as Commissioner Brown-Hruska has indicated, is some specific answers as to why the existing structure is either working or why it is not working, and if so, what changes need to be made. And to that, I think all of you can be very helpful, and I thank you again for being here. I'm looking forward to hearing from you.

CHAIRMAN JEFFERY: Commissioner Dunn.

COMMISSIONER DUNN: Good morning. I would like to thank the chairman for scheduling this hearing today. I believe that this hearing signals a new era of openness and transparency at the CFTC and I commend the chairman for taking this step.

I would also like to thank all the distinguished panelists and our guests for being with us today.

It is important for the health of our industry that we have this public conversation regarding the governance of the industry's self-regulatory system. The industry has always been dynamic, and since the adoption of the CFMA, we have seen tremendous growth and change. SROs themselves are undergoing an evolution in their structure.

Reliance on self-regulation in the futures industry reflects a belief that ensuring the integrity of the futures market can best be accomplished through allowing organizations with firsthand industry experience to assume the lead role.

These regulatory organizations, guided by general principles set out by the CFTC, have shown themselves to be well qualified to protect the integrity of the futures markets.

Our task is to ensure that an adequate firewall exists between the market and regulatory functions of an SRO. We have received many comments through a number of venues expressing differing opinions on how best to accomplish this.

The questions raised include the definition of outside and independent directors, the structure and authority of SRO functions, and the openness and transparency of self-regulatory process to the public.

At the end of this process, I hope we will have a framework that inspires continued confidence in the self-regulatory system, helps ensure market integrity and consumer protection, and adapts to the needs of the ever-changing industry by allowing an SRO flexibility in meeting their responsibility.

I look forward to the guidance, wisdom, and lively exchange of ideas that we will receive today.

Again, thank you all for your participation.

CHAIRMAN JEFFERY: Thank you for that, Mike, and all the Commissioners.

Why don't we now turn to our distinguished group of panelists. I think we should begin with John Damgard, spokesperson and president of the Futures Industry Association. I could make some additional comments, but John is one of our panelists who needs no introduction. Thank you very much for being here, John.

PANEL I: BOARD COMPOSITION IN AN EVOLVING FUTURES INDUSTRY **

MR. DAMGARD: Thank you, Mr. Chairman, and sincerely -- not to correct Fred, but this has been about a 15-year odyssey for the FIA, well before Jim was the chairman, and we are deeply grateful and deeply indebted that we have had this opportunity to talk about not only self-regulatory powers of an exchange, but also composition of the board, because I think they are related very closely. I think we are all on the same page with respect to trying to

make sure that we can eliminate, to the extent possible, any conflicts, whether they are real or perceived, and I believe that the most important role that we have is to increase the public confidence and maintain that public confidence in our markets.

FIA appreciates this opportunity to appear before the Commission on the issue of SRO board composition. Congress has said it is "the purpose of the Commodity Exchange Act to serve the public interest through a system of effective self-regulation subject to Commission oversight."

Since the SRO board composition issue lies at the heart of that statutory purpose, it is perfectly appropriate for the Commission to take action in this area. FIA has recommended the Commission adopt as a best practice standard that each futures exchange board be comprised of at least 50 percent non-industry directors, what we also call independent directors.

This step is essential to remove the misperception that insider deals and cronyism

permeate U.S. futures exchange self-regulation. By sharing power with objective and intelligent decisionmakers, who have no stake in the game, U.S. exchanges will show the kind of strength and self-confidence that has always been their hallmark.

It will put to rest any concern that self-interest, not the public interest, underlies self-regulation. Some exchanges have already taken major steps in that direction. Seven of the 20 members of the Chicago Mercantile Exchange boards are non-industry advisers.

At the Chicago Board Options Exchange, 50 percent are non-industry directors. And the New York Stock Exchange Board is comprised entirely of independent directors.

This movement shows that enlightened exchange leadership has now adopted the view that non-industry directors add real value, not only by including an independent perspective in board deliberations but also by debunking the myth that self-regulation is a facade or a sham designed to protect the members of the club, not the public.

The Commission has raised the issue whether the New York Stock Exchange listing standards are an appropriate guideline for determining whether exchange directors are independent. Our answer is no. The New York Stock Exchange standards were designed to make sure directors of all public companies, whether they manufacture goods or provide transportation services, are independent of corporate management. They were not designed for public companies that operate SROs in order to serve the public interest.

For this reason, as the NYMEX points out in its comment letter, the New York Stock Exchange standards "would not be relevant for conflicts of interest within a DCM."

Self-regulatory failures in other markets have shaken the confidence of many market participants in self-regulation. Adding truly independent directors to U.S. futures exchange boards would be a clear signal that business as usual will not be tolerated and futures SROs will be fully committed to serving the public interest.

We look forward to this morning's discussion on this important issue.

Thank you very much.

CHAIRMAN JEFFERY: Thank you very much, John.

Former Chairman Newsome, Dr. Jim Newsome, President of the New York Mercantile Exchange.

DR. NEWSOME: Thank you, Mr. Chairman, Commissioners, staff of the CFTC. It's great to be back in D.C. and on behalf of the New York Mercantile Exchange, we are very happy to participate on this hearing on self-regulation and self-regulatory organizations in the U.S.

I would just as a bit of history, since Commissioner Hatfield, you mentioned that I at least opened the formal portion of these discussions a couple of years ago, that we did so before there was any crisis in the securities industry, and so we didn't open this discussion in terms of a response to any serious issues that we deemed taking place in the business. It was simply that it had been 20 years or 15 years, John, since there had been a

thorough review, and we thought it prudent for the Commission to take a step back to make sure that the whole self-regulatory process was working as efficiently and as correctly as the Congress and the Commission had intended.

So just as a reminder, those are the reasons that we opened the book and started looking under the cover, and I'm certainly thankful to this Commission for taking these next steps to finalize this process.

In addition to the remarks that I give today, NYMEX has submitted a written statement that hopefully will be included in this record, Mr. Chairman.

NYMEX is an SRO. It is also a for-profit corporation and a demutualized exchange. This model for future self-regulatory organizations has raised heightened concerns about potential conflicts of interest. In my opinion, many of these concerns are misplaced.

NYMEX believes that the increasingly competitive environment has provided even stronger

incentives for markets to place greater emphasis on protecting the company's business reputation through effective SRO governance and compliance policies.

This is particularly the case for NYMEX, where well-regulated markets are an integral component of the company's brand and business reputation.

The NYMEX board is currently comprised of 25 directors, reflecting NYMEX market participants, including floor brokers, futures commission merchants, locals, and equityholders, the trade, and at-large members.

Of these 25, the board has five public directors who are knowledgeable of futures trading and financial regulation. The public director may not be a member of the exchange or affiliated with any member of the exchange or an employee of the exchange.

The independence of our public directors is of great value to our board and its decisionmaking process. Overall, the representative categories of directors and the qualifications for a public

director provide an effective mechanism to ensure that the views of all segments of the NYMEX community are heard.

Additionally, NYMEX believes that this model effectively addresses potential conflicts of interest. The New York Stock Exchange listing standards emphasize independence of board members for management of the company. These listing standards are designed to ensure that the company's directors are not subject to the influence of company's management. Some have suggested with respect to the public companies functioning as SROs that there is a need to ensure that the business interests do not conflict with the regulatory interests, and certainly we agree completely with that thought process.

But consistent with the CFMA's flexible core principles approach to regulation, NYMEX believes that the internal corporate structure of an SRO should be individualized and determined greatly by the SRO itself.

Thus, when considering the independence of an SRO board, the SRO, we believe, is best suited to determine the appropriate qualifications for an independent director and to ensure that the business interests do not conflict with the regulatory interests.

Thank you, Mr. Chairman.

CHAIRMAN JEFFERY: Thank you, Dr. Newsome.

Let's turn to our next expert, Jeff Jennings, the head of the global futures business at Lehman Brothers.

MR. JENNINGS: Thank you. And I hope you use that term "expert" loosely.

I would like to thank Chairman Jeffery and the other CFTC Commissioners for inviting me here today to speak at this hearing on self-regulation in the U.S. futures industry. I very much appreciate the opportunity to be heard.

First and most importantly, it is incumbent upon us all that the U.S. futures industry establish standards that recognize and are responsive to the

realities of our changing industry and marketplace and are fair and without any appearance of conflict.

The case in point is the transformation of exchanges in the competitive for-profit institutions. These exchanges must rightly be the role model for the global industry. We are the leading marketplace globally and the concept of self-regulation and fair dealing plays a vital role in establishing and maintaining the credential.

We cannot accept anything less.

I believe many of us here agree in principle that as part of this proposition, it is a fundamental requirement that exchange boards must have a significant representation of independent public directors. I believe it is appropriate that at least 50 percent of the exchange board must comprise this group. I could accept a larger percentage of independent public directors, but the percentage should not be less than 50 percent, in my mind.

I believe the term, more importantly, perhaps, is the issue of what constitutes an

independent public director. This definition needs to be thoroughly discussed here today and in supplemental hearings and comment letters. It is this definition that the Commission must address as part of its position as the most important futures regulatory agency in the world.

I believe the term "independent director" must be uniquely defined in the context of a publicly traded exchange that lives in a dual world of both an SRO and a for-profit corporation.

The independent director standard typically applied to listed companies was and is still designed to solely protect the interest of shareholders. It was not intended to offer safeguards beyond that and was likely not foreseen to be applied to an institution that shared both regulatory and economic responsibilities and goals.

In my view, given the unique nature of a for-profit institution that also functions as an SRO, the definition of what constitutes an independent director needs to be broadened to encompass industry independence and not just

management independence as originally intended in some of the current guidelines, and further, likely needs to be quantifiable in some measure.

The term independent public director, in my mind, must be defined as excluding any exchange member, and even any employee or officer of an exchange member who has been associated with the exchange with a member firm for the past three years.

While the debate can easily focus on what this minimum time period should be -- three years, four years, or even two years -- the Commission must establish a minimum period of time separating one's direct involvement in the U.S. futures industry before that person may be properly labeled as an independent public director, in my mind.

I look forward to answering any questions that the Commissioners or others may have, and again thank you all for inviting me here today.

CHAIRMAN JEFFERY: Great. Thank you.

Professor Roberta Karmel. We are very pleased to have Professor Karmel with us. She is

familiar, I think, to many of you; a former SEC commissioner and most recently a professor of law at the Brooklyn School of Law.

Thank you very much for your attendance.

PROFESSOR KARMEL: Thank you. I feel very honored to have been asked to testify at these hearings. I am not part of the futures industry, and although I have spent most of my career in and around the securities industry, I have never actually been part of that industry, either. Although I suppose my most relevant experience was as a public director of the New York Stock Exchange, but that was a long time ago, in the 1980s.

I would say there have long been conflicts of interest in self-regulation by exchanges. Many say that there are now greater conflicts due to demutualization in the public company status of exchanges. But I think that technology and competition are creating more serious conflicts and, in fact, it is these forces that propel demutualization in the first place.

The New York Stock Exchange and NASDAQ listing standards, as others have already said, do not squarely address the key issue of whether exchange members should be considered independent or not when they serve as directors of an exchange board or a regulatory subsidiary.

This is an example to me of how detailed prescriptive rules are not as satisfy as principle-based rules. Although exchange members do not work for the exchange or fall into other categories -- and there are many such categories -- which would make them not independent, they do have a business interest in the exchange's affairs that call their independence into question in certain contexts, especially self-regulation.

In the past, an independent member of a stock exchange was a non-securities industry member. Today the New York Stock Exchange has decided not to have any industry members on its board.

Further, the composition of the proposed regulatory or self-regulatory board of the New York

Stock Exchange will have a majority of non-industry members and a minority of industry members.

There are some who would push this even further and have no industry members on these boards. From my own experiences, I would suggest that if an exchange or an exchange subsidiary operates as an SRO but does not have a significant number of industry members, it is no longer entitled to be considered an SRO. The "self" has been taken out of self-regulation. If this should happen in either the securities or the futures industry, I question whether such government outsourcing of regulatory authority is appropriate.

On the other hand, if an exchange does not have a significant number of non-industry members today, given the political and economic climate we're in, its regulatory actions will be suspect.

I understand that some believe there can be better funding of a private sector regulator and greater expertise on the part of its employees that make it more effective than a government regulator. But such an agency could also become starved for

funds by an industry unhappy with its operations, especially if it is a single industry regulator. The model that is out there in the securities field is the PCAOB, and some are questioning its constitutionality.

Although there have been conflicts of interest problems in the past, the element of industry participation in self-regulation has created incentives for tolerating SROs. But if exchanges and their members begin to compete, the structure will become increasingly problematic.

My own recommendation, however, during what is clearly a transition period is that regulators such as the CFTC do not force a particular board model on an exchange but rather allow some experimentation and differentiation so that new models of exchange board governance can develop as the business and regulatory structures of these organizations change with the times.

CHAIRMAN JEFFERY: Great. Thank you, Professor Karmel.

Let's turn to our final panelist for this particular panel, Craig Donohue, Chief Executive Officer of the Chicago Mercantile Exchange.

MR. DONOHUE: Chairman Jeffery, thank you, and thank you to the other Commissioners and senior staff for inviting us to participate here today on behalf of Chicago Mercantile Exchange.

For those of you who may not be familiar with my own background, obviously today I serve as CEO of Chicago Mercantile Exchange Holdings, Inc., but my history and background experientially is as a corporate securities lawyer within the Chicago Mercantile Exchange. In my 17-year tenure, there I previously served as the head of Market Regulation with direct responsibility for the market regulation programs of the Chicago Merc.

Following that, I served in the capacity of general counsel, where I played a leading role in the demutualization process, and helped architect the creation of our current corporate governance structures, as well as many of the changes that we have implemented over the last several years in

response to our transformation from a mutual organization to one of the most successful public companies today, and certainly one of the leading exchanges as a public company in the futures industry today.

So by virtue of that background, I have the unique position of truly eating what I cooked and have, I think, a unique perspective on the issues that you hope to entertain here today.

First and foremost, I think that it's very important to understand that at least in the context of a public company exchange, we have a very comprehensive, time-tested, and well-established set of governance principles that govern our operations. And while I would agree that there may be distinctions between the independence requirements as they relate to protecting shareholders of a public company and the types of independence issues that have been raised by various of the other panelists, I would fundamentally disagree that the self-regulatory functions of a public company are somehow disadvantaged versus a mutual organization.

Obviously we have statutory and regulatory requirements to serve the public interest, no matter how we are organized, whether that is as a mutual organization or as a public company, but as a mutual organization, our key stakeholders are the very members that we regulate. As a public company, our key stakeholders are the shareholders who own our company.

So I think that we have a very strong incentive to execute our self-regulatory responsibilities in a very capable way. We live in a world today where we have much more transparency around what we do, how we organize ourselves, and the types of decisions that we make.

The other comment that I would make is I think we have to be very, very careful to distinguish what might need to be done today in the context of a board of a public company versus a board of a mutual organization exchange in that today, in fact, it is very rarely the case that the board of Chicago Mercantile Exchange Holdings dealing regularly with regulatory types of issues.

These are issues that are generally entrusted to the management of the market regulation function.

We have, as the Commission is well aware, a very comprehensive process. We have a Probable Cause Committee; we have various disciplinary committees; we have a high degree of representation from non-member, non-regulated participants in both our charging committees as well as our disciplinary committees, and we have taken the additional step of creating a Market Regulation Oversight Committee comprised of five non-industry directors who serve on our board, who are entrusted with the task of ensuring that we operate our market regulation function and discharge our self-regulation responsibilities in accordance with not only our statutory and regulatory obligations, but also in terms of what is in the best interests of the exchange and its shareholders.

That independent oversight committee functions, for those of you who are familiar with public companies, like an audit committee. The Market Regulation Department staff has a direct

reporting relationship, not to me, but to the Market Regulation Oversight Committee with an administrative reporting relationship simply for purposes of management and daily operations.

But that relationship is critical for ensuring a significant level of independence of the market regulation function from the rest of the interests of the company.

It is also responsible for ensuring that we do comply with our Federal regulatory responsibilities. It is responsible for ensuring that we devote adequate financial resources to funding our regulatory programs, and it is responsible for ensuring that the compensation and hiring practices with respect to our market regulation function are appropriate for a self-regulatory organization.

All of that should, I think, answer the question that we don't need to deal with the issue of what is the proper composition of the board from an SRO perspective because the fact of the matter is that our board doesn't really deal very extensively

with those kinds of issues because of the structures that we have put in place.

With that, I will await your questions, and I very much appreciate the opportunity to address you today.

CHAIRMAN JEFFERY: Thank you very much, Craig. That was extremely helpful.

Why don't we turn it back to the panel of Commissioners. I'll lead off with a couple of questions, then turn it over to Walt.

To step back for a minute to frame a little bit of why we are here, going back to the days when John first started surfacing these issues to when Chairman Newsome began a formal process within the Commission.

It strikes me that the elephant in the room here, that's implicit but hasn't really been stated, is the fact that over the past three or four years, we have seen a steady migration of at least the larger exchanges in both the cash markets and the futures world, both domestically and

internationally, moving from mutual or member ownership to public ownership.

That, rightly or wrongly, has increased the degree of industry and public attention on these issues of governance, actual, potential conflicts in a variety of areas, most of which we'll talk about over the course of the day.

I would be curious, Professor Karmel, from your perspective, because you have written a lot about this, I know, albeit in the context of the securities markets, what if anything in your professional judgment are the implications? Just because somebody changed their ownership structure, should we all of a sudden be worried about these issues? Or are there legitimate reasons to at least raise the kinds of questions that are being debated today?

PROFESSOR KARMEL: I think there are legitimate reasons for raising the questions because there has been a lot of public attention on these questions. But as I said a little cryptically in my opening statement, I think the reason these

questions are really getting raised is that exchange members are starting to compete in certain ways with exchanges, and that is part of what is driving the changes in the industry.

You could make an argument that there are fewer conflicts now that exchanges are public in terms of self-regulation than there used to be because when exchanges were mutuals, they were only accountable to their members and now they are also accountable to stockholders.

I think the only legitimate issue that can be raised has to do with the funding of the self-regulatory function. As some have said, well, if an exchange is public and has to be responsible to shareholders, it's not going to spend as much of its resources on its regulatory functions. I don't think that's true. I mean if an automobile company makes a car that isn't safe, nobody is going to buy that automobile, and I think it's the same as some people here have said with regard to an exchange. If an exchange is trading in a fashion that is questionable and not in the public interest and

comes under investigation by the CFTC or other regulators, it destroys its brand. So I have never been too persuaded by that argument.

CHAIRMAN JEFFERY: Thank you, Professor.

John, do you mind if I ask you a question, sort of following up on Professor Karmel's comments?

There is obviously a big difference of perception as between certain of you and those who are in the industry and those of you run the exchanges.

John, you used some pretty emotive words. You referred to the insider deals, cronyism, et cetera. Going back to Professor Karmel's analogy to an auto company, if we see a car out there and it's a lemon, we're not going to buy a car from that manufacturer. We have other options.

From your perspective, at the FIA, John, is it that simple in the context of doing business on an exchange? Or are your options limited?

MR. DAMGARD: I think the automobile industry is a pretty competitive business. I mean if you don't like one car, you buy another car. I

think that my members have always felt that if you don't like the way you're treated at a particular exchange that trades a particular product, it's unusual to be able to find another place to go trade that product.

So while my members are extraordinarily competitive with each other and perhaps there may be in the future more competition between the firms themselves doing the OTC business and the exchanges who might be very disadvantaged by business going off the exchange, it seems to me that they are still able to extend their market power much more so than a competitive industry like the automobile business or the steel business or any kind of consumer product business like paper products. And for that reason, we have -- I mean I have heard my directors complain forever that decisions at the exchanges were made primarily on the basis of what was best for the floor.

Now as the floor has gone away and the markets have demutualized, we have seen the Merc, frankly, in the forefront of making these changes.

You know, seven out of 20 is a damned good start. We'd like to see it go to 11.

We also believe that the definition, as Jeff mentioned, of an independent director should be a non-industry director. If you are either a Lehman Brothers executive or a floor trader, that doesn't cut as an independent director. We believe that the importance of independent directors is beginning to be realized as a real advantage to the exchanges. And our view is that the exchanges, because they are also SROs and because they have a tremendous responsibility beyond just serving their equity owners, the importance of these exchanges to the economy can't be overestimated. And therefore, the confidence in these markets can't afford to suffer.

If people don't like the way they're doing business, frequently they have no place else to go, anyway, so they continue to have to take that customer business to the exchange. And we believe that the exchanges would be better served in terms of making sure that their long record of serving the public is strengthened by a greater focus on the

public non-industry director. If that answers the question.

CHAIRMAN JEFFERY: That's very helpful.

My time is up, but I hope my fellow Commissioners indulge me in one more question and let me give Craig a chance to respond to some of John's comments on this issue.

MR. DONOHUE: Well, you know, I mean first of all I think fundamentally I disagree with John's assertion that there is a distinction in this regard between the automobile industry and the futures industry. He's acutely aware of the fact that most users of these markets have the opportunity to use alternative products, whether those are in the over-the-counter sector or other cash market alternatives. And certainly we have seen in the last several years, you know, a number of new and I think formidable competitors in the exchange trading arena globally that have increased the amount of competition that we have and provided alternatives and additional choices to market participants. So I think that is a false distinction.

Secondly, I think that I challenge Mr. Damgard to identify what kinds of examples of cronyism or conflicts he has seen that in fact have been injurious to either the progress of these exchanges or the running of the self-regulatory function that they have. I'm not aware of what those things are.

And again, I think that in at least the context of a public company exchange, I don't believe that that happens. Like all public companies, there are issues that come up with respect to independence and there are issues that come up with respect to conflicts of interest. And the answer isn't always to prescribe what the board should look like but rather to put in place standards and processes for ensuring that conflicts of interest don't permeate the decisionmaking process and don't create negative outcomes either for shareholders or for market participants who do use these exchanges and for which we do have, I think, an obligation to ensure public trust.

CHAIRMAN JEFFERY: Thank you very much.

Commissioner Lukken. Thank you for indulging me. I appreciate it.

COMMISSIONER LUKKEN: Sure. I wanted to pick up on a point that Professor Karmel had talked about. As I read a lot of the comment letters before today's hearing, many of them were very detailed in their recommendations for our agency, what sort of directors to put on the board, what percentage, and certain other requirements that were very, in my view, reminiscent of pre-CFMA days. And many of you were involved in the passage of the CFMA and touting its benefits, but one of its great benefits was the idea that it transformed our agency from a rules-based, prescriptive-based agency to an oversight agency.

This sort of leads into my question, which is, as we approach this for a general theme: How can we best preserve the CFMA's benefit of flexibility but still get to our mission of what we are attempting today?

I don't want it to turn back the clock to a one-size-fits-all structure, as we try to implement

this. Is it best practices? I have suggested and the CFTC has drafted core principles in this area that might provide some flexibility. I notice FIA suggested performance standards.

Or is this such a mission-critical area for us as regulators that we need to be detailed, as detailed as we need to be in this area to get to the right answer?

Maybe I'll start with John, but I'll open that up to everybody if they can think about an answer to that.

MR. DAMGARD: We all applaud the CFMA. The CFMA did a wonderful job. I mean I think reauthorization this time was meant to be just a fine-tuning of those areas that needed to be fine-tuned, and unfortunately it hasn't been that simple.

But the CFMA does not dismiss the Commission's primary mission of protecting the public interest. And when I speak of cronyism, I speak of those boards and exchanges that are made up primarily of guys who used to be on the floor or primarily of members of the exchange who now have

much more of an incentive to sort of feed the bottom line, and with due respect to Craig, I mean it is not as competitive an industry as the automobile industry.

I mean to the extent that competition came to this country in the form of the Eurodollar contract where it was offered by an international exchange of very high reputation, they went home without making any success inroads into that contract at all. And I think the same is true of Eurex's efforts to invade the Chicago Board of Trade's bond complex.

So my members continue to believe that it's apples and oranges to say that the OTC market is an easy alternative to the futures market. When customers come to a broker and they say I want my order placed at the Chicago Board of Trade, they used to be able to say the Chicago Board of Trade or if there's a competitive market that offers a better transaction price or a more liquid market, you know, you use your judgment. Today that option is no longer there.

So I believe that the public interest needs to be, you know, front and center, and I think it's enhanced by some prescriptive formula that increases the number of public directors so that the public who uses the markets is not of the opinion that the insiders or the cronies are the ones that are making the decisions in order to enhance the profits of the exchange.

I mean and one other thing that I should add. I mean the S&P is a contract that's a licensed contract, and if you are going to go out and hedge your portfolio in the liquid market, there's only one place to go, and that's the Chicago Mercantile Exchange, which does a fabulous job. And everybody believes it's a great exchange. The NYMEX is a great exchange. We're in this together.

But I do believe that you're overstating the case when you say that the futures market are as competitive as the automobile industry. It simply isn't true.

MR. JENNINGS: Well, at risk of pushing this car analogy too far --

[Laughter.]

It was actually good. It was a good one. The point that I would make is I wouldn't even focus on the competitive nature of it. I would just take a look at the number of recalls that occur every year in the car market, despite the fact of its competitive nature. And I would say that without some sort of regulatory oversight or the court of public opinion weighing in, it's very doubtful we would have airbags, it's very doubtful that we have SUVs that didn't tip over.

So what we are advocating in here is just that this is a very dynamic market, and as things change over times and relationships between exchanges and the users of that exchange, and the FCM community as well as others change, and as the exchanges become for-profit and by their very nature evolved into more expansive economic animals than what they have historically been, we have to recognize the issues that that raises, and the risks of there being some sort of conflicts of interest present, either overtly or --

COMMISSIONER LUKKEN: I notice my time is up, but I want to give Jim a chance to answer. I guess we have a variety of different exchanges, different models, different sizes. You know, the big ones we hear from a lot, but there are also small ones, and so I'm trying to figure out how we can provide some flexibility not only for the big ones that we talk about quite a bit but also for the others, the electronics, the other things that we see. So that's what I'm trying to get at. How do we provide flexibility in this area? Jim? And maybe if you have a comment, Professor Karmel?

DR. NEWSOME: Thank you, Commissioner Lukken.

And I want to go back to the flexibility issue that you raised as part of the CFMA because I think that is one of the critical components of the CFMA for both industry participants as well as the regulatory agency, and I think we have to make sure that we are very careful that we don't put everyone in the same box, because when you talk about competition, there's no more competitive market than

the energy marketplace. At the exchange level, at the OTC level, you know, at numerous levels. So I would argue, John, that there is real competition for the same products in our space as compared maybe to other spaces in the marketplace.

But I think there are a couple of different components here that are completely different, and one is a governance issue, one is a regulatory issue, and we have to be careful not to necessarily combine the two completely together, even though they are certainly related.

Those of us -- the CME has already taken the step, the CBOT, we're headed down the path to become a publicly traded company. We have governance rules provided by the SEC which we will have to adhere to once we take that step. But I think beyond that, what we should focus more upon is the self-regulatory structure; how that board is or is not involved in the self-regulatory process, to make sure that we are not all in the same box. Because in terms of NYMEX, our definition of public directors is different than other exchanges, and

that's fine. That's part of the flexibility that works for both of us.

But I think how that regulatory body intertwines with the board, the conflicts of interest of the SRO kind or unrelated to governance, I think they are extremely important. I have taken steps to improve the perception issue, to strengthen the Chinese wall between compliance and the business interests at NYMEX since I have been there, even though I did so without any instances of wrongdoing or any potential wrongdoing at NYMEX. But just because there was the perception that that could be the case, I thought it was in the interests of the exchange to take those steps. So we have and we continue to do so.

COMMISSIONER LUKKEN: She had one comment. If you could make it quick. I'm over my time here.

PROFESSOR KARMEL: Very quick. I would say if you are looking for a kind of principle-based idea here, and the CFTC feels it's appropriate for the CFTC to talk about the structure of exchange boards, it seems to me it is better to do something

like say that exchanges must have a board structure where there are representatives who are sufficiently independent from the industry and exchange members to fulfill its self-regulatory functions, rather than to specify there must be a majority of non-industry members or there should be 49 percent non-industry members. That's what I was getting at when I said why make prescriptive rules set in stone at a time of transition? Let people experiment as long as they have a sufficient number of independent directors to continue to be regulated.

COMMISSIONER LUKKEN: Thank you.

CHAIRMAN JEFFERY: Commissioner Brown-Hruska. I'm sorry for cutting into your time, but go ahead. We've got plenty of time.

COMMISSIONER BROWN-HRUSKA: This is excellent. I'm really enjoying this discussion, so I think that this is a good opportunity for us to think about these issues, especially in light of the CFMA which I agree with Walt has really brought a level of flexibility and enabled a lot of the innovation that moves the ball forward and raises

some of these questions. It actually made possible some of the competitive entrants, new entrants that John mentioned, the Eurex and Liffe, Eurnext-Liffe entrance into the Eurodollar market. It made it possible. But it also brought into focus the self-regulatory powers of the exchanges when it appears in some instances they may have used that rulemaking ability to try to tip the scales in their favor in the competitive environment.

I would like to, though, sort of stay on task and on point with regard to the membership of the board, and ask, because we talked a lot about independent directors, and I think that there is a clear consensus in my hearing of what people are saying that that is an important component -- to help us align incentives and to help us dispel the perception of conflicts of interest.

But I think the question that I would ask, and I'll first tee it up to John, is do you think that diversity among market participants in board composition, staying away from mandating a specific percentage or a majority of independent directors,

do you think that diversity of interests on a board would also help us to address potential conflicts of interest between self-regulation and exchanges' commercial interests?

MR. DAMGARD: I do. I think diversity is very important. But I also, going back to Roberta's statement, I think that there has to be an adjudicator of what a sufficient or what a reasonable number is. And if in the minds of one particular exchange it's one independent director, that's not enough. And I do think that the definition of independent director needs to be a non-industry person, and I think either 50 percent or so, which we are recommending of independent directors, the other 50 percent is where the diversity should take place. There should be customers, there should be floor traders, there should be FCM management types, not just somebody that stands on the floor and executes a trade, because in many instances the FCMs have complained they haven't been properly represented. They are elected by the floor who comprise the membership,

and they don't know who runs the company. They know the guy that stands on the floor that executes the trade who has no concept of what the firm's policy would be on a particular issue.

That isn't to say that I have had a lot of success getting my members, including the representatives of -- Charlie Nastro, your predecessor, served on the board of trade for a long time, but it was back in the days when there were 31 directors, two of them were FCMs. These guys would fly out from Chicago, they would rehearse their piece, they would make this impassioned plea to do it a certain way that would benefit the customers of the FCM, and the vote would be 29 to 2.

At some point they decided that it really wasn't worth their while to continue to participate in that kind of an environment. I think the NFA makes the point of having no particular group in such a dominant position that they can affect the policies in a way that serves their interest. And I think that would be a very good policy for the

exchanges to follow in terms of populating the other 50 percent. Diversity is good.

COMMISSIONER BROWN-HRUSKA: Craig, would you like to comment?

MR. DONOHUE: There are a couple of responses to that. I mean, first of all, I think we have to be asking ourselves the question are we dealing with a demonstrable fact-based problem that needs a solution, or are we dealing with opinions and conjecture and fears of conflicts or cronyism and things like that? And I think one has to be very, very careful in asking that question and answering it.

I would suggest to the audience here today that if you go back six or seven years and you look at the composition of our own board and the fact that a lot of the directors do have in their history a floor background, whether that is running a floor-based clearing member firm or acting as a floor broker or a floor trader, and one would have thought that those kinds of conflicts or attachments to the floor would have been a substantial obstacle in

transitioning to an electronic exchange environment, which today we are more than 70 percent electronic and continuing to grow very rapidly as an electronic exchange.

Our success as a public company is due to many things, but in part it is due to the fact that if you looked at our history of pricing determinations over the last six or seven years, for the most part we have increased the fees that we charge members and we have decreased the fees that we charge non-member public customers of the exchange, and so these traditional sort of perceptions or ideas that a certain person, by virtue of their background and experience, is likely to approach a problem incorrectly and come to the wrong outcome, I think are unfounded, and I think we have to be very sensitive to not rearranging the way in which the industry is organized and the way in which exchange boards are organized and the way in which self-regulation is appropriately conducted, just because somebody thinks that that's the way

it's going to be, even though history in many respects is to the contrary.

So that's number one. Number two is I think we have to be very, very careful not to become prescriptive in what we are doing. I think Professor Karmel said it very well -- we have to have a very, very flexible approach in terms of how we do this.

If you were to look at traditional corporate governance principles, having nothing to do with exchanges or exchange public companies, the fact of the matter is that it's extremely unlikely that a firm like Lehman Brothers or a firm like Goldman Sachs or a firm like Morgan Stanley could or should be on the board of a public company exchange because the volume of business and revenues and the critical nexus between their business and the business of the exchange is in fact much larger than would be true of an independent local trader on the floor or a floor broker. It's just the way that people measure independence and measure the attachment of an organization to another company for

purposes of thinking about is that director likely to serve the interests of the shareholders.

I'm not suggesting that that isn't desirable and that it wouldn't be a good idea to have representatives of FCMs on exchange boards, but one has to be astute and aware of what these other principles are for public companies and how they play out. So you have to be very careful in this area to be examining is there a real problem that needs to be solved, or are these just opinions and there isn't a problem.

COMMISSIONER BROWN-HRUSKA: I think a couple of years ago when I first came into this regulatory position, I definitely was convinced that demutualization was a good thing and that that would increase the representation of stakeholders. But then over the course of time I would say that, on the margin, there have been some examples where I felt the motivation was questionable regarding some of the rules that were floated at the exchange level.

So that there are, at the margin, some examples. I'll just say that, and I guess Jeff would like to say a few words.

MR. JENNINGS: Just to be very brief, just to follow up on Craig's point. I think he raises a very good point on fact-based versus perception regarding these issues, and I think one of the things that would make probably a good historical frame of reference and study is to go back and just take a look at what FCM representation has been on the various exchange boards over the course of the years, whether it be publicly traded FCMs or otherwise. And to that point, what the representation has been from the financial community and the financial futures traders as opposed to the agricultural and commodity-based traders. And I think you would find over time, and I haven't gone back and done this study myself, so it's anecdotal at this point more than anything else, that it will be heavily skewed towards one group and almost de minimis representation from the FCM community or, for that matter, from the financial community.

So I think that would be a worthwhile exercise. And I think it's that sort of facts from a historical perspective that would help kind of put our concern and interest in perspective.

MR. DAMGARD: Sharon, I would just add that yes, we ought to be careful, and yes, we all think flexibility is a real hallmark of what the CFMA offers. But, truthfully, if there wasn't a problem in this area, then I wouldn't be beating this drum for 15 years. I hear it every board meeting from my members, and if everybody was delighted with the status quo, then there wouldn't have been a Broker Tech -- I mean the Lehmans and the Goldmans and the Morgan Stanleys and the Merrills decided unsuccessfully, I might add, to try to compete with the existing exchanges because they weren't satisfied with the way they were being treated, and it's the firms that bring the customers to the exchange.

I think that we are in a very, very fast-changing mode, and to just sit back and say, well, everything has worked perfectly in the past, so

let's not be too anxious to make changes -- everything else is changing, and I think it's almost overdue.

I think Jim was absolutely ahead of the curve when well before the Grasso incident on the New York Stock Exchange, the CFTC took it upon themselves to begin this review, and that's why I said earlier I'm so pleased that we are here today to talk about it in public and on the record.

CHAIRMAN JEFFERY: Commissioner Hatfield.

COMMISSIONER HATFIELD: John, I'd love to drill down a little bit in that. With the exception of some issues in your submission letter that you state can only be addressed legislatively, can you address what you believe are the current inadequacies of the SRO system, whether they be inadequacies or biases from a specific standpoint, as Craig and Jeff have both just talked about? Can you give some specific examples, without the ones that you have already acknowledged you believe need to be addressed legislatively, where there is an inadequate current SRO regime or there is a bias?

MR. DAMGARD: Well, I mean, first of all, I don't think we're that far apart from the Merc. I think the Merc has a system where they have -- and we're going to talk about this on the next panel. But it certainly goes a long way toward addressing the concerns of the industry to have a committee that oversees regulation, that's made up entirely of independent directors. And those independent directors, the next question that I would raise is, how were those independent directors selected? If they're all selected by management or if they are selected by the Chairman Emeritus of the board, they end up with a lot of responsibility or loyalty perhaps to the person that put them on the board. And as other exchanges -- and I think we have generally admired the CBOE model, where the independent directors choose themselves.

They make nominations for the independent director slots and those independent directors then are sent to the nominating committee, and for the most part, at least at the CBOE, there may be a petition process where others could run. But it

really goes, Fred, to the kind of rulemaking that takes place in an SRO that affects the member who may be -- I mean at the CBOT you have a committee I think of five floor guys that run the disciplinary committees at the exchange who sit in judgment of a firm that they believe may have done business off the exchange in violation of their rule. They are the adjudicator. They know that if they fine that person and discourage him from doing business off the exchange, that they are going to directly benefit by having that business come back to the exchange.

Anything that smacks of defeating a competitive environment is something that we believe needs to be addressed.

COMMISSIONER HATFIELD: Craig, I wanted to ask you, and you can feel free to respond to any of that if you care to, but taking off of what John says, how can a member of an exchange be a truly independent board member?

I think it's very helpful what SRO governance reforms the Merc has implemented and the

explanation of your ROC, but when all of the exchanges comment to us that one's business reputation is of paramount importance, particularly as you move toward becoming publicly-traded companies, how can not having more independent board members of non-exchange members on the board not help your company's business reputation?

MR. DONOHUE: Well, I think it is very helpful to have a diverse representation on the board. Obviously I deal very extensively with our shareholders, and so from their perspective I believe that what they like to see is a board that is knowledgeable, a board that understands the industry and the business that we are operating, a board that has different types of expertise and experience and background to contribute to helping set the strategy for the company and helping guide the company successfully toward the future and toward the creation of value for shareholders.

So I think, you know, we have been very successful in the hybrid kind of governance structure that we have, and I think also, frankly,

that our shareholders have well understood that the nature of the changes and the transformations that we have undertaken are quite difficult to achieve. It is very difficult to go from being a hundred-plus-year-old membership organization that exists to serve the purposes of the members, to being a well-run public company accountable to shareholders.

It is equally difficult to go from a hundred-year-old floor-based delivery system for trading futures and options to a predominantly electronic kind of market, all at the same time, all with the same intersecting stakeholders, and so to accomplish that, I think the diversity of representation that we have on our board has been very, very critical. And I am not certain that we would have been as successful as we have been if we had subscribed to some of the traditional, conventional wisdom concepts out there about what a board should look like and who's independent and who's an industry director versus a non-industry director and so on and so forth.

So that is point number one.

Point number two, in response to your question on how do we think about independence. You know, again just separating for the moment the separate issues that have been discussed here about the regulatory aspects of a public company exchange and just focusing on the board of a public company exchange, the listing standards for the New York Stock Exchange and NASDAQ as well as numerous different corporate governance best practices guidelines put out by large institutional investor groups have formulated different standards for determining whether a director is independent, and I think it is important here for people to understand equally that independence isn't just independence from management; it's independence from the company itself.

The concern of the shareholder is, is that director in some fashion too connected to the company or the management or too dependent on the company or the management in some fashion relative to the amount of earnings or revenues that are produced by the relationship between that director

and his company and the company on which he serves as a director.

Those things have thresholds. They have revenue tests, and percentages, and other criteria that one uses, and when you look at the volume of business that is done typically between some of our directors who might trade on the exchange or serve as a floor broker on the exchange, again these are very de minimis levels of activity that normally just would not rise above that threshold such that they wouldn't be deemed to be independent.

Those are fact-based, objective tests. Anyone can look at those. You can look at the listing standards, you can look at all those corporate governance standards and criteria. You can look at our own corporate governance principles and guidelines. They are all available on our Web site.

COMMISSIONER HATFIELD: Thank you, Mr. Chairman.

CHAIRMAN JEFFERY: Thank you. Commissioner Dunn.

COMMISSIONER DUNN: There is such a great pool of knowledge out there, and so many questions and so little time.

What I would like to do is give you a broad overview question and ask each of the panelists to address it as it may apply to them.

I would like to ask about the definition of what is independent, what is an outside director, and is an outside director at a disadvantage compared to the insiders who know how the business operates, and what type of mitigating things should boards be doing to help outside independent directors get up to speed, and for Jim and Craig especially, I would like you to zero in on a little bit on what it took for you as your boards evolved and the principles and guidelines that you developed.

Craig, when I was at the Merc and I asked about the governance question, Marty brought me back a big stack of information. It took me three days to read through all the information that went into

it. It occurs to me it was a great deal of expense, time, and effort.

The final part of this multi-question here is how can the smaller exchanges do some of this? Should there be a difference between the size and types of futures exchanges and what we expect of them?

Let's start from your side and go this way.

MR. DONOHUE: First of all, compliment accepted from John. I think that much of the work that we have done has provided, I think, a very good model for the industry to follow. I think it is flexible and I think it does address a lot of the kinds of issues that we have been talking about here.

You know, we had a very traditional model of governance and a very traditional model for an exchange, self-regulatory program, if you go back 10 years in time, and over the course of that 10 years we have made, I think, very substantial changes.

I talked about the fact that we have modified substantially the composition of our

internal investigative committees and disciplinary committees so that not only do we preserve industry knowledge and input by people who are subject to regulation; we also have a diversity of interests, so we have three-member panels typically that serve on those types of committees.

One is typically a floor broker representative; one would be a floor trader representative; and the other would be an FCM. So we have a diversity of interests. And then separately we have non-member panelists, typically lawyers engaged in the financial services practice area, with substantial knowledge and expertise about trading and things related to the way in which we regulate activity in our markets.

So we have certainly begun moving very aggressively in the direction of making sure that we have a very fair process and a balanced process, one that strikes the balance between outside, objective, independent people and yet preserving some sort of knowledge and understanding of the way in which the market operates.

I mentioned the Market Regulation Oversight Committee in terms of the role that it plays today, which really again is intended to address these kinds of issues. We recognize that people can have concerns or perceptions about potential for conflicts of interest or lack of attention to our regulatory responsibilities, and that's the very reason why we created the Market Regulation Oversight Committee so that we have a substantive way to actually deal with that.

In terms of the board composition itself, we have a very extensive board orientation program. We try to help non-industry directors understand the critical aspects of our industry and our business and our strategy. And we learn from each other. We teach them about our industry and our business, and we learn other things from them.

PROFESSOR KARMEL: I think you have to distinguish between concepts or definition of independence for exchanges as public companies, exchanges as businesses, and exchanges as

regulators. And it seems to me that you have to deal with two different concepts.

As many have said, in terms of the board composition for an exchange board member on a public company, industry members or exchange members are not necessarily not independent. I think the only time under current concepts that you run into an issue would be if that industry member is responsible for such a high percentage of the trading on the exchange that they would be like a customer that dominates any business.

But I think for purposes of independence of directors when the exchange is functioning as a regulator, that is a different issue, and to me that is where the need for both industry members and non-industry members is important and critical.

I think one of the aspects of the industry component of a regulator that is helpful is a certain amount of diversity. I think that can alleviate some of the problems that have been talked about, both in terms of perception and reality.

It also is helpful because different kind of cases come up before a regulatory board and if you have a diversity of members from the industry, you have a different kind of input as to whether something that happened was or was not contrary to normal business practices.

So I do think you have to separate out the concepts of independence where the exchange is a business and the exchange is a regulator.

MR. JENNINGS: I tend to look at this fairly simplistically, which is probably a good thing because wedged in between two doctors, it's probably my safest approach.

But our drawing on this analogy of various listing standards I think is absolutely appropriate, but I think we have to keep in mind that these listing standards were really drawn up and intended broadly for publicly traded companies. And I think we also have to keep in mind that exchanges which also function as for-profit institutions as well as SROs are truly occupying an absolutely unique space in corporate America out there.

I think with that in mind, it is relevant for us to think about applying standards separately and distinct from those that we apply to just publicly traded corporations at large, and I would draw or point out the New York Stock Exchange. We keep talking about the New York Stock Exchange listing standards, but the point in fact is the New York Stock Exchange board of directors does not comply with those listing standards. It's much different in their mind than what they apply to publicly traded companies.

Now I'm not saying that that -- I think they have gone a long way there in having a fully independent board, and I'm not advocating that that's what we do in this particular instance, but I think it would be very difficult to argue that the New York Stock Exchange is not viewed as a stronger institution today than it was a couple of years ago, and I think at least in part that has to be because of the composition of the board.

DR. NEWSOME: Mike, a couple of things, and I'll try to be very brief. I want to go back to the

FCM category because, again, not everyone is in the same box. At NYMEX we have FCM categories to be elected. Unfortunately, what has happened over time, instead of John's members getting together to decide who they would want to serve on the board, they get splintered and we end up with FCM representatives that come from the floor.

Now some of those guys are very good board members, but they certainly don't represent more the corporate interest that you were speaking about, John.

But my point is that they have the opportunity to do so, and with some effort and some work could absolutely use that category to the benefit and over time have just not done so.

MR. DAMGARD: Some exchanges allow the FCMs to vote for their own members, as does the NFA, but at the Chicago exchanges I believe that they are all subject to the membership or the board.

DR. NEWSOME: Back to the public director, I think again we have -- the exchanges have differing definitions of independents and publics,

and the NYMEX definition is that they are completely independent from all the activities of the exchanges. And that was instituted when NYMEX was the first exchange to demutualize some seven or eight years ago, and I think they were kind of stepping outside of the box and making some moves that now have become rather normal.

But I think because of the way we define the public directors, they work great on the audit committee; they work great on the compensation committee; but if our compliance committee was solely made up of our publics and the way we define them, it would be a disaster because they don't understand the business.

So we are moving in a direction that a majority of our Compliance Oversight Committee should be made up of those public directors but not the entire committee.

So I think we have to go back to -- and it reminds me of a comment that Chairman Greenspan made in one of our present working group meetings when the SEC and the New York Stock Exchange were

considering some of the board issues, Chairman Greenspan commented that the potential risk was that you develop a structure in which you have a board that looks very, very good on paper but leads the business to failure because of a lack of understanding of a business in a very technical field.

And so I think we have got to be careful that we don't lead ourselves in that direction, that we have got something that looks great on paper, but then it doesn't work in the real world.

MR. DAMGARD: Well, I think that's a concern, but it's not a current concern because the exchanges are all doing extremely well, and I believe that the exchanges are able to find public directors who are extremely well qualified to understand what the business is all about.

I do think that the public directors that serve on the ROC at the Merc have ample access to the experts who are the industry members and they can listen long and hard to what they have to say. But when it comes to making decisions relative to

the regulatory policies of the exchange, I compliment the Chicago Merc by making that an all-independent directors.

Now I can give them some tips on how they ought to select those directors, which I mentioned earlier, but I also want to say I am so pleased that Roberta and Jeff are here because Craig and Jim and I do this all the time and I have never been up here when I haven't been wholly outnumbered by the exchanges, so it is particularly pleasant to have you both here.

When you went out to -- Mike, you said you wanted to make it spirited. I admit there has been a lot of changes. You were out there and you met certain people. I think I went out there 15 years ago and it was Fast Eddy, Slick Willie and Tony the Tuna, and those were the guys on the board.

[Laughter.]

And those floor members that dominated the Merc's exchange are gone. I mean the floor is almost gone. So the people that dominated the decisionmaking aren't there anymore and that's

because, albeit slowly and reluctantly, the Chicago exchanges recognized the benefits of electronic trading.

I am here to help management. I think Jim and Craig and Bernie would all be better served by having a diverse board that had strong public representation instead of just being dominated by one type of member of the exchange that probably, more often than not, though they can't admit it here, gets in the way of management making the right decisions.

CHAIRMAN JEFFERY: I think we will try, unless there are a whole lot more questions, to end this a little bit early, but why don't I first offer the opportunity to the individual panelists and witnesses if they have any questions of each other that they would like to ask, that is, before the assembled group; and secondarily, I notice there are a lot of people in the audience who could well have been on this panel and may therefore have points of view from the industry as to the issue at hand, and if they have -- you know, Bernie Dan from the board

of trade, Chris Hehmeyer and others, that's not to put you on the spot--this would be a good opportunity to interject.

But, first Craig.

MR. DONOHUE: Not to keep arguing with John, but just to sort of not leave that pregnant assertion out there without confronting that and challenging that. I mean I certainly don't agree with that and don't think that you should interpret that there are things that I would like to see that would be different that I'm not prepared to say to you today. But thankfully John is there to do it for me.

[Laughter.]

I think that our board has served us very, very well, not only in terms of conducting the right strategy for the company to move forward in a very successful direction as a public company but also in terms of I think creating enormous value for our customers and our clearing member firms in terms of efficiencies.

I think, John, some of your description of the way you thought it was is quite pejorative. I'm not sure that it was ever the way that you remember it, but it certainly isn't that way today, and you are welcome to come to the Chicago Mercantile Exchange at any time you like, and I think you will find it to be quite different than that, as all of you are welcome to do that.

MR. DAMGARD: With or without my flak jacket?

MR. DONOHUE: You keep saying stuff like that, you'll need to bring it with you.

[Laughter.]

CHAIRMAN JEFFERY: Anyone else on the panel? President Newsome?

DR. NEWSOME: I don't have any questions to my fellow panelists. I would simply say that again the flexibility afforded in the CFMA I think is very critical to this discussion as it is in all the discussions of Commission oversight.

NYMEX specifically is in a great period of change, changing governance, changing the way we

operate, greater acceptance of electronic trading. So as we face many of the changes that we are going to face over the next six months, I would simply request that the Commission afford us as much flexibility as possible to not only fulfill the self-regulatory responsibilities that we take very, very seriously but also allowing us the opportunity to address the many business and competitive challenges that face us.

CHAIRMAN JEFFERY: Anyone else on the panel?

Jeff? Professor Karmel? Anyone from the audience feel compelled to say something or add anything?

MR. DAN: Mr. Chairman, this is Bernie Dan from the CBT.

CHAIRMAN JEFFERY: Bernie Dan.

MR. DAN: I just want to echo Craig's comments.

Thank you, Mr. Chairman. I just wanted to say a couple of comments to support Craig is that if there is any doubt that myself or Craig or Jim

Newsome would speak other than what's on our minds about representing these institutions, I think he is terribly mistaken, is point one.

We have a public responsibility in the case of Craig and I right now in terms of duty to our shareholders and the SEC. So I think John is reaching a bit there.

Two is I think it is an important distinction that while John represents himself as a representative of this industry, he certainly doesn't represent the broader users who drive most of the volume at all of the U.S. exchanges, and I think it is very important to understand the profile of users.

I think thirdly is that like all member organizations that John leads, they are heavily influenced by their policy of their members, and that is a clear transition that, at least in the case of the board of trade, we continue to transition on.

So I'll just leave you with that thought on this topic, and I do look forward to this afternoon to participate on my own panel.

Thank you.

CHAIRMAN JEFFERY: Thank you very much, Bernie.

MR. DAMGARD: I would just like to say that FIA members comprise 90 percent of the volume on U.S. exchanges.

CHAIRMAN JEFFERY: Thank you for that, John.

Okay, getting back to the Commissioners. I'll start in inverse order. Mike, please go ahead.

COMMISSIONER DUNN: Yes, for a point of clarification, are you going to leave the record open for a couple of weeks so that people --

CHAIRMAN JEFFERY: Yes, I think technically it's open for a business week, a week following this hearing.

Let's go back to the Commission, please.

COMMISSIONER DUNN: Just a follow-up on my question. To begin with, I did ask about the

difference between the various sizes and functions of the exchanges, and realizing that we have two of the larger exchanges here on this panel, is there a difference there and should that be taken into consideration as we go about looking at this particular issue?

DR. NEWSOME: My assumption would be, Commissioner, that there are definite changes between the sizes of the exchanges, and that the proper amount of flexibility afforded by the Commission would probably be appropriate to allow both the large and the small to move forward acceptably. But I think you will hear from some of the smaller exchanges later and they can probably more appropriately address that.

MR. DAMGARD: And I would add to that I think that one size does not fit all; that on the Minneapolis exchange, for instance, I suppose half of the clearing members are members of the FIA. Our concerns are never, ever -- we never hear them from Kansas City and we never hear them from Minnesota. So we are not suggesting that anything be done that

in any way compromises the way they are currently doing business.

If they have legitimate FCMs that are local firms that do a fine job of judging what needs to be done on those exchanges, it seems to me that it would be a mistake to do anything to change that. And we support those member exchanges in whatever process -- I mean Jim's argued flexibility, whether or not they would petition for exemptions to the things that you might otherwise require of the larger firms. But certainly in the 20-some-odd years that I have run the Futures Industry Association, the problems that I have talked about and that I have heard about from my member firms do not extend to either Kansas City or Minneapolis.

CHAIRMAN JEFFERY: Commissioner Hatfield. Anything else?

COMMISSIONER HATFIELD: No.

CHAIRMAN JEFFERY: Sharon?

COMMISSIONER BROWN-HRUSKA: I was just reflecting on some of the comments that have been going back and forth between Craig and John, and

also reflecting on Bernie's comments. It is true that the board makes decisions regarding management's hiring and firing and their compensation, and so in some sense you are in a very real sense limited -- it's something that I contemplated coming in here. Everyone, including John, is somewhat limited in a very real sense in what they can say or how they say it in this kind of forum.

So I would just make the observation that, even though I know you come with a desire to be as forthcoming as possible, it is true that these kinds of decisions regarding compensation and hiring and firing are made by the board with regard to your position. Right? And the position of all managers in the exchange.

MR. DONOHUE: Well, I mean if you are making the argument that the board makes the decision on whether to retain me and how to compensate me, I can't argue with that, certainly. Certainly it is the truth of the matter. But I will stand by what I said before. I mean I think we, at

least I'm speaking for myself, operate in a public company environment so I think I have an obligation to the shareholders to say what I think is true, and I think I have tried to reflect what I think is true here today about governance and about some of these issues.

I think you really have to ask yourself the question is there a problem to be solved here, or are we just talking about opinions and perceptions, and I don't know why anyone would be looking at structural changes or systematic changes in the way that these things operate unless there's a true demonstrable problem. And it doesn't appear to me to be the case. It seems to me that these exchanges are growing, they are more outwardly focused than they ever have been in the past. I think they are more responsive to customers and FCMs than they ever have been.

The industry is growing at a rate that far exceeds that of most industries, and so sort of like the old adage, don't fix what ain't broken.

CHAIRMAN JEFFERY: Commissioner Lukken.

COMMISSIONER LUKKEN: I want to pick up on a point that Professor Karmel again had raised. This really deals with the issue of board composition from the SEC perspective, and NYSE perspective. And it seems to me they are coming at this from a different mission than we are, really one of shareholder protection. Exchange boards, like any publicly listed company, have a duty to the shareholders and corporate law requires that as a fiduciary duty as well.

We are coming at it from a market integrity regulatory perspective. There is a conflict at times, I think, in those two missions.

I'm trying to figure out as we look at whether to modify board structures or whether we spend time in this area, ROCs were mentioned as one idea that will be discussed later today. Is this the most focused, tailored way to approach this?

I wonder, even if we made the boards completely independent, that conflict is still going to exist between the mission for the shareholder and the mission for the markets. So I am trying to get

a grasp on what staff thinks about these different areas. Is board composition an area we really should be focused on? And I think obviously independence is going to help in some of those decisions, but even independent members are going to be left with that conflict.

So am I wrong on this? And maybe I'll open it to the board to discuss.

PROFESSOR KARMEL: I think you're absolutely right on this, and I think ROCs are one way to go. You can have other structures that achieve the same objective, but I think it is a very good thing for the CFTC to keep in mind, that there are different constituencies and different public policy interests.

I was on the committee for the review of the New York Stock Exchange. I was on the National Adjudicatory Committee of the NASD. Those were different structures, they operated differently. I think they were both satisfactory, you know, although today much more has been put on these kinds of self-regulatory committees or organizations, more

bells and whistles, more independent structures. But there is a need for a separation between the self-regulatory function and the business function of some kind.

Again, I would urge flexibility and not a one-size-fits-all model, and this gets back to the question that Commissioner Dunn was asking. I would say regulated industries often end up being oligopolies, and I think this is something that any regulator has to really guard against in making rules.

MR. DONOHUE: Walt, I also agree. I think that you have hit the nail on the head. I would actually encourage the Commissioners and the Commission staff to come in and look at what we deal with at the board level of Chicago Mercantile Exchange Holdings, Inc., or the exchange subsidiary, look at the types of things that we as a board do today versus what was true 10 years ago, and you will find that the board is focused on strategy, business plans, expenses, earnings, capital structure, dividends, issues that a public company

today deals with. You won't find a whole lot of activity dealing with regulatory issues at the board level.

Again, separately you will find that there's a very strong record of activity by the Market Regulation Oversight Committee and the various disciplinary committees and then separately the activities of the professional market regulation staff. So I think you have hit on a key distinction. As you think about what changes may be necessary for the industry in the area of self-regulatory organization responsibilities, I would encourage you to not focus so much on -- at least for those of us that are public company exchanges, focus less on the composition of the overall board and focus more on how is the regulatory responsibility being handled, being discharged, how are the decisions being made, by whom are they being made. I think you will satisfy yourself, in our case, anyway, that I think it works extremely well.

But I think the focus here is potentially very confused in talking about the board itself and

the composition of the board. I think it really in fact has very little to do with self-regulation.

MR. JENNINGS: I would just respond to that, I think it must be very difficult -- and I can't obviously put words in Craig's mouth, not being in his position -- but I think it is must be very difficult to bifurcate things that cleanly. And when they are undergoing all this business planning and strategizing, in many, many instances it's going to be addressing competitive issues directly in competition with a number of the institutions that they are responsible for regulating.

So I think in that respect, it is difficult to cleanly split the two of those.

MR. DONOHUE: If I may, again, are we talking about business issues and competitive considerations? Or are we talking about the core responsibilities that we have as an operator of a market, a designated contract market, a designated clearing organization, statutory and regulatory responsibilities? And I do think that that is a

bright line. I think that that is easy to manage separately. We do it, I think, exceptionally well, and I think we can't be confused in this discussion about what we're talking about. Are we talking about regulatory responsibilities or are we talking about the issues of competition between exchanges and their clearing member firms, which aren't new and have nothing to do with whether an exchange is a public company or a mutual organization. That was always true; it continues to be true. It's no different than the past.

DR. NEWSOME: Walt, I think you're completely on target, and it goes back to the comments I made earlier, that I think these are two different issues, a governance issue and a self-regulatory issue. And I think that is in line with your thinking.

I think the independent compliance or self-regulatory committee concept is a very good one, at least the majority made up of independents. Again, in our scenario, the way we define our independents, I think it would not be as effective as potentially

others. But I think you can follow the same line as our audit committee implementing Sarbanes-Oxley over the last couple of years. They did so completely independent of the remainder of the board. The board accepted their findings, accepted the implementation in full, and I think they would do so in the same way with regard to the compliance functions if you set up that similar structure of which the public was currently served in the audit function and could serve in the compliance function as well.

MR. DAMGARD: And I would just argue that there is a difference between a mutualized for-profit exchange and one that is not. I mean there was a time when in a not-for-profit exchange there was not the incentive to raise the fees because there was a natural pressure from the guys on the floor who had to pay it, and in a exchange where profits become primarily the motivation of a board dominated by the stakeholders, it seems to me there is a danger that the public gets the short end of the stick.

Independent, non-industry directors add value. I don't think there is any question about that and that's why the Merc has added them, and that's why there's seven now, and there didn't used to be, and I'd say they're getting there.

DR. NEWSOME: Are the fees a regulatory issue, John, or is that a business issue?

MR. DAMGARD: That's a business issue. But I also think the public interest has to be considered as a part of the responsibility of an exchange and an exchange's board. So I don't think that you can totally disassociate it from the composition of the board.

MR. DONOHUE: I disagree with that. I mean, look, at the end of the day, John, we don't -- I don't think we need this august body to tell us how to do that. If we create value for shareholders, I think it can only be done if we are responsive to our customers and considerate to our customers, or we are not going to create value for shareholders. And that's just a plain and simple fact. I think you are very wrong when you suggest

that customers have to trade at the exchange. They don't have to trade at the exchange. There's all kinds of speculative trading interests with correlations between a multitude of other products that they can trade with and trade European products versus our products and, frankly, it doesn't matter to them.

On the hedging side of it, they have all kinds of alternatives. It's not just a question of whether they have two Eurodollar futures contracts, they have the swap market. You gave the example of we have a virtual monopoly on the S&P 500 stock index futures market. You seem to have forgotten about the CBOEs' S&P 500 equity index products. You seem to have forgotten about equity swaps and all the other things that people can do. You seem to have forgotten about the ETF markets and cash baskets of securities. It's not just true.

So we have to manage our business, we have to manage in the same way that Lehman and Goldman and Morgan Stanley do. You know, how much do we charge our customers, and is it reasonable, and

that's the only way that we can create a good business and that's the only way we can create value for our shareholders. And if we make the wrong steps there, then we are going to destroy value and they will replace us.

MR. DAMGARD: And I just would argue that there is no other place to trade a futures contract on the S&P and there is no other place to trade a futures contract on the Eurodollars futures markets, and those are extraordinarily valuable products for the customers of my member firms.

I'm just saying the market power cannot be denied, that that's where the business is, and it's nowhere else.

CHAIRMAN JEFFERY: Okay. I think that pretty much exhausts the debate this morning. I want to say on behalf of my fellow Commissioners how much we appreciate all of your participation, both the panelists and those of you in the audience who sat through this morning's discussion. I particularly value the frank, honest but civil exchange of views on issues that obviously people on

all sides of these questions have very strong feelings about. It's really incumbent upon us now as a commission to take these comments in this proceeding into account along with all the comments we've received to date, the information and data that's been assembled over the past several years as we have looked at these various questions at varying levels of depth and detail and come back to the community with something further by way of suggested way forward.

Again, thank you all for participating. It's time for a break. We'll reconvene, those of you who are still interested, at 1 o'clock promptly.

And to that end, I am encouraging you to stay. I believe there are sandwiches or coffee or something outside, and then of course there's the Port of Piraeus. I have no financial interest in the Port of Piraeus.

[Laughter.]

So thank you all very much. I appreciate it.

[Whereupon, at 11:56 a.m., the hearing was recessed, to reconvene at 1:00 p.m., this same day.]

AFTERNOON SESSION

[1:06 p.m.]

CHAIRMAN JEFFERY: Good afternoon, everybody. I notice we've had some attrition -- I can't understand why, after that highly stimulating and instructive session this morning, but I also know we have our two wing players here in their familiar seats, Mr. Damgard and Mr. Donohue, as well as some new panelists.

So welcome to the second panel of the day, the subject of which is Alternative Regulatory Structures - Regulatory Oversight Committees and Third Party Regulatory Providers.

Hopefully during this panel we will elicit really a continuation in some ways but albeit in greater detail of the discussion we began this morning related to the separation or the appropriate degrees of separation of the regulatory functions of an exchange from those of the market-making and profit-making functions of an exchange.

To that end, we will adhere to the same format we adhered to this morning, but skip with the

opening statements of the Commissioners, since we have said what we had to say, and then turn to the panelists. And in this case, those of you who have spoken before, don't feel like you have to say something this time, but feel free to say something if you want to say something on this topic.

And in order to mix it up a little bit, with all respect to the president of the Futures Industry Association, Mr. Damgard, I think I'll start from the right this time and we'll hear from Mr. Donohue from the Chicago Mercantile Exchange.

PANEL II: ALTERNATIVE REGULATORY STRUCTURES - REGULATORY OVERSIGHT COMMITTEES AND THIRD-PARTY REGULATORY PROVIDERS **

MR. DONOHUE: Thank you, Chairman Jeffery. I'll be brief since I had the opportunity to talk about some of these topics earlier this morning. But I would like to begin with our point of view with respect to some of the more narrow issues of how to organize the self-regulatory function in the context of a publicly traded exchange today, and in particular advocate for the way in which we have

approached it, which is to maintain market regulation as an internal function and responsibility of the exchange.

We fundamentally believe that the critical mass of expertise that we have achieved over the last number of decades in these markets is critical to ensuring market integrity and maintaining a very healthy market environment for users of our market.

We have, in the case of our Market Regulation Department, senior management that has in most cases 20 or more years of experience, similar depth of experience and knowledge in the financial supervision and capital supervision and audit area, and then again a similar depth of knowledge and expertise in the market surveillance area, dealing with issues related to potential manipulations and other issues that can affect actual prices in the market.

We pride ourselves on the integrated approach, where we bring those experts and professionals together in dealing with market regulation issues. We think it is very important

today in particular that those people be directly involved in new product development, product design, and looking at the way in which the clearinghouse functions, or the way in which we develop technology, all of which sometimes have regulatory implications. So we are a very strong advocate for keeping the self-regulatory function within the exchange itself. It has worked extremely well, we think, and it's been a time-tested and proven model.

Thank you.

CHAIRMAN JEFFERY: Thank you, Craig.

Let's turn to Dan Roth, president of the National Futures Association. Dan, welcome. Thank you for being here.

MR. ROTH: Thank you, Mr. Chairman, and thanks very much for the opportunity to appear here today.

I would like to make a couple of points quickly, if I could, and to the extent possible try to avoid endless repetition of what you heard this morning.

It will come as no surprise to anyone that I am a fairly staunch defender of the self-regulatory process as the president of NFA. And I think it bears repeating that everybody focuses on the dramatic increase in trading volume on the U.S. exchanges, and I always like to point out that there has been an equally dramatic drop in the number of customer complaints over the last 20 years, and that is the result of a very close working relationship between and among the SROs and between and among the SROs and the Commission.

I think the fact that we can ask these very important questions that you are asking here in this forum today and do it an atmosphere that lends itself to very reflective, very deliberate sort of consideration is because we can do this in an atmosphere where we haven't been wracked by scandal and we haven't been wracked by the sorts of problems that have beset other industries. I think that in itself speaks of how well self-regulation has worked.

Obviously there are changing conflicts of interest. It's in the interest of all of us to make sure that those conflicts of interest are managed well. It seems to me that there are three basic tools to manage those conflicts of interest.

One, I think, was touched on this morning a little, and that's just in a certain sense the governance structure of the SRO I think has to be designed to ensure two things:

Number one, to ensure that regulatory activities are appropriately insulated from the business interests of the exchange, but also, number two, to make sure that there is a system of checks and balances in place to ensure that no one group subject to the SRO's regulation can control the regulatory process.

There was an awful lot of discussion about public representation on the board. I think that is important. But public representation on the board isn't an end; it's a means to an end. The end is to ensure that there is a system of checks and balance to ensure that the regulatory process works. Public

representation can be an important part of that, but there are other ways to do it as well.

So I would just again urge the Commission to a point that was made several times, that I think it is entirely appropriate and necessary and critical for the Commission to set standards for SROs to ensure that the checks and balances are in place, to ensure that the insulation is in place, but to do so in a way that doesn't set prescription -- to prescribe how those standards are met.

NFA is a very different creature than exchanges. What works at NFA may not work at the exchanges. Large exchanges are different than small exchanges. So by all means, set the standards, but I think work closely with the SROs to make sure that those standards are being met, without prescribing how they are met.

The red light has already come on, so I will just -- with one final thing. I think a second tool that's available is allocation of responsibilities among SROs. I assume at some point we will talk about the so-called SIA hybrid model.

I think at a conceptual level that has an interest, but frankly, the idea of having a fundamental reordering of the self-regulatory structure in light of a track record of proven success -- I just don't think the case has been made for a fundamental reordering of regulatory responsibilities among the SROs.

And finally, there is no silver bullet on any of this stuff, and I think we all have to bear in mind that there is no substitute for the continuing vigilant oversight of the SRO process by the Commission. I think the Commission has a long track record itself of overseeing that process, but I would remind you what we constantly remind ourselves of at NFA -- we all have to avoid the tendency and the temptation to do things a certain way because that's the way we've always done it.

I think as self-regulation challenges change, the way the Commission oversees the self-regulatory process needs to change as well, and that's something that all of us I think need to be alert to.

Thank you.

CHAIRMAN JEFFERY: Great. Thank you, Dan.

Next panelist is Dean Phillips from George Washington University, former chairman of the CFTC, someone who is steeped in knowledge of the futures industry and governance issues generally. We are pleased to have you with us, Dean Phillips. Thank you.

MS. PHILLIPS: Thank you very much, Chairman Jeffery and Commissioners. I am delighted to be here with you this afternoon.

In the interest of full disclosure, I do want to let you know that I serve on the board of NFA and I also serve on the board of the Chicago Board Options Exchange, which isn't your regulatory purview, but there they do have a futures exchange and I serve on that board, and in addition they have a regulatory oversight committee, a ROC, and I serve as chair of that committee.

I am delighted to be on this panel and I would be happy to share any thoughts with you about our experience at CBOE.

Obviously the whole exchange environment is changing dramatically, probably more so now than at any time in history. It used to be that I think exchanges as SROs, as a condition of membership, had much more control over their members, but that scene is changing dramatically, as you no longer have to have face-to-face meetings to execute trades, you've got distant members, distant market makers, joint ventures, partnerships and so on.

There are a lot of pressures on exchanges. There are organizational pressures coming from inside the exchange, many exchanges wanting to demutualize. Multiple classes of members, so you've got different interests even within exchanges. External pressures. As exchanges become publicly listed. Of course, Sarbanes-Oxley comes into play. And then one exchange says, well, if it's good for that exchange, we should be doing the same kinds of things and board members are putting pressure on exchanges to make changes.

But the exchange community is really not homogenous, and I think that for regulation,

probably one size doesn't fit all. And this clearly is going to have implications, I think, for CFTC oversight. It may well be that what is good for a large publicly traded exchange in terms of compliance function may not be as good for a smaller exchange.

In that case, it may make more sense to outsource essentially the regulatory function or pieces of the regulatory function.

So I will stop at this point because there were a number of questions that you asked, and I would be glad to respond to those when the time is right.

Thank you.

CHAIRMAN JEFFERY: Thank you, Susan.

Next panelist is Chris Hehmeyer, who is the chief executive of Goldenberg Hehmeyer & Company, an active participant in the futures markets of Chicago in particular. Chris, thanks for being here.

MR. HEHMEYER: Thank you, Mr. Chairman, and I would like to reiterate as everybody has said today the gratitude that we all have for you all

holding this hearing. I know it's difficult for you all to get together, government regulations, et cetera, and so for you to have this exercise to air a lot of these issues out, we are all truly grateful for you all doing this.

My own participation here today reminds me of a couple of sayings from my upbringing, which was in Memphis, Tennessee. When I look at my fellow panelists, I can't help but think of the term "high cotton," and I am flattered to be here.

I included in the record my committee experience at CBOT, and not for self-aggrandizement. I think I served on 45 committees at the CBOT in the '80s, including the board of directors, and I include that only to give you some idea of my experience, where I came from. I moved to Chicago out of college and started on the floor as a runner. My partner Ralph Goldenberg and I formed Goldenberg Hehmeyer & Company in 1985, and we have mostly cleared local traders, and we have been fortunate enough to have a good book of commercial ag business.

In my upbringing at CBOT is typical of so many people. The interests of the members and the exchange were so aligned in a mutually owned organization, and so many of us served on those committees. John may have called that cronyism, but the fact of the matter is that many of us spent a lot of time working on committee structure, and I served, as you can see, as vice chairman of the Business Conduct Committee, and in the '90s, you can see my committee service at the board came to an abrupt end because I was elected to the board of governors of the Board of Trade Clearing Corporation, and there was some conflict at times, many of us will remember, between the Board of Trade Clearing Corporation and the Board of Trade, and I served as chairman of the Board of Trade Clearing Corporation, and now I serve in the name of full disclosure on the board of the NFA.

I say all of that because the regulatory structure, in my experience -- and I just wanted you to know that I have been at this for a while here -- for the most part, the regulatory structure of the

exchanges, I believe, has worked very, very well. In my experience, the vast majority of the people that walk in and close the door, that sit trying to determine whether a company or a person has violated an exchange rule, those people are thoughtful, well-meaning, give a lot of effort into trying to understand the issues, and I believe that another term that comes from my upbringing in Tennessee was called the Great State of Compromise. We're really not far apart from what the industry wants and what the exchanges want on this sort of narrowly focused issue of regulatory oversight.

The idea of a regulatory oversight committee that is mostly comprised of, I'm not sure about 100 percent comprised of, but mostly comprised of non-industry people, of independent people is a very good idea, in my view, and would serve like an audit committee of a board and be truly independent, oversees the choosing of the director, the chief staff person at the exchange, the budget, et cetera. But not a separate company. But the committee would be independent.

And then at the disciplinary committee level, there was a quote in the Wall Street Journal in the discussion of the New York Stock Exchange contemplating a separate company by the CEO of the Philadelphia Stock Exchange who said that the inside people, the industry people give you knowledge; the independent people give you wisdom. And I think that's very well said.

So the makeup of the Regulatory Committee Oversight Committee, in my opinion, should be mostly outsiders, and on the disciplinary side it should be mostly but not all industry people because they bring their knowledge.

I don't think that it should be, as I heard Dan Roth say, it should not be prescriptive, and I don't think the exchanges are very far away from that.

So with that, I would like to conclude because I know there will be questions.

CHAIRMAN JEFFERY: Chris, thank you very much.

Speaking of high cotton, let's turn to Mr. Damgard, who needs no further introduction.

MR. DAMGARD: Yeah, you stole my quote on Sandy's knowledge and wisdom, and I agree with you as well.

Also I think cronyism is much better off with guys like you sitting on the board, plus once you learn how to run an FCM, that gave you much broader interest in --

[Laughter.]

Any SRO that operates a for-profit business and performs self-regulation faces an inherent conflict of interest. As a for-profit entity, the exchange must be interested in maximizing trading revenues. As an SRO, the exchange must be interested in rule enforcement and punishing market abuses.

Any large traders that contribute heavily to exchange revenues by abusing exchange rules present this conflict in one of its most visible forms.

On the other hand, for-profit exchanges may use their disciplinary powers as a source of revenue by extracting massive, disproportionate fines for those out of favor.

Recognizing these potential tensions, exchanges have developed regulatory oversight committees to serve as the focal point for administration of the exchange's self-regulatory efforts. While some have called for completely isolating an exchange's business arm from its self-regulatory apparatus, FIA believes that such a drastic measure at this time is unwarranted.

Instead, we suggest a number of ways to make the ROCs more effective and independent. We have recommended that the Commission establish a best practice; that DCMs create formal, not advisory, ROCs comprised of non-industry directors in a manner analogous to the independent audit committees public companies must maintain under Sarbanes-Oxley.

The ROC should be responsible for the full panoply of an exchange's self-regulatory activities

from market surveillance to financial integrity. The ROC should be empowered to select compliance personnel, supervise their activities, and determine their compensation.

It is vitally important that the ROC's self-regulatory staff be independent of management for the SRO's business operations. The ROC would be charged with selecting the members of the exchange's disciplinary panel.

Periodically the ROC should report to the board of directors on the ROC's activities and resource needs. The board would be responsible for making sure that the ROC had adequate resources and could offer advice to the ROC on self-regulatory activities as they arise.

But the self-regulatory buck would stop with the ROC, subject of course to the Commission's oversight. FIA would also encourage the Commission to set performance standards for the ROC and to meet periodically with each ROC to discuss its performance and any interests of mutual interest.

Based on these reviews, the Commission should revisit the performance of the ROCs after an appropriate period of time -- we suggest two years -- to determine whether a total separation of self-regulation is warranted. But for now we recommend giving the ROC structure a chance to work in the public interest.

Thank you very much.

CHAIRMAN JEFFERY: Thank you, John.

Okay, with that, why don't we turn it over to the various Commissioners, and why don't I start with just a couple of questions.

When we think about these ROC issues -- and they get technical pretty fast -- at the risk of oversimplifying, there are sort of three broad categories of issues and sources of difference when one analyzes the various papers that have been submitted.

One question is should the ROCs be optional, advisory, or binding mandatory. Some we note are of an advisory nature; others are more

completely independent and have final authority in the areas of their responsibility.

Secondly, what should the composition of a ROC be? I don't think there is any dispute that there should be some independence there, but how much independence? Is it all independent, majority independent? This is very similar to the debates, but in a different context of the discussion that we had this morning.

And third, what is the reporting of a ROC? If the people involved in regulatory activities are within an exchanges, or a self-regulatory organization, should there be a whole separate reporting line directly to the board? Do they report to management? How should that best be structured?

Those are the three -- covers a lot of ground -- but I would be curious, maybe, first, Craig, if you had any comments on any or all of those three sort of brief takes on those three lines of distinction or difference of opinion?

MR. DONOHUE: Yeah. Thank you very much. I think a large part of what John described is in fact precisely what we have done with our Market Regulation Oversight Committee. It is a committee that is comprised of non-industry directors from our board, so it is people who are not involved in any aspect of futures and options trading or markets.

And, in fact, they have broad oversight for essentially all of the things that John was describing. The charter for the Market Regulation Oversight Committee is available on the corporate governance section of our Web site so everyone can have access to it. But in broad terms, it does have direct responsibility and oversight for all of the regulatory functions of the exchange, including the market regulation function, the market surveillance function, self-compliance and market surveillance, as well as the audit and financial supervision functions of the exchange.

This morning when we were talking about this topic, I described the Regulatory Oversight Committee as very much like what many people would

be familiar with in a public company context, an audit committee, and that the head of Market Regulation and the head of the Audit Department actually report to the Regulatory Oversight Committee. They have separate administrative reporting lines, obviously, to management, but they are, in the same way that an internal auditor would be directly accountable to an audit committee, the market regulation professionals at the Chicago Mercantile Exchange are directly accountable to the Market Regulatory Oversight Committee. The Market Regulation Oversight Committee does have within its scope of responsibility and authority ensuring that the programs are well funded, adequately funded in order to meet our statutory and regulatory obligations.

They conduct a review of our compliance with our different regulatory responsibilities. They actually do review the annual performance evaluations and compensation determinations of market regulation management and professionals, and they have also the ability to employ independent

advisers and consultants in the event that they need to, including legal and regulatory advisers on matters of regulatory policy.

So I think in many respects what we have done is I think unique and a very good model for the industry to follow.

I should mention that in one respect that I think is important we actually go farther than what John was describing in that we actually allow the head of Market Regulation to determine who should be appointed and comprise the various members of the Probable Cause Charging Committee as well as the different disciplinary committees. That is not a decision that is made by management. It is also not a decision that is made by our board of directors. It is a decision that is made by the people and the professionals who run market regulation.

CHAIRMAN JEFFERY: Thank you.

John, did you want to speak?

MR. DAMGARD: I was curious to know whether or not their ROC reports to the board, and if a recommendation by the chairman of the ROC on behalf

of the ROC, if that recommendation is rejected by the board, is there a mechanism whereby that becomes public information, or should that be reviewed by the CFTC? Or is it independent and the recommendations automatically become policy?

MR. DONOHUE: Our Regulatory Oversight Committee is not a separate board, it's not a separate company, and so obviously in keeping with the structure of our company, it's a board-level committee and so it does fit underneath the board of directors.

I don't think we have had any instance in which there has been a determination by the Regulatory Oversight Committee that has been reviewed by or modified or changed or altered by the board of directors. But obviously if there were something like that, it would be recorded in the minutes of both the ROC committee as well as the board of directors, which the CFTC has access to and is welcome to not only look at on a historical basis but certainly on a going-forward basis.

CHAIRMAN JEFFERY: Thank you both.

Commissioner Lukken.

COMMISSIONER LUKKEN: Specifically on some of the authorities that were described that a ROC should have, I'll maybe direct this to Susan, being a chairman of a ROC -- I mean in your view, what are the tools you need in a ROC in order to fulfill the mission that has been asked of you of a public company? We talked about rulemaking, compensation of the regulatory staff, separate counsel has been mentioned. You need experts at your disposal. Do you have those resources available to you? All these sort of authorities. And it would be helpful, I think, for us to know which ones are necessary and which ones aren't in order to fulfill your public mission.

MS. PHILLIPS: Well, let me say that the ROC at CBOE has been in existence since 2000, so it has been operating for a while. We have made changes to it over the years.

It is a board committee, so the members of the ROC are all independent directors of the board, and I brought with me a copy of the charter of the

committee, and I will be glad to let you have a copy of that. I checked with them this morning; it's fine for me to let you have a copy of it.

It has as its major mission really to keep the regulatory functions of the exchange free from inappropriate influence. So it has a very broad, general mandate.

We are required to meet at least four times a year. Since I have been chair, we have been actually ending up meeting about six times a year, including one meeting a year with the senior staff at the SEC.

So far as I know, we are the only ROC under SEC supervision that does do that.

We have a -- there is a direct line of reporting between the ROC and the board. I make both a written and oral report to the board once a year, and then in between on an as-needed basis, the Chief Regulatory Officer, the CRO, of CBOE, he reports directly to the committee, and we also meet with him in private session at the end.

So we operate very much like an audit committee.

In addition, CBOE has set up an internal regulatory auditor, and that person resides in the audit department of CBOE, and we meet with that person on a periodic basis.

The other person that we meet with regularly is the Chief Enforcement Officer, and CBOE has set up their system so that if there are appeals from the Business Conduct Committee, they come to the ROC. So we regularly hear about the enforcement decisions.

Now the ROC does not do rule writing, and I want to emphasize that. In fact, we have been asked a couple times should we take that on, and we consult, but it is not our primary role.

We have all felt that because we are all independent that it would be better to have a lot of input from the members of the exchange in writing the rules. This is where the "self" of self-regulation is really important.

So no rule writing, but compliance and enforcement are the things that we focus on.

We do have ability to hire independent outside advisers. The staff of the regulatory division report to us, but for administrative purposes do report to the management of the exchange. But we oversee the budget, staffing, and technology support. That turns out to be a very important sort of day-to-day operating challenge for the regulatory people.

So we in fact meet with the technology people at the exchange. So it is a broad-ranging committee.

We have also overseen, depending on what's going on in terms of SEC rulemaking, we have often also looked over and edited, made comments on exchange responses to rule proposals that have come out of the SEC.

So we are actively involved in an advisory capacity, but our major focus in terms of our charge is really compliance.

COMMISSIONER LUKKEN: Thank you.

CHAIRMAN JEFFERY: Sharon.

COMMISSIONER BROWN-HRUSKA: Well, I think it is really fascinating to see how these have evolved, and I really do think that it is appropriate to commend the CME and the CBOE for moving in this area. I think they have really been on the cutting edge to accommodate this desire to manage the conflicts we are concerned about here.

I am interested in probing the specifics, and Susan raised a number of the important issues that I am interested in.

You mentioned that the ROC does not write rules, and you also mentioned that the ROC reports directly to the board and discusses also from time to time with the SEC matters of interest.

Is there a formalized structure -- and I'll ask this to Craig also -- is there a formalized structure wherein the SEC would intervene or would review the activities and the decisionmaking of the ROC?

MS. PHILLIPS: They haven't so far. So far what we have done is we have sought to meet with

them, so this is sort of voluntary on our part to seek their input. And when we meet with them, I might mention that it's just the independent directors; no CBOE staff are present when we meet with them.

I think that they have appreciated the opportunity to ask lots of probing questions. So I think that the -- and we have really emphasized not getting involved in the writing because I do think that is a broader based kind of thing that really does require the input of the industry. So that was the second area that you mentioned.

But like anything, it is a committee of the board and certainly the SEC has the right to review all the minutes and the minutes of the board meetings, and through their rule enforcement review process, if they come in and do a rule enforcement review, one of the things that we do is oversee how the recommendations are being implemented, or how the exchange is responding to that.

So we are involved in that process, but the SEC has maintained its direct oversight through its rule enforcement review process.

COMMISSIONER BROWN-HRUSKA: Craig, then I guess I would put it to you in the same general question, but from the perspective of the CME -- who the ROC answers to and what kinds of authority they have. It also goes to this issue of whether they are primarily advisory or whether they have real influence -- the force of authority where they can make decisions. That's one issue that I would ask you to speak to, and then the other is, would you be averse to a review process wherein information or discussion took place between the ROC, apart from the rest of the board, with the CFTC?

MR. DONOHUE: Yeah, I think Susan said it well and essentially reflected the same way in which it works within the CME Regulatory Oversight Committee. So I don't really have anything to add; I would just be repeating what she has already described because it's essentially the same as how we approach it.

On the first question, as I indicated before, the Regulatory Oversight Committee is a committee of the board. It has actually authority, though, for the things that I described earlier within its charter or jurisdiction, if you want to think about it that way.

And like other board-level committees like the Audit Committee or the Compensation or the Governance and Nominating Committees, it certainly does make regular reports of its activities to the board.

As I said earlier, it makes those decisions. I'm not aware of any instance where the board has altered a decision of the Regulatory Oversight Committee. Theoretically that could happen, but again that would be a matter of public record.

Obviously you are aware the CFTC conducts regular, on-going rule enforcement reviews of us as a designated contract market. We would not only welcome but encourage and fully expect that in that process or in the course of conducting that, if

there were a desire to interface directly with the Market Regulation Oversight Committee, we not only would not oppose that, we would welcome that.

CHAIRMAN JEFFERY: Commissioner Hatfield?

COMMISSIONER HATFIELD: Just to follow up on the point about the report that you do as chairman of the ROC to your board every year, I gather from what you say that that report is not submitted to the SEC. Being that is correct, is there information in that report that you would be reluctant to share with the SEC?

MS. PHILLIPS: No. It's just they, I think, get lots of paper, and it's part -- when it's submitted, it's part of the minutes of the board, and they have access to it. So it is really their choice if they want to review it.

But we tell them when we meet with them in the -- I make my report to the board in January, meet with them usually in the spring, and I tell them what we have done the last year. So they have an oral report, and they can follow up if they want to.

COMMISSIONER HATFIELD: Thank you.

Craig, in your written submission to the Commission, there is a really, I think, good point and an interesting point that I want to delve into a little more, and perhaps, Susan, you might have a take on it, too. But you're talking about the regulatory function and the business function, if they were to be completely separated how that might hurt in surveillance and innovation with technology especially. Can you talk to that a little bit -- I mean that sounds really good. I'm just trying to find out how real it is.

MR. DONOHUE: Well, we think it's very real, and I think the unfortunate circumstances of Refco are a great example of that, when we need to come together to solve very difficult problems.

But I think it is a very important aspect of what we do, particularly as we innovate in new areas, new markets, and new products. It is very valuable to have market regulation professionals involved in that process, so that they can have input, for example, into contract specifications or

contract design choices that could have implications for the capabilities of the market regulation function or its effectiveness in ensuring market integrity as we launch new products.

One of the other values to having that sort of cohesive, cross-functional involvement within the exchange enterprise itself is that it allows us not to have to catch up on the market regulation side in terms of technology.

You know, Susan mentioned that there is a great deal of involvement in understanding what the needs of the market regulation function at CBOE are in terms of technology. Having the ability to interface our market regulation professionals with our technology organization, with our product development and research organization gives us the ability to essentially ensure that from the day that we launch our product, we are going to be well-positioned to have the correct information that we want, that we think is appropriate for regulating the market, and that it won't become a sort of follow-on technology priority that we need to sort

of get around to some day when the business priorities are exhausted and we can get around to market regulation types of priorities.

So I think from that perspective, it's very, very important.

And then I guess the other aspect of that is this sort of interdisciplinary approach where it is valuable to us to have our compliance, our market, surveillance, and our financial supervision and capital supervision and audit function working very closely together so that we have the truest picture of the total situation that we might be dealing with, whether that's a market manipulation kind of problem, a trade practices kind of problem, or a financial condition or sales practice kind of issue. And I think that integrated approach really has served certainly the Chicago Mercantile Exchange very well, and I think it has existed at other exchanges quite well, as well.

MR. ROTH: Let me just mention that obviously certain exchanges and the newer entrants have chosen to outsource certain functions related

to surveillance to NFA by contract that have been approved by the Commission, and I would just like to point out that for those exchanges, our contracts with those exchanges -- and those contracts have always been reviewed by the Commission -- they expressly call for and require the exchanges to consult with NFA well in advance of the introduction of any new products, precisely so that we can make sure that they are advised of what the surveillance implications would be of a particular contract and so that we can work with them to make sure that both they and we are ready for the introduction of those new products.

So our contracts require that sort of consultation so that we very much don't want to be in that situation where we are taken by surprise and our technology or surveillance programs aren't up to gear for the new product.

MR. DONOHUE: If I could just add something that I didn't really get into, but one of the things we believe is that having the market regulation functions as I have described them within the

exchange is also valuable from the perspective of attracting or retaining, we think, very talented professionals, because the career path opportunities for them are multidimensional.

I mean just in thinking back over the last 20 years, we have had a large number of people that have started out their careers in Market Regulation or maybe in an early part of their career -- including myself, by the way -- spent time in market regulation and many of those people have gone on to pretty significant positions in product development. Some of those people have gone on to run clearing member firms or into other areas of the exchange. And we think that that is sort of an added benefit of this retention of the regulatory functions within the exchange. It gives people, I think, very broad opportunities.

COMMISSIONER HATFIELD: We should keep that Donohue window open?

[Laughter.]

MR. DONOHUE: You would have done better than I, but --

COMMISSIONER HATFIELD: Thank you.

MR. ROTH: I would point out that Bernie Dan's first job in the futures industry was as an NFA auditor. He's done somewhat better than a lot of our auditors.

[Laughter.]

Fred, the one point that I think is important is that exchanges make business decisions as to whether to outsource certain functions or to do them inside. It seems to me that from a regulatory point of view that the critical point is that regardless of the business decision made by that exchange that the regulatory policies and the standards to which they are held by the CFTC have to be the same. So that in certainly every facet of our operations that we perform on behalf of exchanges are subject to the Commission's oversight authority, just as if it was being done by the exchange. We're held to the same standards.

Those exchanges are held to the same standards as other exchanges, and the Commission's

access to information from NFA is the same as its access to information from the exchange.

So it seems to me that the exchanges make business decisions as to how to carry out these functions. The important thing from my point of view is that the regulatory policies and standards are the same regardless of what decision the exchange makes.

MS. PHILLIPS: I would like to endorse the comments that have been made regarding the need to have some integration of the regulatory with the business side.

As new products are developing, if there are going to be regulatory issues that are going to raise their heads, it would be better to find out about it early because the worst thing in the world is to have a new product introduced and then to have regulatory problems with it.

So the goal, of course, is to try to get the regulation hard wired so that at the time that you introduce the products, you are ready to go with both the regulation and the product.

So that takes participation on the budget front, on the systems front, and so on. So it does require some integration.

I would mention that one of the things that we have done at the CBOE ROC is we have given thought to outsourcing, and we have developed -- we have done two kinds of outsourcing so far.

One is sales practice audits are now being done by the NASD, so that was an area that was outsourced.

The second area is they set up sort of a joint SRO function and for auditing and looking after insider trading investigations, and all of the exchanges, SEC-regulated exchanges, belong to that and actually CBOE does that piece of it.

So other exchanges have contracted with CBOE. So the point is there are different ways to do this, and different kinds of functions may require different arrangements. There are a number of ways these things can work.

MR. ROTH: I think CBOE futures has just entered into an agreement with NFA to outsource

certain functions related to its futures contract, and all the integration sort of procedures that Susan has mentioned and that are incorporated into that contract as they are in all of our other contracts.

CHAIRMAN JEFFERY: John.

MR. DAMGARD: We have an awful lot of agreement on this panel. I must say the model that Susan describes and replicated to a large degree by Craig is extremely attractive. But I should say it's more attractive by virtue of the fact that the independent directors or non-industry directors at the CBOE are responsible for selecting the other independent directors, and that further divorces the commercial aspects of the exchange from the regulatory exchange.

The independent directors, therefore, would have a higher responsibility of picking other independent directors who have an interest not just in the commercial aspects but the self-regulatory responsibilities of the exchange.

CHAIRMAN JEFFERY: Thanks, Fred.

Commissioner Dunn.

COMMISSIONER DUNN: Thank you, Mr. Chairman.

Following up with my multifaceted questions -- I learned that from watching the White House press corps at work -- I would like each of the panelists to very precisely tell us what they think the single most important feature that is needed to establish a firewall between the commercial and regulatory interests. Just one. So I'm limiting you, I want to know your priorities there.

For Chris and Susan -- Chris, I got this list of the committees, the 45 different committees you have been on. I would like you to maybe amplify a little bit about the time it takes to be on these committees and what resources you feel that you need to be effective in there.

And then for all the panelists, again, a follow-up on Susan's question is what is the role that the CFTC and the CFTC staff should have with a ROC committee.

John, would you like to start off?

MR. DAMGARD: Well, I would encourage a more aggressive oversight and interaction between the ROC and the CFTC staff. I think Susan made the point with regard to meeting with the SEC once a year. I think that is a very, very important part of the ROC's responsibilities, meeting with the CFTC once a year. And as we describe the ROC, I also think that the establishment of a ROC is probably the best way to build a firewall with the features that we have thought about and talked to in our testimony.

MR. HEHMEYER: The structure that we are discussing, as I say, is in my view in those committees, and those committees take a lot of time, the many afternoons that you spend listening to whatever the issues are, whether they are regulatory committees or new products or rules or whatever those committees. They do take a lot of time.

The members of the exchanges have a lot of interest in it functioning well, and as I said, in my opinion, all of the way that they've got it set it up now, particularly the Merc and with a little

compromise the board could move in that direction, and they have just gone public, so they are moving in that direction, I think. That all works very well.

The independents, I think, is the single most important wall there, and I think it will probably work pretty well.

What I would say, though, is that the Commission's job is whatever you all decide and however you then approach it, your job, I think, is not over because this has been a bit of a honeymoon. These stocks have taken off, the exchanges have done very well, they have performed their regulatory function well. But it would only take a couple of bad quarters, God forbid, on the part of the exchanges, for there to be pressures on some of the conflicts that haven't revealed themselves in the past.

I think it will be those bigger issues, fundamental issues between the commercial interests -- and not necessarily the regulatory side. I don't want to suggest that that hasn't worked well because

it has. But the commercial issues that were approached in the last panel are probably the bigger issues.

MS. PHILLIPS: I'll try to respond to all three of them.

First of all, with respect to the single most important firewall, I think that the job stability of the Chief Regulatory Officer is probably the most important thing. That person has to feel like they can get directly to the board, and if they take a stand, they are going to be heard and backed.

In terms of resources, time, I know it sounds like we do a lot on the Regulatory Oversight Committee. I would liken it to an audit committee. I don't think it's much different in terms of load than any other audit committee of a large corporation.

Clearly it is important to have good staff support, and for that staff to help you, help set the agendas, assemble the materials, so that you

don't abuse those independent members' time, and to make them willing to continue to serve.

In terms of the role of the CFTC and the CFTC staff, mentioned earlier, you know, submission of materials by the ROC to the Commission -- that is certainly one way. I guess I'm a little skeptical that you start to get mountains of material and how much of it really gets carefully read or becomes so rote that you miss the big issues.

I tend to think that it's better to look at it, maybe spot check when you come in to do a rule enforcement review, then maybe sit down and look at a set of minutes.

I also think that periodic meeting, either with the chair of the Regulatory Oversight Committee or the full committee, is a constructive thing.

The staff can learn from that what's going on, and I think it creates a better open dialogue.

MR. ROTH: I think I'll just make two points, Mr. Chairman:

The first is just as I had mentioned in my opening comments, that I think it is important to be

sensitive to differences between SROs. At NFA we have a group of people who have nothing to do in overseeing business operations, who are exclusively devoted to overseeing NFA's regulatory activity, and we call it our board of directors, because NFA doesn't operate an exchange. All we do is regulation, and our board has traditionally performed exactly the same functions as a ROC because that is really their sole mission.

So I think in discussing it, I would just like that distinction to be brought in mind. I think it is consistent with the point that we should be setting standards and work with each exchange and each SRO to make sure that those standards are met.

CHAIRMAN JEFFERY: Craig.

MR. DONOHUE: Commissioner Dunn, I think the single most important facet of this is really having an effective and specific confidentiality policy and internal controls related to information of a regulatory nature that cannot pass through to the commercial or business interest side of the organization.

We have adopted a specific confidentiality policy for market regulation and audit department professionals pertaining to position data, financial information, detailed transaction data, and other investigative materials and information, none of which is allowed to be accessed outside of those regulatory professionals that are involved in market regulation activities. And we must have internal controls designed to ensure that that actually happens, and it's not just a piece of paper that people forget about.

So I think that is, from my perspective, the most critical aspect to making this work, although there are obviously many critical aspects.

On the second part of it, our experience has been our Market Regulation Oversight Committee typically meets I would say for two to three hours anywhere between four and 10 times a year, and I would say that the matters that they are looking at are rather substantive and rather complex, and they normally are meeting, frankly, with the market regulation professionals. I don't attend those

meetings, unless I am requested to do so for a specific reason, and neither do other of our management. So it's very much oriented toward the type of process that you would have again for an audit committee.

On the third part of it, I think again similar to the audit committee, the external auditors will interface with professional management of the exchange 90-plus percent of the time, but they will interface directly with the Audit Committee alone regularly, certainly at each audit committee meeting, and I think that that is again very appropriate in terms of the CFTC.

MR. HEHMEYER: That's a better and more precise description of the type certainly than I gave. That's very good. That's about what it takes.

CHAIRMAN JEFFERY: We should probably wrap this up. Any questions from the floor? Comments? Panelists? Fellow Commissioners?

Sharon.

COMMISSIONER BROWN-HRUSKA: I wanted to once again follow up on this issue of rulemaking because I think that this is an important issue, and I note that in FIA's statement they suggested that the ROC should have rulemaking authority. Going back to my original statement, which was my concern, that in fact we see a new competitive environment coming from firms and globally, as well. My question is -- and I'll put it to John first and then anyone else who would like to answer. How can we ensure that exchanges don't use their SRO power, their rulemaking power, to pass rules in such a way to foreclose competition or activities by their member firms that they regard as detrimental to their business activity?

MR. DAMGARD: This is a concern, and I think that is one of the reasons why we suggested that the ROC should have rulemaking authority. I guess it is possible to have the ROC review rulemaking authority, but the real protection against that, Sharon, is the core principle that requires the exchanges to refrain from any

anticompetitive activity, and from time to time we are not always convinced that some of the things that take place on the exchange are in compliance with that anticompetitive core principle.

So we would only encourage the CFTC to look more carefully at those issues when and if they are called to your attention by, among others, us.

CHAIRMAN JEFFERY: Other comments from our panelists? We'll just go down the line. Chris, go ahead.

MR. HEHMEYER: The exchanges in many ways -- we are not going to decide this certainly here today. As I said, the issues are sort of out there, because the exchanges today don't really need the regulatory rulemaking authority really to use for anticompetitive reasons, in many ways, because a lot disagree with what Craig said this morning. They don't need that to have it to be a marketplace.

At our exchange, we trade a lot at the Eurex exchange and pay them a lot in fees, and at the beginning of this year they sent us a notice and said the line charges to the exchange, the

connection to the exchange, electronic connection, was going to 5,000 Euros a month; kindest personal regards for the New Year, have a nice New Year.

You either quit the business or you have got to pay. And so they don't need a rulemaking authority to do that. And so those issues, I think, are out there, and I don't think that they are using the regulatory side of things to be in a competitive -- certainly yet, so it has yet to play itself out, but they have done a really good job so far.

MS. PHILLIPS: I just wanted to add and maybe clarify, the regulatory oversight group at CBOE can make recommendations on rules. Largely, and they have done so largely having to do with regulatory procedures, internal procedures. But it goes to the full board, and is reviewed by other committees. So it all comes together at the board, and any rules that are approved go through the board process.

So whether we like it or not, I think it comes back to the governance process and the

independence of the board to really make those kinds of reviews meaningful.

MR. DONOHUE: Just to add to that, I think this is precisely the value of the market Regulation Oversight Committee. I think we have to acknowledge that there are instances where an exchange may take some action, may adopt some rule or interpretation that firstly could have the appearance of being done for competitive reasons or competitive purposes, apart from whether that's really true or not, or even could have the potential to do that for competitive reasons.

In our case, where we have had that come up, and it hasn't come up often, that has been the value of the Market Regulation Oversight Committee which is that we have referred those kinds of rulemaking activities to the Market Regulation Oversight Committee so that they independently and in consultation with the market regulation department strictly focused on what is appropriate as a self-regulatory organization determine what should be, and so thereby insulating them from

having to worry or think about is there a separate sort of competitive or business interest associated with what the result of that rule might be.

I think firstly that is the purpose and the value of these kinds of regulatory oversight committees when they are used correctly. I think their access to outside independent legal and regulatory advisers is also imperative in order for that to work properly, and so that's how we have constructed it.

And then I just want to add that I think it is important that it not be lost, that of course the CFTC has the ability to determine and review whether these rules that are adopted are appropriate and are in the best interests of the market, and I don't think anyone should be suggesting that that is not the case.

So I think that system has worked very, very well for a long time.

CHAIRMAN JEFFERY: With that, why don't we try to wrap this session up.

One thing I would note is I sense a lot less contention and a lot more consensus on this panel, whether we attribute that to substance or the first hour after lunch, I don't know. The devil is in the details, but I'll leave that for the fine-tuning.

But thank you all.

Why don't we reconvene at 2:25 promptly and try to get this moving and shorten the afternoon, if possible. But thank you again.

[Recess.]

CHAIRMAN JEFFERY: Why don't we get started here. I think we are going to take some liberties with the schedule, given that every time we have a break, we seem to lose more people. By popular demand, we are going to try to go through the afternoon, the next two sessions, we are going to truncate them probably by 10 minutes, skipping the break. We may have a stretch where everybody can feel free to get up and walk out if they need to, or make a call or whatever, but in the interest of moving this along and being respectful of other

demands on people's time, we'll try to compress the next two sessions and get you out of here somewhat earlier than originally anticipated.

The next panel, for those of you who don't have a schedule is Enhancing Self-Regulation Through Increased SRO Transparency and Disclosure.

That sounds a little bit like some of these "lose weight quick" schemes we see advertised on the cable networks. I won't pursue that analogy, but our distinguished panelists, we have again some repeats and some new panel members.

I would like to introduce our two panelists, new to this group and new to today. We have Mark Bagan from the Minneapolis Grain Exchange, known to many of you, but for the first time to appear on the panels today, and who will give us a particularly interesting and needed perspective of the special situation which I think is unique in many respects of some of the non-public, more specialized exchanges and the things that are of most concern to their community.

Then we have Ruben Lee, who is here from London, managing director of the Oxford Finance Group, a research and consulting firm, who has written extensively on the subject of exchanges and exchange governance and brings to us really an international perspective -- not that we don't have others in this room who can provide that -- but a unique kind of comparative perspective on these issues, many of the issues we have been addressing over the course of the day, and how they have been dealt with or thought about in other jurisdictions that operate developed capital and futures markets.

So without further ado, why don't I turn to our first panelist, Mr. Bagan, from the Minneapolis Grain Exchange.

Thank you, Mark.

PANEL III: ENHANCING SELF-REGULATION THROUGH INCREASED SRO TRANSPARENCY AND DISCLOSURE **

MR. BAGAN: Thank you, Chairman Jeffery.

The Minneapolis Grain Exchange appreciates the opportunity to participate in these public

hearings on self-regulation and self-regulatory organizations with the United States futures industry.

The Minneapolis Grain Exchange is a not-for-profit self-regulatory organization, and our clearinghouse is a division within the exchange. The Minneapolis Grain Exchange is in the process of celebrating our 125th anniversary. The value of that statement is two:

First, obviously, self-promotion, but secondly and more importantly --

[Laughter.]

CHAIRMAN JEFFERY: That's okay; it's allowed.

[Laughter.]

MR. BAGAN: But secondly and more importantly, it is to point out that we have been an institution, we have been in this industry for a long time.

The MGX, along with the other exchanges, has seen many changes to our industry and our markets over the decades. One change in particular

the MGX is pleased with was the Commodity Futures Modernization Act and the movement towards core principles.

The CFMA and core principles have led to new exchanges entering the marketplace, and record volume within our industry.

From the MGX perspective, it was also recognition that prescriptive regulation or the one-size-fits-all model is not what is best for everyone.

As a smaller exchange, we strongly support this approach.

Additionally, I would like to point out that each of the exchanges has a common interest in ensuring fair and competitive markets, along with protecting customers.

Effective self-regulation is vitally important to ensuring market integrity and proper function of our marketplaces. Our reputation as exchanges is based on our ability to ensure market integrity and the proper safeguards are in place.

If we were to fail, our customers would have a choice and they would find another marketplace.

In closing, the Minneapolis Grain Exchange does not believe any changes need to be made to the current self-regulation model. We believe it is efficient, and that is evidenced by our market growth.

However, in the event the Commission believes change is necessary, the Minneapolis Grain Exchange requests the CFTC note the distinctions between publicly traded and non-publicly traded exchanges, as well as profit and not-for-profit exchanges.

The MGX would ask that the progress resulting from the CFMA and core principles continue forward with the flexibility being afforded to all exchanges and more particularly to smaller exchanges such as the Minneapolis Grain Exchange.

Thank you.

CHAIRMAN JEFFERY: Mark, thank you for that.

Bernie.

MR. DAN: Thank you, Mr. Chairman.

CHAIRMAN JEFFERY: Good to see you again.

MR. DAN: Good to see you again.

I am pleased to be here today, and thank you, Mr. Chairman, for the opportunity, as well as your fellow Commissioners and senior staff that has helped prepare this.

Before I go on with a few prepared remarks, I do want to lay a background just to be clear. I did begin my career with NFA, and I did learn a lot of the industry rules and regulations from that time. I did spend 17 years at Cargill Investor Services, the last three of which were as CEO. We were one of the larger members of the FIA at the time, and so my perspective as I sit here today as the chief executive of the CBOT is fairly broad within the industry, and I would say representative of both sides of some of the perspectives.

I will say that in the context of that, it is clear that even as members of the FIA, as CIS was at the time, we didn't always necessarily agree with the perspectives put forward, and that is consistent

with my thoughts earlier, is that all industry representatives need to be represented equally to the extent they can.

Self-regulation has been a cornerstone of the regulatory structure for the U.S. futures markets for many years. At the CBOT, we pride ourselves on the regulatory standards we have established over the years which are not only rigorous but also fair and balanced.

As the exchange industry evolved, we continue to develop these standards to uphold the integrity and soundness of our business and our marketplace.

Under the oversight of the CFTC, designated contract markets have long demonstrated the ability to effectively regulate their own numbers through the establishment and enforcement of rules and regulations that are designed to ensure market integrity and protect customers.

This has been accomplished through various forms of exchanges ownership, governance models, and regulatory structures.

We understand and agree with the Commission that methods and processes of futures industry self-regulation should periodically be examined to ensure they remain effective as business and governance models progress.

That said, the CBOT continues to believe in the value and strength the current system of self-regulation affords the U.S. futures markets, and that the SRO system, combined with Commission oversight, is the most appropriate model of regulation for often complex and ever-evolving industry.

So with that, I would like to say thank you for the opportunity and I look forward to any questions.

CHAIRMAN JEFFERY: Thank you, Bernie.

We will introduce our next panelist, whom you have also not seen before, at least not on this panel -- Mike Schaefer from Citigroup Global Markets -- not only representing Citigroup but also as the chairman, if I'm not mistaken, of the NFA.

I appreciate your being here, Mike, and value your perspective.

MR. SCHAEFER: Thank you very much, Mr. Chairman, and good afternoon to all the Commissioners, to my fellow panelists, and everyone in attendance.

I am the managing director of Citigroup Global Markets, Inc., and on behalf of Citigroup I am pleased to have the opportunity to participate in today's hearing.

I have spent the entire 40 years of my professional life in the financial services industry, the last 30 years specifically in the futures industry.

To continue the full disclosure of the panelists who have gone before, in addition to my role at Citigroup, I am currently chairman of the National Futures Association, a member of the Executive Committee of the New York Clearing Corporation, and a board member of the Futures Industry Association.

I am a member of the Chicago Board of Trade, NYBOT, and the COMEX division of NYMEX. I currently serve on the COMEX Adjudication Committee, and have in the past served on various exchange disciplinary committees.

Today I am speaking solely on behalf of Citigroup.

Citigroup Global Markets, Inc. is a registered futures commission merchant and broker-dealer. Measured in terms of customer futures funds under segregation, we are currently one of the three largest FCMs. We are members of the Chicago Board of Trade, the Chicago Mercantile Exchange, NYMEX, the New York Board of Trade, the Kansas City Board of Trade, the Minneapolis Grain Exchange, the U.S. Futures Exchange, the Winnipeg Commodity Exchange, and various exchanges throughout the world through our affiliates.

On the securities side we are also members of the New York Stock Exchange, AMEX, NASDAQ, and other major securities exchanges.

And, of course, we are members of both the NFA and the NASD.

So clearly Citigroup is familiar with self-regulation and with a wide variety of self-regulatory organizations.

Citigroup firmly supports the concept of self-regulation. Over the years the basic concept of self-regulation has worked well for the public, and for the industry. However, as exchanges move away from floor trading to electronic trading and to a for-profit, publicly held business structure, and as the business activities of both exchanges and intermediaries have evolved, there is a need to continuously reassess how self-regulation works in the context of potential and sometimes actual conflicts of interest, and whether there are ways for self-regulation to work better.

So we commend the Commission's review of the relevant issues through the public comment process and its consideration of the remarks it will hear today.

Given the focus of this panel on transparency and disclosure, I will limit my opening remarks to that topic. However, I should note that Citigroup participated in drafting comment letters on the broader range of SRO-related topics that have been submitted by the FIA, and we support the substance of those comment letters.

I would add that the issues I and others will discuss during this panel on transparency need to be viewed in the context of other aspects of SRO structure and functions.

For example, in considering the process an exchange uses to adopt trading rules, we should look not simply at the transparency of the process itself and the oversight role of the CFTC, but also at how the exchange is structured and how the exchange organizes its regulatory versus business function.

On the issue of transparency, we believe that there is a need for limited changes in the exchange rulemaking process, including adoption by exchanges of substantive rule interpretations.

As we all know, exchanges have dual roles. As business enterprises, we understand and agree that they need the flexibility to make commercial decisions and change behavior to respond to business conditions, and to do so without intrusive government regulation.

In fact, Citigroup, like other FCMs, has ownership interest in some exchanges -- in Citigroup's case, most notably the CME, the CBOT, the U.S. futures exchange, and the Philadelphia Board of Trade -- and therefore has a commercial interest in the exchanges' business successes.

However, exchanges also have self-regulation powers and concomitant responsibilities. Exchanges can adversely affect their members and market participants directly through disciplinary actions, through adoption and interpretation of trading rules, through changes to contract specifications, and through commercial actions that may in fact compete with their members.

At the same time, they hold highly confidential information about their members gained

through their audit functions, position reporting, large position accountability reviews, and exchanges also have statutory immunities that attach to some aspects of their conduct as SROs that make it difficult to challenge in court many exchange actions.

It is important to bear in mind that an FCM's DSRO can in fact be a competitor with the FCM or with the exchanges of clearing organizations that the FCM may partially own.

In light of all these factors, when exchanges adopt and interpret rules, they have a responsibility not just to be fair but to observe scrupulously even the appearance of fairness.

In its January 23rd, 2006 comment letter to the Commission, the FIA observed that too often exchanges adopt major rule changes without adequate across-the-board vetting and comment by all sectors of exchange membership and market participants. These exchange rules may be as significant, if not more significant, than regulations adopted by the Commission itself.

We agree with those characterizations and we encourage the Commission to consider two responses:

First, in those instances in which an exchange would change the terms and conditions of already trading futures and options contracts and where those changes are likely to have a material and immediate impact on the traded price, or adopt a rule that would change materially the financial risks and obligations of participants in a derivatives clearing organization, we believe that self-certification has not been an adequate process.

Instead, in the very limited circumstances I described, exchanges should be precluded from self-certifying and instead be required to seek an expedited commission review with a meaningful opportunity for public comment.

Under this formula, most exchanges' rules could continue to be self-certifying, but we believe this strikes a more appropriate balance between the desire for flexibility and the need to preserve the integrity of the exchange trading markets and ensure

that the views of all with an economic stake in the markets are considered and ensure that the Commission and the public have a realistic degree of oversight.

I understand there has been considerable discussion of whether the Commission's existing statutory authority allows it to adopt such a requirement.

If the Commission does not believe it has the needed statutory power, we would urge you to support amendments to the CEA to explicitly provide that authority, and we would support the needed amendments.

Second, we believe that the industry and Commission would benefit from greater transparency and predictability in how the Commission itself handles its oversight of exchange rules submission and interpretative actions. It is not clear what procedures the Commission applies in its consideration of self-certified exchange rules.

The FIA has cited as examples the CME's 2004 fictitious trading interpretation and the

approval of the CBOT's self-certified Treasury position limits. We agree that in both cases, there has been a marked lack of certainty on how the Commission would proceed with the review.

To date, there has been no Commission action or report on the CME interpretation and considerable questioning of the recent Commission approval of the CBOT's self-certified Treasury position without a public comment process.

This is an area where the public and the industry in general should have greater clarity on how the agency intends to proceed.

Finally, SROs in general can and should enhance the transparency of their actions by other means. For example, even when self-certification is appropriate and permitted, SROs should have in place a robust process for seeking broad input from their members and market users as part of the rule changes.

Citigroup stands willing to work with the Commission in completing its review of self-regulation and self-regulatory organizations, and we

thank you for your consideration of our views. I will be happy to answer any questions.

CHAIRMAN JEFFERY: Great. Thank you very much, Mike.

I will turn to Ruben Lee.

MR. LEE: Mr. Chairman, thank you. I thank you, Chairman, Commissioners, and staff, for inviting me. It is a great pleasure and an honor to be here.

A couple of disclosures and some disclaimers. I am not a lawyer; I don't deal in the futures markets, nor am I an American.

[Laughter.]

So I should note that whatever knowledge I have should be treated with if not disdain at least caution.

The second disclaimer, I am not representing any clients, but more importantly in this context, I am leading a big research project on the governance of exchanges, clearinghouses and CSD, central security depositories, in securities markets.

The views that I present here are not necessarily going to be the views that are presented in the final report, nor of the people participating in the report, including Roberta Karmel, who is one of the cocontributors.

That said, I would like to focus my remarks on what I believe to be the beef here; that is to say, the key issues. And I would like to talk about three broad questions.

The first is the nature of self-regulation. In my view, this is an approach to regulating markets which has been if not pioneered in the States, it was certainly started here very, very early, and it has shown a very, very great deal of success in many, many ways.

The fact that many of the exchanges have moved from a mutual to demutualized structure or from not-for-profit to for-profit has perhaps changed the conflicts of interest, but have not in any way diminished them nor actually increased them.

So I don't think we are seeing a huge range of -- we are not in a drastically new world, if you

will. There have been a range of responses to conflicts of interest which is the key problem with self-regulation, and they are well known. That is to do with how do you respond to governance structures, how do you respond to the individuals, and how do you respond to procedural issues, to do with transparency consultations and so forth.

You were talking about in many contexts the technicalities of these. I think they are important, but in general I think these issues have been very well discussed for a long time.

I would note one thing to do with the general approach in the futures markets, which I actually take to be very beneficial in this context, which is actually far from much of the discussion which has been going on here. I take it to be self-evident that we should not seek to eliminate conflicts of interest.

On the contrary, that is exactly what you want from self-regulation. It is the management of that that is important, and indeed my view that the approach that has been taken in the futures markets

in America, which is essentially ensuring that people don't act in bad faith, is a very nuanced approach and a very beneficial one. So it allows people to be conflicted and still take those decisions. I recommend that. I think it is an interesting and positive approach.

The second area that I would like to talk about is competition and I find it interesting that we can have, on a factual question, such intense disagreement as to whether there is or is not competition between exchanges and other types of markets or entities. I think this is a decision -- this is an area on which the Commission needs to come to a view, and it is a very, very important one. It is also one where there had been views reached in different markets, and not only views but regulatory interventions, for example, both in the takeover or potential takeover of the London Stock Exchange or in aspects of clearing and settlement in the European context. And I would encourage you to look at some of those contexts.

Finally, I would come to the third area, which is where I think this is where the beef is. Contrary to what some people are saying, I think that the decision as to what is the optimal governance structure for market infrastructure and institutions, namely exchanges and clearinghouses in this context, has not been reached. There has not been a consensus. We have certainly seen a very, very big trend towards demutualization for profit. It has delivered a very large range of benefits, but it has a series of issues which are beginning to bite people in Europe and may start biting them here.

It is the intersection of that question and self-regulation on which the key issues turn, and that is once again where I would encourage the Commission to focus their attention, not on the details of how to enhance necessarily the self-regulatory process by independence, governance, or procedural issues.

Thank you.

CHAIRMAN JEFFERY: Very helpful. Thank you very much.

Mr. Newsome, Dr. Newsome.

DR. NEWSOME: Thank you, Mr. Chairman.

CHAIRMAN JEFFERY: Good to see you again.

DR. NEWSOME: It's good to be back.

[Laughter.]

CHAIRMAN JEFFERY: Welcome home.

DR. NEWSOME: Thank you.

I appreciate the opportunity to make comments on transparency and disclosure with regard to SROs. NYMEX believes strongly that transparency and public disclosure by SROs helps increase public and industry confidence in the self-regulatory process.

It is important to the continued success of any business concern, particularly an SRO, that information regarding the governance, regulatory and compensation policies and procedures are readily available to the public and to regulators.

Transparency through the disclosure of pertinent SRO information provides many benefits,

including enhanced public perception, which I think is one of our biggest problems today when we are talking about SROs, of the efforts devoted to ensuring the integrity of our markets.

NYMEX currently makes a considerable amount of information on governance, regulatory structure and compensation available to the public. NYMEX bylaws and rules are available to the public on the exchange's Web site, including rules on board composition, board nomination and election procedures, regulatory structure, and committee composition.

The shareholder relations link on the exchange's Web site displays the exchange's SEC filings, the 10(k) annual report, and the quarterly 10(q) filings which contain extensive information on both budget and staffing.

This link also includes exchange notices to members addressing a broad variety of topics -- annual proxy statements, which contain executive compensation and other disclosures required by the

SEC rules are available on the exchange's Web site as well.

A link under the shareholder relations section entitled "Corporate Governance" includes the code of ethics for the exchange's principal executive officer and senior financial officer, the whistleblower complaint procedures, among other things.

As both an SRO and a public company, NYMEX believes that its current disclosures provide useful information on the exchange's governance, self-regulatory issues, and compensation.

That said, Mr. Chairman, any decision to increase the amount of regulated transparency through additional disclosures I think should be carefully considered.

In particular, careful consideration should be given to determining the type of information that would be most relevant and appropriate for public dissemination beyond what is already made available.

This open dialogue between the Commission and the futures industry I think is essential in achieving the best result.

Thank you very much.

CHAIRMAN JEFFERY: Thank you very much, Jim.

Okay, why don't we turn to the Commissioners. We'll reverse the order this time. Mike, you want to lead off?

COMMISSIONER DUNN: Thank you, Mr. Chairman.

This is really, I think, a very, very important panel. For us on the Commission, when we promulgate a regulation, we have to follow something called the Administrative Procedure Act, and that requires that we at some time give advance notice of proposed rulemaking, that we publish in the Federal Register the proposed rule, give a certain period of time for comment, allow people to comment on those proposed regulations, and then we have to address to comments as we put out a final regulation. Everyone very clearly can see what was

under consideration, what were some of the contentious items in there, and how we addressed those contentious items.

Do we see the same need under the self-certification process, or is there a need for adoption of something akin to the Administrative Procedure Act for the self-certification process, and do we even have the authority to require that in the CFTC? I would like the entire panel to address that and for folks not of this country, they can be exempted if they want to be.

[Laughter.]

DR. NEWSOME: Commissioner, I will take the first stab at that. I would start by saying I think that self-certification was a very important component of the Commodity Futures Modernization Act, and I do believe that it has fulfilled the purpose of being part of the act and to allow the exchanges the opportunity to make quick decisions, to compete in what has become a very competitive marketplace.

I fully understand that it is a sensitive issue at this point. I think the difference between the scenario that you outlined and self-certification is primarily the competitive aspect. You take time because you can take time to gather lots of comments and make a decision. And I think in many aspects the exchanges feel limited in time because of what's happening in the competitive landscape.

I would point out, I guess, two specific things:

The reality of the situation is that even though you have what is called self-certification, I think in every instance that I am aware of, the exchanges reach out to the staff of the CFTC and have dialogue with regard to this self-certification, and if there is discomfort by the staff, then we work to resolve it before an issue then becomes self-certified.

Secondly, and obvious to everyone in this room, the Commission, if they end up disagreeing with the rule that is self-certified certainly has

the responsibility and the capability to reject that after the fact.

So I think that there are some protections in place, one from a practical standpoint, one from a regulatory standpoint, and I think if we look across the board and we don't just single out one self-certification or two self-certifications, you look at the multitude of self-certifications that have taken place over the last six years, I think they fulfill the intent that Congress had in mind.

COMMISSIONER DUNN: Ruben.

MR. LEE: Just a very brief point. My understanding in the UK, although I'm not a lawyer, is that exchanges are required to notify the FSA -- as you know, the equivalent though larger than the CFTC, if I may say so -- the FSA, notify the FSA of rule changes rather than to seek approval for rule changes.

That said, I think they find it very difficult to implement a rule change without it being approved.

MR. DAN: Just to build on Dr. Newsome's comments, in addition to the commercial obligations that Jim focused on, we also have a core principle in terms of maintaining market integrity. So the process that you described as an analogy, in certain circumstances that time allowed to maintain orderly markets may not, depending on the circumstances, warrant the type of process that you yourself have to go through as a commissioner.

I think examples of that would be unequivocally a board of trade, pursuant to the DCM licensing, has an obligation to prevent manipulation, price distortion and disruption of delivering in cash settlement process.

When you consider that responsibility in the context of the core principles, what our license is based on, the broader administrative process that you describe is in some circumstances not applicable or a reasonable thing to ask marketplaces that are charged with that responsibility.

Having said that, exchanges, board of trade included, and I'm sure every other DCM in the United

States takes seriously establishing rules, amending rules, and understanding the impact on the market.

Clearly, as a centralized marketplace, rules that get amended, changed, or added are done with a very broad understanding from key market participants -- it might not be all and it might not be some specific ones where they expect to be consulted. Part of that has to be due to maybe the confidential nature of a particular change or the manner with which it might get implemented or the manner with which that firm may be compromised due to their position.

Those are all factors that, from the outside, some market participants just don't understand that responsibility or some of the sensitivity associated with the data.

Finally, to reemphasize a point that Dr. Newsome made, all of these self-certified rules, at least in the experience that I have had at the board of trade, have really been in direct dialogue with the CFTC prior to taking action, and so they are not done in what I would call -- give the appearance of

done without a lot of interaction with the CFTC, the staff, and in some cases even some of the Commissioners.

I would say that that history of working in the United States with the SROs, the CFTC, in these cases has been very beneficial to the overall industry, and has helped enhance the integrity associated with customers participating in this industry.

Thank you.

MR. SCHAEFER: I want to say as well that I think self-certification has worked very well in the main over these many years since the CFMA was adopted. And so our suggestion was very surgical, that there are limited circumstances in which we think that self-certification does not work.

To Bernie's point, there are occasions when an exchange must take action and is unable to consult, and we think that the exchange then, instead of self-certifying its rule, should take an emergency action so that in the light of day, after the rule is implemented, the CFTC has the ability to

oversee the process. Who had conflicts on the board. Who had positions. What did those positions look like. Were there conflicts, were there no conflicts. Should the rule stand. Should the rule instead be suspended.

I think that it was not the intent of the CFMA to substitute the self-certification provisions for the emergency powers of the exchange, and I think that if the Commission and if the industry tolerates self-certification in these circumstances, I think we run the risk of never seeing emergency action again, and never having the opportunity of review that we have under the emergency provisions.

Do I think that the industry has been consulted? Generally speaking, yes. Do I think I agree with Bernie that not in all cases have all participants been consulted, and we have heard from those participants from time to time. I think that the position limit change that the board of trade adopted was greeted with great surprise by the industry end users, and by us as FCMs, and I

understand the reasons that it was undertaken; I just think it was undertaken in the wrong way.

MR. BAGAN: The Minneapolis Grain Exchange is a strong advocate of self-certification. I think -- and I would certainly concur with the comments of Dr. Newsome and Mr. Dan as well.

But one thing that I would like you to think about a little bit, though, is that there is a self-inspection process that takes place at each of the exchanges before our board of directors approves rules. Generally speaking, rules are -- the genesis of the rules are coming from committee discussions and that sort of thing, and our committees are made up of members and non-members and so forth. And so there is discussion at the committee level.

There is discussion at the board of directors level, and then finally, at least as it pertains to the Minneapolis Grain Exchange, we issue all of our rules out to our ownership, to our membership to vote on these topics, and so there is significant discussion there.

So I guess I don't look at it that self-certification is a way to try to sneak something in. Rather, it's been self-inspected at the respective exchanges and as the other gentlemen have indicated, there are discussions with CFTC staff on these issues.

So, frankly, we are strong advocates of self-certification and not changing anything there.

CHAIRMAN JEFFERY: Commissioner Hatfield.

COMMISSIONER HATFIELD: I was intrigued, Ruben, with your comment about conflicts of interest and you're essentially saying that the conflicts of interest are good if they are managed. But my question is, Bernie, for you, in both your written submission and in the Merc's written submission you talk about conflicts of interest, and you refer back to your corporate governance code of conduct, as does the Merc.

In both cases, when I look for conflicts of interest, I see a lot about employment conflicts and things that Mr. Damgard referred to as cronyism that you have eliminated over the years. But I don't

find anything that deals with conflicts of interest that we were talking about in the broader sense, whether it's somebody on the board itself that might have a business conflict with a decision that the company is making, or even if you drill down to the disciplinary committee level, somebody overseeing a case that maybe he or she shouldn't be overseeing.

Where do those checks and balances and other safeguards come from if they aren't in here?

MR. DAN: They come, Commissioner Hatfield, in a couple of areas. First off, all of the board has extensive education and training as a board member, which includes not only the code of conduct, the code of ethics, but also the duties and standards of loyalty and care that each director has for the corporation.

Included in that is the conflict of interest policy which the board has, which precisely talks about the areas that you are addressing, that refer to decisions we make at any level at the board of trade of whether or not there is an opportunity for them to participate in the dialogue or not, or

whether they should participate in any decisionmaking.

That same conflict of interest policy extends down to the disciplinary committee levels. They are renewed each year. So each board cycle, that process continues. And so all of those are part of our statutory listing requirements and get embedded as part of an educational process to educate people on their responsibilities and fiduciary duties representing those interests.

COMMISSIONER HATFIELD: So those are written policies that actually exist?

MR. DAN: Yes.

COMMISSIONER HATFIELD: Thank you.

Jim, I wanted to ask you -- I asked Susan Phillips earlier about information coming from the ROCs and from the disciplinary committees, and whether or not that information should be filed with the Commission. And her answer referenced a decision not to burden the agency with paper. But what is your take on the question of information that you have and whether or not especially with

regard to regulatory oversight, that we should be seeing more of that?

DR. NEWSOME: I think that information should be very transparent to the Commission. I think it is up to the Commission to decide what form you want that in, whether you want the submissions and you decide whether you want to deal with the paper or not, or to use the rule enforcement review as your mechanism to collect that information. But I think that is a decision for the Commission.

From my viewpoint, that information needs to be very transparent to you as the oversight regulator.

COMMISSIONER HATFIELD: No other questions.

CHAIRMAN JEFFERY: Thank you.

Sharon.

COMMISSIONER BROWN-HRUSKA: Yes, in ruminating over this, I was looking at an article by Macey and O'Hara on self-regulation, a good study that they did. I am sure you are familiar with it, Professor Lee, and one of the things that they say is another reason why there is less competition

among exchanges than at the state level is that the Federal government plays a critical role in coordinating the regulations promulgated by the exchanges.

I think that is the experience that we have had as well, in that when the exchanges pass a rule that hasn't been well vetted or hasn't -- all the sort of competitive implications haven't been fully explored, ultimately the Federal government, we at the CFTC, have to clean it up, take action, or somehow respond to the concerns of those interested parties.

So in some sense the incentives are there on the part of the exchanges to work with the CFTC, but in some recent cases, we have not seen the kind of interaction that we like to see.

The question is, even in these rarified circumstances where we have not felt that the level of vetting was sufficient, does that warrant some kind of formalized structure wherein transparency -- I guess transparency is not the right word --

disclosure to the CFTC when a regulation has a material effect is required?

Let me ask Jim.

DR. NEWSOME: Well, I think again, I think if the exchanges get direction from the Commission that in instances of self-certification, if it rises to a particular level, that the discussion should not only be with the staff but should be with the Commission, then certainly we are respectful of that, will be respectful of that.

But I think this is an issue, and Commissioner Lukken would be more familiar with it than I, but I think this is an issue that the Congress debated when they discussed the CFMA because they took specific direction with regard to the enumerated ags to not allow self-certification on contracts that had open interests.

So I mean I think the Congress looked at it, they made a determination or drew a line in terms of what could be self-certified and what couldn't, and I think to the point, for the most part, everyone has been comfortable with it.

But again, I think -- and I won't speak for all the exchanges, but from the NYMEX standpoint, if our discussions regarding a particular self-certification need to get elevated to different levels at the Commission, we are more than happy, more than happy to do that.

MR. DAN: I'd like to add a little bit. You know, I think there is some analogy that is being drawn by some that self-certification implies self-interest as well, which I think is an improper conclusion to draw.

For instance, imposing position limits on Treasuries with 10 days to expiration, you know, the board of trade clearly from a commercial perspective would not want that sort of barrier.

So some decisions are made in the context of other core principles like quarterly markets. I think that is very important to understand. So the implication that self-certification is because of self-interest on the part of any marketplace is just entirely a misrepresentation.

MR. SCHAEFER: I don't think that is implied at all in my discussion, at least. I think that certainly there is an opportunity -- there certainly is the potential for an abuse of the exchange's ability to self-certify its rules in those circumstances. And I think that it is entitled to the light of day. I think that when we talk about transparency, I think that that is precisely what market participants want in a credible functioning, robust marketplace. They want to know when they enter into a contract what the contract specifications are and what the economic risk-rewards are. And when we change the circumstances by which they entered into the contract, I think they are entitled to the light of day.

I don't mean to debate it with Bernie because I certainly am not impugning the motivation of the exchange at all. I think the exchange took the necessary action, and I think it could have been done differently.

If I can just follow up quickly, Commissioner Brown-Hruska, on the issue of self-certification and disclosure. It is currently the requirement under the part 40 regulations that the exchanges submit among the certifications that they make to the Commission some declaration as to the dissenting views that were uncovered in the vetting process, and why those dissenting views were not incorporated in the rule as submitted to the Commission.

I think it is incumbent on the Commission to examine closely the process. I don't understand how an exchange can submit that kind of certification without a vetting process such as the administrative procedures that Commissioner Dunn talked about before. There are many constituent parts to an orderly marketplace, and I think that all of the constituent parts are entitled to be heard, and that that process is implied at least in the part 40 regulations.

COMMISSIONER DUNN: Under 40.6, it indicates that the DCM or DCO that submits a rule

must provide an explanation of opposing. Now I don't know if it goes quite as far as you are saying you would like to see it go, but it says provide an explanation of those opposing views.

MR. SCHAEFER: And I think, Commissioner Dunn, the explanation of the opposing views implies that they know what the opposing views are in order to explain it to the Commission. And I'm not sure that the process is so robust that there can be adequate disclosure without augmenting the process as it exists today.

CHAIRMAN JEFFERY: Commissioner Lukken.

COMMISSIONER LUKKEN: I think this discussion on transparency is very helpful. Obviously, as a public entity, we value transparency because it provides legitimacy to the decisions we make, and even those that are on the wrong side of decisions we make feel they had a voice in the process.

I think this concept applies to exchanges with their quasi-governmental authorities. It's helpful. I think it is within the exchanges' best

interests to have more transparency in this process as best they can without divulging confidential or proprietary information.

So on that issue, I would like to hone in on a couple matters more focused on our discussion today on the regulatory side of things. One issue that has been brought up to us at the Commission is the compensation of regulatory staff.

Obviously, with publicly listed companies, stock options are available. How should we handle this as far as making sure that the conflicts are managed with the regulatory staff? Whether to allow them to have stock options? Obviously, regulation is a part of the value of an exchange. Maybe they should. But should that be disclosed? Should we not allow them?

And I guess the second part of this question -- I'll do Mike's multi-tiered question -- is dealing with when there is a recommendation to the board by the ROC. When the board does not agree with it or does not follow the recommendation, should that be a triggering event for us at the CFTC

for disclosure for something? As we look for red flags to uncover wrongful activity, this might be something, in my view, that might be a red flag. But if not, please tell me why.

I don't know if anybody wants to start with those two questions.

MR. DAN: Commissioner Lukken, I'll start, if it helps.

On the first question, the CBOT's compensation committee charter, which is another document that is publicly available, describes just the philosophy of how we compensate senior executives generally. The distribution and/or the question of equity grants associated with really any role in the organization, at least in the case of the board of trade, is fairly limited.

So one way to guard against improper incentives for certain profiles is to reward them differently. So the charter provides that flexibility to have the right incentives for the right profile of responsibility.

So I would say that the committee that governs that charter on the board of directors has been very prudent in understanding which sorts of roles should have which types of incentives, so that they aren't compromised or linked to the commercial aspects of the organization. And that has been strengthened with the broader historic separation of duties and responsibilities from the board of trade acting as an SRO in some way, shape, or form, for 158 years and continues to get reinforced.

With respect to the second topic, in terms of maybe compensation generally, if I understood it right, in the context of the ROC, one of the things that I think that I have learned and listened a little bit from Ms. Phillips' comments is those committees function very much like audit, nominating. They are going to meet relatively frequently a year, but not day to day. So I think there should be guidance and oversight with respect to that topic. I think it is very difficult to understand what it takes commercially to attract highly skilled, very experienced, regulatory

oversight staff to lead some of the complex systems we have to monitor the markets, and I think that that type of judgment is best left with the exchange, particularly in context of product development, international expansion, and what it means as those responsibilities broaden.

Our markets today run at least 22 hours if not 24 hours a day. The types of tools, sophistication, and skill sets required in the regulatory staff to monitor that is much, much different than it was a decade ago, and in order to really understand and operate a marketplace, I think that control needs to be at the exchange level with the appropriate oversight.

DR. NEWSOME: I will make just a couple of comments. One, you know, that kind of information certainly I think should be transparent to the Commission should you want it.

But at some point you have to be careful of what you ask for because then you decide what you're going to do with it once you have it. And do you

want to assume that kind of responsibility as a commission looking at compliance staff.

Certainly I would be hesitant to have any limitations on how I could compensate compliance staff because, quite frankly, I want the best and the brightest within that group, and my fear would be if there were barriers put in to what I could pay compliance staff, we could end up in the same situation we were at the CFTC before pay parity. You know, we'd lose a lot of our best staff to other agencies or other positions, and I could see that happening at the exchange. Regardless of what kind of job you did bringing good people into compliance, they get to a level of education and expertise and then they move to another division of the exchange or to a separate exchange just because of compensation limits and compliance. So that's a tough one.

MR. LEE: Just a couple of comments. Even in exchanges which are not run on a for-profit basis, there are a range of different criteria which CEOs use to assess the strength and delivery by

regulatory people, which include performance, efficiency, costs, outputs, and so on and so forth. So I would be very, very careful on your part to be getting too much into that, and one could easily see in a particular exchange which has got a very bad regulatory technology, you need to pay by a certain form of compensation, but in another one you might need something else.

I think you should be focusing more on outputs rather than these sorts of measures.

MR. SCHAEFER: I subscribe to the prevailing view that there should be ROC kinds of constructs at the various exchanges, whether demutualized or not, and reporting up to independent directors doesn't eliminate the conflicts, certainly, but addresses, I think, very well those potential conflicts. And I think that the experience of the CBOE and Dr. Phillips and the experience at the CME is a good blueprint, frankly, for the industry. And I think that the issues of compensation are best left to that committee of the exchange.

As to what happens in the event that there is a substantial conflict in a recommendation to the board that is then ignored by the board or defeated by the board, I think that as Dan Roth said before, there is no silver bullet here for these topics that we are discussing today. I think it is the Commission's role, its oversight role to take that under review.

It may be fine, and the issue may not be material, and the Commission moves on. But it seems to me that a recommendation by a ROC to the board is a significant event in any circumstance, and to have the board reject a ROC's recommendation I think is worthy of review. And that's where I come out on it.

MR. BAGAN: From a transparency standpoint, you know, I think all the exchanges support transparency because that's one of the underpinnings of our marketplace. We are there to provide price discovery and transparency. But there is a fine line then when it gets to compensation and issues like that. As a not-for-profit exchange, we don't

have the issue, in a non-publicly traded exchange we don't have the issues with stock option and that sort of thing.

But I would echo Dr. Newsome's comment in that if the exchanges were to provide this information on compensation for the regulatory people, what is the value to the Commission in having that information?

CHAIRMAN JEFFERY: Just to wrap up, a couple questions related to this issue of rule self-certification.

First a comment. It strikes me that there is a real tension here between, on the one hand, maintaining orderly markets and not getting in the way of normal market processes; and on the other, making sure that all market participants have some high degree of confidence in the fairness and integrity of the markets that the exchanges maintain.

And where that leads one on this question of self-certification, I am not sure, but to that end, maybe it would be useful for each of the

exchanges to describe generally their process for rule change that's substantive, however defined, and the rule change with respect to the 10-year Treasury position limit would certainly fall under that category.

MR. DAN: Since you used that as an example, I'll just start off. First off, there is a letter of record that went to John Damgard in August that kind of describes in detail what some of the factors were, and I think the process is sometimes dictated by the unique circumstances. And the unique circumstances of this particular one is essentially a broader disconnect maybe between the broader Treasury markets of cash repo and futures and what people have to understand is we're one leg of a three-legged stool that are very integrated to provide liquidity across the capital markets.

Clearly in that unique circumstance, we worked and consulted with a multitude of regulators in terms of orderly markets, futures, cash, repo, and implication of any change.

There were some inherent drivers behind the situation which primarily was lower cash deliverable supply, but I won't get into that detail.

But essentially what understanding is happening across all three markets, we had very detailed discussions with groups of people who are active users in cash futures and repo markets, the largest users in the world, different profiles, and in our own staff work in terms of maintaining what our core principle.

So I would say in that unique circumstance, that was probably much broader because of maybe the nature or significance of what was going on, what was ongoing in those underlying markets, but nevertheless it was thoroughly industry driven.

Once we came to a conclusion of what our suggested actions were, it only at that point in time that a recommendation was going to go up to at least in this case the executive committee and to the board in terms of what it was.

So there was no board involvement until basically a recommendation came to myself on how to

manage the situation that was fairly unique. It included a broad array of input from a variety of users, again users of the market, not necessarily users who represent customers who access the markets. We went to actual users, and basically heard all sides of a multitude of issues, and like everything else that comes into this sphere of the board of trade is we evaluate all of the input and reach a conclusion of what we think is the best interest of the broader spectrum of market participants, knowing that when we have to make a choice like that, that not every participant or every profile may broadly encourage or support our action.

Sometimes when you are an SRO, you have to do that in order to maintain integrity. I will say since that action was taken, the confidence in integrity that might have been lacking prior to that has been fully restored. The open interest is up and growing and it has proven to be a very prudent action.

There has been some feedback associated with that of how to get more inclusive in the communication process, and in my letter in particular to the FIA, we concluded we're going to try to figure out ways to do that without compromising some of the confidentiality associated with these decisions.

So we respect that input, we value that input, and when the circumstances allow us to, we will exercise that.

CHAIRMAN JEFFERY: Dr. Newsome?

DR. NEWSOME: I mean I think our process, Mr. Chairman, is a pretty straightforward one. Typically the issues are identified by the senior staff, sometimes by members or committees, but typically by the senior staff. We discuss the issue, come up with a potential solution, typically involve the CFTC staff at that point, take that to the appropriate committee at the exchange where it is discussed, and then the action of the committee then goes to the executive committee and the board, of which ours meet very, very regularly. So

normally not a lot of time lapse in between all of these meetings.

In terms of emergency action was mentioned earlier, and we do use that emergency action, and as recently as the hurricanes, and the activity that created on our markets, and that responsibility lies solely with the president of the exchange to make a determination when an emergency action needs to be implemented.

CHAIRMAN JEFFERY: Ruben, do you have any concluding comments? All right.

All right, thank you all very much.

Why don't we take five minutes or less and then we'll come back to the final panel, the subject of which is discipline.

[Recess.]

CHAIRMAN JEFFERY: Welcome back, everybody, to our final panel of today's proceedings, Balancing Expertise and Impartiality on SRO Disciplinary Committees.

With us today again we have some familiar faces and some new ones. In particular I would like

to welcome Audrey Hirschfeld from the New York Board of Trade. We will hear from her momentarily. And Joe Ott, from the Kansas City Board of Trade. I think between Audrey, Joe, and Mark, and the preceding panel, we will have heard from a substantial majority of what I describe as non-public, more specialized or regional exchanges, and I would encourage each of you, Audrey and Joe, if you have particular issues you want to get on the table that may be at best even obliquely related to discipline but more related to your particular areas and concerns as they arose during the course of the day, don't be shy about so raising those issues.

Without further ado, why don't we start with you, Joe, and hear your comments on behalf of the Kansas City Board of Trade.

PANEL IV: BALANCING EXPERTISE AND IMPARTIALITY ON SRO DISCIPLINARY COMMITTEES **

MR. OTT: Chairman Jeffery and Commissioners, the Kansas City Board of Trade greatly appreciates the opportunity to participate in today's hearing. We understand with all the

changes in the industry that it is prudent for the Commission to periodically review SRO programs to ensure that market integrity is being upheld.

However, due to the complexity of the commodity futures and options transactions, and the potential rule violations that occur with such, the Kansas City Board of Trade is of the opinion that our current disciplinary program is the best model for our exchange.

Our disciplinary program has been extensively reviewed by the CFTC Commission staff numerous times over the years, during biennial rule enforcement reviews, and found to be highly effective.

Our disciplinary program has served our marketplace well in ensuring that market integrity is being upheld at the highest level possible.

By proposing changes to a system that has worked with a high degree of success for many years, you run the risk of creating unintended consequences that could have the opposite effect. For example, if changes are mandated requiring disciplinary

committees to include public committee members, you open the door to the possibility of having individuals hearing disciplinary cases that don't fully understand the intricacies of the particular market or the transactions underlying the alleged infractions.

Persons charged with churning violations deserve nothing less than to be judged by persons with a thorough knowledge of the subject matter. Expertise and impartiality are equally important aspects of a disciplinary committee. Kansas City Board of Trade rules set forth strict guidelines to ensure disciplinary committees provide both expertise as well as impartiality. Expertise is essential in disciplinary committees due to the complexity of matters that committee members often are asked to deliberate on.

Members of disciplinary committees often bring unique or special expertise, knowledge, and/or experience to the matter under consideration.

In addition to providing expertise, exchange members also possess the experience

necessary to ensure that an appropriate sanction is imposed in order to have a deterrent effect.

Impartiality is equally important to ensure that the matter is given a fair hearing. Our rules require that disciplinary committees include sufficient different membership interests so as to ensure fairness and to prevent special treatment or preference for any person in the conduct of a committee's responsibilities.

Our exchange established and enforces appropriate fitness standards for all members of disciplinary committees.

The multi-tiered disciplinary process at the Kansas City Board of Trade helps to ensure that an individual will be given a fair disciplinary process. Since the individual has the opportunity to have the case heard by up to four different bodies beginning with our complaint committee, the complaint committee is the grand jury of our exchange. The committee's primary responsibility is to review staff reports into possible rule

violations to determine if formal disciplinary proceedings are necessary.

The committee has a standard of reasonable basis. If the committee determines a reasonable basis exists for finding a violation, and prosecution is warranted, then the matter is forwarded to a business conduct committee for full adjudication.

Promptly following the hearing, the business conduct committee renders a written decision based on the weight of the evidence presented.

The charged party has the opportunity to appeal an adverse decision to our board of directors. The decision of the board will be the final decision of our exchange. If the charged party is not satisfied with the decision of the board, then of course the matter can be appealed to the Commission.

All disciplinary committee members are aware that each disciplinary case will be scrutinized by the Commission upon completion of the

disciplinary process. This multi-tiered process is effective due to the systems of checks and balances that are in place at each level of the disciplinary process.

We take very seriously our responsibility in providing fair representation of all membership interests on disciplinary committees.

The Kansas City Board of Trade requests that the Commission remain flexible going forward when reviewing the results of the SRO study. As a mutually owned, for-profit corporation, we feel our current rules provide a balance of expertise and impartiality on our disciplinary committees for a highly effective disciplinary program.

Thank you.

CHAIRMAN JEFFERY: Great. Joe, thank you very much for that.

Dan.

MR. ROTH: Thank you, Mr. Chairman.

The question before this panel involves balancing expertise and impartiality in the disciplinary process, and I think that question

carries with it an implicit suggestion or an implicit premise that the involvement of members in the disciplinary process may undercut impartiality; that the involvement of non-members in the disciplinary process may undercut expertise; and based on my experience in NFA, I reject the premise of the question.

Maybe it's different for different SROs. I can tell you that at NFA on our Business Conduct Committee, one-third of our members of our Business Conduct Committee are required to be non-members of NFA. One-third of any hearing panel that we put together to preside over a case must be a non-member of NFA.

I have never felt that the involvement of members undercut our impartiality. We regulate 50,000 firms and individuals. If there is a member of our Business Conduct Committee or a member of our hearing panel that has any sort of personal or business relationship with the respondent, that member is required to recuse himself from that proceeding. And they do.

For the most part -- it may be a small world, but it's not that small when you've got 50,000 people that you are regulating. For the most part, the people that come before our committees have no business or personal relationship with our members that serve on those committees, and I don't think there is anything to undercut their impartiality.

Similarly, with our non-members that serve on the disciplinary process, either on the Business Conduct Committee or on the Hearing Committee. I have no reason to question to their expertise. It doesn't do you any good at all to have public involvement in the disciplinary process if the members of the public that are involved have their eyes glaze over every time you hit a technical issue that sometimes comes up under our rules. That's why the non-members that we pick aren't members, but they all have industry experience.

We include people that have left the CFTC and gone into the private sector. They sometimes serve on our disciplinary process. People that have

left the exchanges serve on our committees. Members that have retired from -- people that have retired from their firms after a period of time can serve on our Business Conduct Committee and our Hearing Committee. We have members of academia that serve on that committee.

All of them understand the futures industry. All of them bring a degree of expertise to the process. So I question the premise that involvement of non-members necessarily implies a lack of expertise.

So we have a balance. We have one-third public representation on our disciplinary process. Frankly, for us, it was as much a matter of perception as anything else. I think that perception counts, and we wanted to make sure that both members and the public could restore confidence in the disciplinary process, and that was the primary reason we included non-members in that process and will continue to do that. We think that is sound policy for NFA.

But I reject the premise of the question that the members can't be impartial or that the non-members can't have expertise.

Thank you.

CHAIRMAN JEFFERY: Thank you.

Audrey.

MS. HIRSCHFELD: Thank you. I appreciate the opportunity to be here. I'm not sure if NYBOT is the smallest big exchange or the biggest small exchange, but whichever way you characterize it, the issues presented are very important to us, and whichever group we fall into, flexibility is the key to our survival and to continuing to thrive as we have in the recent days.

I would like to give you a little bit of information about the exchange so you can understand how our views are colored.

We have a board of 25 directors, five of whom are public, 10 of whom come from the FCM and trade community. We have seven floor and three additional that can be from any category that would be our chairman, vice chairman, and treasurer.

So basically that at least 50 percent of our board is coming from FCM and trade, and in addition we have five public directors.

Those directors cannot be members or affiliated with member firms. However, many of them do have prior association or links to the industry, and we feel that it is because of that experience that they are able to make the kind of contribution that they have.

As Dan pointed out, many of them also serve on our disciplinary committees, and it is their ability to understand what is often a very technical and complex area that makes them valuable and allows them to contribute.

We have our own clearing corp where FIA members dominate and control the issues that are pertinent and significant to their purse strings.

We contract out our sales practice and we do not act as a designated self-regulatory organization for any FCM. We do have one that we have contracted with NFA to perform audits, but otherwise we are not involved in that aspect of the

business. So we have that balance of sending out to an independent third party some of the regulatory functions and retaining others that we feel we have the expertise and the ability to handle.

We do have a ROC. I would say it is quite similar to the CMEs and the CBOE. It is relatively new. It has met twice, and we are still probing how it is going to operate going forward, but essentially the responsibility is to ensure adequate staffing, budgeting, to review rules that have a significant impact on the regulatory function, and to review the rules review conducted by the CFTC and hopefully going forward to even participate in some of the quarterly meetings that we have with division of enforcement staff, just to get a different personal take on how things are going, and how the department is functioning.

We feel strongly that there has been no evidence that there needs to be a change and that we need prescriptive rules for how our disciplinary committees are constituted. There is a system of checks and balances that has worked effectively. We

have diversity on all our disciplinary committees. We have a public director on every panel and on every committee we have representation from FCM, trade, and floor categories. We have strict conflict of interest rules.

In fact, I daresay that before I was even born, the predecessor to the New York Board of Trade pioneered the notion of having a public director on its board and of having conflict of interest guidelines before they were in CFTC guidelines or in core principles.

There is a right to appeal to the CFTC. I am not aware of any instance in the last decade where one of our decisions has been appealed and reversed. I'm sure in the annals of history there must be some along the way, but that seems to suggest to me that the exchange disciplinary committees are doing what they are supposed to, and if they weren't, there was recourse to the Commission.

Our rule enforcement reviews give another opportunity for the Commission to verify that the

disciplinary process is working as intended. And in the absence of any evidence to the contrary, we don't feel there is any need to dictate to the exchange how they carry out that responsibility.

Thank you.

CHAIRMAN JEFFERY: Great. Thank you very much.

Mr. Dan.

MR. DAN: Mr. Chairman, just a few brief comments on this. The CBOT believes that any SRO that enforces its rule through disciplinary committees should have the flexibility to determine how such committees are comprised so as to ensure the necessary expertise and impartiality.

There is not necessarily a single structure that fulfills these goals, so flexibility is very key in this. Board of trade's history has been to adopt best practice in this regard and it's one of the reasons why as a 158-year-old institution, integrity and transparency have been the hallmarks, and that is why it has survived.

An SRO's determination of the appropriate composition of any particular disciplinary committee may depend on the nature of the matters handled by that committee. And what I mean by this is product, geography, complexity of trade, a whole host of issues may dictate different sorts of composition depending on the issues. So, again, the key theme I'm trying to stress here is flexibility in terms of any particular committee because not any one profile can necessarily address the complexities of manning and managing the 24-hour marketplace.

And finally, I think that as Dan Roth has stated, clearly the importance of all these committees is just to ensure that the wealth of understanding is built into any member comprising them, and I think that they can be drawn from a wide variety of sources, depending where that is, and that is something that is very important to the board of trade and exercised when appropriate.

Thank you.

CHAIRMAN JEFFERY: Great. Thank you very much.

Jeff Jennings.

MR. JENNINGS: Thank you, Mr. Chairman.

CHAIRMAN JEFFERY: Welcome back.

MR. JENNINGS: Thank you very much. It's good to be back again. And thank you to all the Commissioners for inviting me here today to take part in these hearings.

The issue of the SRO disciplinary process and the need to balance expertise and impartiality on the committees is one of great importance, obviously. It goes to the heart of the legitimacy and integrity of the self-regulatory process, and the approach of the U.S. exchanges on this point must necessarily act as the role model for the global industry.

I am an advocate for greater diversity as well as greater independence on the disciplinary panels of the exchanges, even though I sense that that is a distinctly minority opinion today.

I look forward to our discussions here today to explore the relevant issues and make

progress towards a collective understanding of the appropriate course of action on this topic.

Thank you again.

CHAIRMAN JEFFERY: Great. Thank you very much.

We'll turn to Commissioner Hatfield.

COMMISSIONER HATFIELD: Joe, I want to make sure that I understand a little bit about how your Business Conduct Committee and your Compliance Committee work. Do I understand that they don't have independent members but they have a diversity of membership that compose those committees?

MR. OTT: You are correct. They are -- for the Business Conduct Committee, it's a five-member committee that is made up of the first vice chairman of the exchange, the president of our clearing corporation, and then three elected members. And what they do is they serve a three-year term. It's a staggered term so that each year one goes off and there's a new one on, but so we always have experience on the committee of at least two years.

The Complaint Committee is a 10-member committee that is appointed by the chairman of the exchange with the approval of our board of directors, so they all are exchange members. Again, we have the fitness standards to ensure that the people on the committees -- you can't have a conflict of interest, direct or personal matter, direct or personal -- I can't think of the word I'm trying to say here, but conflict or a -- you can't have a conflict of interest with any of the people or we just want to make sure that they do meet our fitness standards.

COMMISSIONER HATFIELD: So is there a diversity of people that are on those, or are the people who are elected generally in the same line?

MR. OTT: That's one thing our rules require, that there is a diversity of membership interest on all the disciplinary committees. So there are people that do have some floor traders, FCMs, commercial interests, so we do try to get all the various membership interests of our exchange represented on the committees.

COMMISSIONER HATFIELD: Did you say there's two other levels? It's the Complaint Committee and then the Business Conduct Committee, and then does it go to the board?

MR. OTT: Then it goes to the board, that's correct.

COMMISSIONER HATFIELD: So there's three levels --

MR. OTT: Three levels at our exchange and then an appeal to the complaint.

COMMISSIONER HATFIELD: Okay. Thank you. That helps.

Dan, I wanted to ask you, in your written submission, you made the point and others have reinforced this, that the more important principle is not the number of independent people on a board or a disciplinary committee, but there is diversity.

MR. ROTH: Right.

COMMISSIONER HATFIELD: And I wanted to get your take on how that should be achieved. Obviously you believe your board is quite diverse, with a third of your members, I think, being public

members. How diverse do you think the other SROs are, in your opinion, and do you think that the CFTC ought to prescribe what that diversity is?

MR. ROTH: Let me -- I am singularly unqualified to talk about how diverse the business conduct committees are at other SROs, because frankly I don't know. But you've got a wealth of talent here and knowledge, and I'm sure they can address that.

Our disciplinary committees -- and I should point out, it's not only that we have one-third public, but just as at the Kansas City Board of Trade, we strive to ensure that the other committees -- that the rest of the committee draws from all of our constituent groups, so that we have FCMs and CPOs and CTAs and IBs, all represented in the disciplinary process.

And just a recurring theme that we have been spotting today is that I think the focus isn't how many public representatives do you have either on your board or on your disciplinary process, but rather does the SRO have a system in place which

ensures checks and balances so that we can be assured of the fairness of the disciplinary process.

I don't think it is up to the Commission, frankly, to prescribe the formula by which that is achieved by each SRO, but I think it is definitely within your -- it is a critical mission for you to work with each SRO to make sure that they have in fact achieved that goal. And I think that is more important than trying to set it in stone in a rule how that goal should be reached. I think it is more important to work with each SRO to make sure that they have in fact achieved it.

COMMISSIONER HATFIELD: Thank you. Anybody else?

MR. DAN: Just to build on that, I also agree that there should be no prescriptive measures, and I think there's lots of ways to achieve particular goals, and I agree with Dan Roth that I think it is an action step or point of order as part of our annual reviews, our 18-month reviews from the CFTC, that there is an opportunity for the CFTC to determine that. And we welcome that.

MR. ROTH: Can I just make one more comment? That the -- part of the Commission oversight of the disciplinary process is obviously the appellate process. Cases that get decided by an SRO can be appealed to the CFTC. I can't imagine you are real overburdened with appeals coming up to the Commission from the SROs because, frankly, at least in our experience at NFA, most of our cases settle, and settled cases aren't going up to the Commission on review.

So I think again none of us can fall into the trap of doing things the way we have always done them, and I would urge the Commission to consider how to perform your oversight functions with respect to the disciplinary process, and there may be a way outside of the rule enforcement review process to take -- don't take formal review of an action but on a spot check basis contact the exchange, contact the SRO, contact NFA. Find out why we settled a particular case the way we did. We would be happy to talk to you about it.

And I would urge the Commission to again be vigilant and perform your oversight function with great vigor, just as you always have.

CHAIRMAN JEFFERY: Sharon?

COMMISSIONER BROWN-HRUSKA: Dan, I'm taking notes here. Very good.

I'm thinking that what Dan has said especially, it harkens back because we do from time to time contend with issues that have been raised in the disciplinary process and the committees. Sometimes it's regarding the appropriate penalties or whether or not, in fact, a rule violation occurred. Sometimes it's trade practice; sometimes we seem to have some points of contention in the financial side of the equation.

So we do from time to time see troubled areas. And again going back to what Dan said, I think we have to focus on our core principles and our core mission, and that involves protecting the public interest, and ensuring financial and market integrity.

So what I would like to ask is if there is a best practice approach that would provide options -- in other words, guidance -- on how to meet our core principles, and would be a good approach in this case?

MR. ROTH: I would certainly think that that would be the preferable -- vastly preferable to trying to set in by rule what the composition of various disciplinary committees should be. I think guidance from the Commission is always helpful.

But then you have to follow the guidance up by working with each SRO and making sure that both you and the SRO are comfortable that the guidance is being satisfied.

COMMISSIONER BROWN-HRUSKA: It also seems that there is a lot of diversity. On my favorite little big exchange, I'm glad to hear that you did in fact pioneer the public director on the board. It doesn't surprise me at all because I think you all have always done a very good job and have been very responsive to the Commission in difficult

issues, and yet you still retain a floor and have struggled to grow and have done a wonderful job.

So what is your perspective on whether best practices or guidance would be of value to the smaller exchanges?

MS. HIRSCHFELD: I personally don't think that it's necessary. I think it could be addressed in the context of the rule enforcement reviews. There's a lot of time that the Commission staff spends with us, and honestly, you have been doing it for a long time with us, and I think we have all tweaked our disciplinary programs to the point where you don't expect to find anything significantly wrong, and we would be shocked if you felt there was something major that we were not doing correctly.

So certainly rather than prescriptive rules, that would be preferable. But I think it could also be accomplished on a more informal basis in a dialogue with the exchanges.

COMMISSIONER BROWN-HRUSKA: Bernie, do you have public or independent members on your

disciplinary committees and those types of committees?

MR. DAN: No, we have current board members on disciplinary committees, but they wouldn't be classified today as independent, pursuant to the definition people are kind of inferring. They are independent relative to listing standards of the New York Stock Exchange, but they aren't independent I think in the context of what people have talked about in these panels.

I will say on the earlier point that I don't think guidelines in this context are also of much value, at least for longstanding exchanges that have demonstrated clear compliance with the core principles of the CFTC. They might be very beneficial to emerging markets and new markets in the United States about how to go about it, but I agree with Audrey that we go through these enforcement reviews as often as we do. We have continued to evolve as the industry evolves, and I think in the same context as we mature as a publicly traded entity, that will continue and we will have

greater incentive to do so because of that governance structure today.

I will also say, if I could, I made some comments that you often get a lot of comments for trade infractions or other things. I think one of the things, just to caution the broader CFTC on this, rules and values of marketplaces differ. And where one practice might be acceptable in one marketplace, it may not be allowed in another, and that's part of the competitive offering we all have. So often some of these complaints, of which I am familiar with, obviously, have to do with the different values marketplaces which choose to project themselves in the public domain.

Some users may not value some of the decisions we make in that context, and might not understand why some infractions might be in their mind very punitive. But if they compromise the values of our organization that we take seriously, we will choose to enforce them accordingly. And that might be a totally different value proposition in a different marketplace.

We respect and understand that, and it is one thing that we don't want to compromise because some of the values we choose to maintain are hallmarks of the integrity that we do provide today and will continue to do so.

COMMISSIONER BROWN-HRUSKA: Could I ask a question? Would you consider having independent directors or independent members on these committees if you could find some that would be suitably qualified and have expertise?

MR. DAN: There would be value with independent in the broader definition to have them part of our disciplinary committees and just currently today they don't exist.

CHAIRMAN JEFFERY: Commissioner Dunn.

COMMISSIONER DUNN: Thank you.

Are there guidelines for disciplinary actions for the penalties, or sanctions for particular infractions that take place? And if there are, how are those developed?

And then my multipart question for all of you:

Should the outcome of disciplinary committees be
made public? And should they be in some type of depository, something akin to Basic?

MR. OTT: They currently are, Commissioner. The outcome of disciplinary actions, we are required to submit those into the NFA's disciplinary database so anyone who has been found guilty of a -- or charged with a trade practice violation, that information is submitted to the NFA currently.

MS. HIRSCHFELD: Disciplinary actions are also posted on our Web site, outside the trading floor, so members are made aware of it, and in some instances we have even issued press releases in the past regarding particular cases.

MR. DAN: Commissioner Dunn, our trade infraction penalties are also -- or those who are charged are also recorded at the NFA, and there is a central depository for that information which has proven to be great value for the industry.

And secondly, on your first point, on the guidelines, from the board of trade perspective we

rely on history in terms of infractions and significance, so the staff, the regulatory staff keeps a record of prior violations, repeat offenses, you know, degree of significance of what it is, and so there is a history that the staff will draw on to determine current infractions of what penalty, if any, should be applied and gives recommendations based on that history, which could include repeat offenses to any particular individual or company that is subject to such review. And that has proven to be very effective.

MR. ROTH: With respect to sanctions, the CFTC has issued guidance on the factors to be considered by SROs in determining the appropriate sanctions, and we follow those. And they include obviously the seriousness of the offense, and harm done to customers, if any, and the disciplinary history of the individual. The Commission has issued fairly specific guidance saying the factors that we should consider, and that's what we abide by.

It is difficult for us -- we have considered at times trying to come up with a schedule of sanctions. Violation of this rule results in this sort of sanction. And that's workable in some more ministerial type of rules. But in other rules, I mean our basic rules involving solicitations or advertising or promotional material, any of those things, it depends entirely on the degree of the violation and the magnitude of the violation. And our rule is 229 for our promotional material -- not all 229 violations are created equal. Some of them are much more serious than others. And the idea of having a uniform schedule of sanctions, we found to be not workable. We found much more workable the guidance that the Commission has already provided.

COMMISSIONER DUNN: Joe? Audrey? Do you have a schedule?

MS. HIRSCHFELD: We don't have a schedule, but our starting point is always what's the disciplinary history of the individual involved, and then what has the Business Conduct Committee imposed

as a sanction on other individuals charged with a similar violation. Other than for recordkeeping, we don't have a schedule per se, but we do know for substantive trading abuses what the range has been. In that context we think it is important to -- for the committee to be aware of the nuances in determining what is the appropriate sanction. You can't always say that a particular offense is worth $500 versus $15,000 because you don't know the circumstances are similar or alike or different -- excuse me.

Very often if there is recidivism or if there is prolonged period of a violation -- for instance, failure to maintain order tickets by an FCM's trading desk, cease and desist orders and additional penalties of that type are deemed appropriate, just as they are when the Commission brings administrative proceedings.

I think those are the kinds of issues that in the past we may have had disagreements with some FIA members on because of the consequences that a cease and desist might have with respect to

reporting to other agencies and so forth, but by and large, we try to view every case on its own merits and deal with what we feel is the appropriate sanction for it.

MR. OTT: We do not have a disciplinary schedule, either, but past precedence of course is looked at closely to give guidance.

CHAIRMAN JEFFERY: Commissioner Lukken.

COMMISSIONER LUKKEN: As we talk about disciplinary panels, I sort of revert back to the prior panel dealing with the insulation of the regulatory functions in a potential ROC. Should disciplinary programs fall within the ROC's sort of umbrella -- is discipline part of the regulatory program, and should there be some direct oversight within that framework as we think about these issues?

MS. HIRSCHFELD: I guess since we are not the only one on the panel that does have an ROC, definitely, yes, and but not in the day-to-day sense, not in determining what is the appropriate fine, but just in the high view sense of is the

program functioning properly, are we hearing grievances from any particular segment of our community, are we viewed well in the eyes of the CFTC. How do our rule enforcement reviews compare to other exchanges.

One of the items that I present to my committee, although it's really not an apples-to-apples comparison, because exchanges are not all reviewed in the same year, but I can give them statistics on this is what is publicly available regarding the CME's last rule review, NYMEX's, ours, and depending on your take, we're either too aggressive or not aggressive enough, depending on your point of view, but at least they have a basis on which to determine if overall the program seems to be working. And I think a dialogue with the CFTC also will be a key component of that going forward.

MR. JENNINGS: I would just add as well, I think it is very appropriate for an ROC to take an active role in determining what the composition and makeup of a given disciplinary panel might be for a given exchange. And I for one would certainly

welcome any sort of empirical data we might be able to get from any of the exchanges that would evidence what the composition currently is of the disciplinary panels.

MR. DAN: Commissioner Lukken, the core principles, as you are aware, already are in place for DCMs that already address governance, fitness standards, as well as monitoring the trading, financial integrity, and protection of the marketplace. And I would say in that context is that clearly the motivation on the part of a DCM is to maintain their license is to obviously comply and demonstrate their compliance with those core principles.

So the first point is that we have the necessary incentives in place in order to maintain our designation as a DCM to perform and fulfill all our duties as a self-regulatory organization, including disciplinary committee.

So I don't know where necessarily on the one hand where value of that reporting to another

committee is going to change that incentive materially.

On the other hand, if it brings broader perception and greater perception issues, I could understand why some people would view it as valuable.

But I want everybody to understand, particularly on this panel, that, trust me, there are incentives enough to maintain the designation, to fulfill those in the most open and transparent manner. And I think that is one of the reasons why this industry has in particular been very strong is because of the cooperative nature with which the CFTC, the NFA, the SROs all work together, because they understand that significance.

And so with that, I first compliment the CFTC on their role in that regard.

COMMISSIONER LUKKEN: I want to sneak in another quick question before my light turns red.

But as we think about the cost-benefit of these regulations, if we decide to do anything in this area, disciplinary committees -- it sounds like

pulling teeth to me. I don't know who serves on these committees. Hopefully they are paid for doing this, but how difficult is it? Can you give some real-life stories about how difficult it is to get members to participate on these committees? If we're too prescriptive, are you going to have difficulty filling the seats to hear these issues? And give us a little more meat to the cost involved with being too prescriptive in this area and how difficult it is right now to fill disciplinary committees.

MR. OTT: We don't have any problem at all on our disciplinary committees just because it is a peer review, and therefore as an exchange member, you do have a responsibility to serve on committees. So ours are not of course compensated, and I don't necessarily think that they probably should be, at least in our environment.

You know, again our disciplinary committee members know that if rule violations have been committed that they do need to enforce sanctions in order to have a deterrent effect. So as Bernie had

stated earlier, that as a DCM you are going to be sure that you do have an effective disciplinary program in place to discipline members or anyone else that has violated rules, to ensure that market integrity is held at the highest level possible.

MR. ROTH: Commissioner, in my view, the reason to avoid prescriptive regulation in this area is not because of the difficulty of getting committee members, but rather simply an approach that works at one SRO may not be well suited for another SRO. In our experience, just as he said, we frankly don't have any difficulty in getting members to serve on these committees. Most of the members are willing to give back. They recognize it is their duty; they want to be involved.

It does get for us a little tougher with respect to the non-members that serve on the committees because you are looking for people that are not members of NFA and yet associated with the industry and that is a tougher find sometimes.

But where it gets most difficult for us, and it's frankly probably beyond your concern, when

we have a hearing. We have hearings that can go on for a week or two, and to find a panelist that can serve on those panels, that's where you just thank God for retired people, because they just seem to love it.

[Laughter.]

But that's where we have a little bit of a problem.

So I think the problem with prescriptive regulation has less to do with the ability to find committee members as it does -- it's more the idea of a solution that works at one place might not work at another.

MS. HIRSCHFELD: We would find it very difficult to have the FIA's definition of an independent director and committee member to serve on 50 percent of our board and to serve on 50 percent or more of every one of our disciplinary committees. We have been successful at the committee level thus far because we have tried to keep the committees small. So when you go forward with the hearing of three people and one of them is

a public, you can say you have 30 percent of the panel is a non-member.

If 50 percent of the BCC, which is comprised of 16 people, have to be non-members, as a small exchange, I don't know where we would find people who would be willing to put in that time.

I asked Susan Phillips in fact whether the members of the ROC are compensated and she said of course. Our public directors, I think, would say they are not compensated. We do give them a token acknowledgement and cover their expenses. Many of them live in D.C. and come to New York to sit on these panels and work on these cases, and I just don't think that we would be able to fit what FIA feels is appropriate, nor do I think it would make the process any better.

I think there is a real risk that a panel of non-industry, non-informed individuals sitting on complex cases will either say I don't know, I guess I should defer to the members on the committee, because I really don't get it, in which case you have now given the power to an even smaller group of

members; or you run the risk of them going the other way, which is I guess these people can't be trusted, that's why 50 percent of the panel has to be outsiders. So whatever they say, I should ignore and I'll just reach my own decision. And I think what you would be faced with in either event is the exchange asking for a way to appeal these decisions to the Commission.

MR. DAN: Commissioner Lukken, no one is paid on these committees. They all do volunteer their time, and they do so in the interest of just building the marketplace. And, too, while there has been some suggestions that these sorts of committees plug into a ROC or anything else, again I think that these decisions should be left to the individual SRO of what works best with them and really what we want to demonstrate to the Commission is our ability to adhere to the standards, not be dictated to how to go about it. Each situation is a bit different.

CHAIRMAN JEFFERY: Just to pursue that a little bit, I would be curious to know for each of you who are at exchanges, what is the typical term

of somebody who is on a disciplinary committee? How do you balance the need for knowledge, expertise and substance with the need for some degree of freshness and independence? Are there any term limits, for lack of a better term?

MR. DAN: At the board of trade, each annual meeting, the new committee structures, which include the disciplinary committee, are approved by the board, and it is at that time that everybody on that committee could be in theory replaced or certain members are replaced.

Throughout the year, if there's changes for whatever reason, we maintain a minimum okay, so it's an annual sort of either affirmation for those who continue beyond one term, and it's an opportunity for those who haven't yet served to in fact get that opportunity.

MS. HIRSCHFELD: It's the same at NYBOT. We solicit annually. We solicit members who want to serve on the committee. At our annual meeting the board will appoint them for a one-year term. There are no term limits, and we do have people who have

stayed on the disciplinary committees for four or five, six years. In fact, our chairman has probably been on there longer. He comes from an FCM trade category and we just find him to be an effective administrator, and not many people are willing to put in the time and the work that's involved because chairmen often get to deal with procedural issues and motions that are made in selecting panels and so forth.

There are also volunteers who you have to weed out because of 163 considerations, and we generally do not get the sense from our floor community, who are the subject of most of the disciplinary cases, that they are not being afforded a chance to rotate on and off of our committees. So we think we struck a balance of having some continuity of people with knowledge to keep the process going and bringing in new people to replace those whose time has really run.

CHAIRMAN JEFFERY: Go ahead, please, Joe.

MR. OTT: Our grand jury type complaint committee is appointed by the chairman of the

exchange with the approval of the board, so they all serve for a one-year period, and as Audrey stated, we do have people that typically serve maybe for two or three consecutive terms on that. And then again with our Business Conduct Committee, which is like our trial board, those are elected, so you do have the first vice chairman of the exchange, which will go on there for one year, the president of the clearing corporation, which will go on there for one year, and the other three members are the ones that serve the three-year staggered term, so therefore you always have at least two on there with at least one year of experience, which is helpful.

CHAIRMAN JEFFERY: Just to close with a final question, at the risk of being a little provocative. It has been asserted, informally if not formally, from time to time, that when you try to balance objectivity and fairness on a disciplinary committee with members who have a history of working together, friendships, and commercial relationships, sometimes objectivity is the first to take a hit.

I'm not saying I agree with that or disagree with it, but what is your best rebuttal to that assertion?

MR. ROTH: For me at NFA, the best rebuttal we have to that assertion is that we have 50,000 people that we are regulating, and frankly, most of the people that come before our Business Conduct Committee or our hearing committees are not -- we have the benefit of having not only nationwide but members from all over the world, and that greatly diminishes the likelihood that someone is going to be sitting in judgment of someone that they do business with every day.

CHAIRMAN JEFFERY: Any other comments? Jeff?

MR. JENNINGS: I would just say I would make a couple of comments here. I guess -- and I'm all for flexibility, and I think we have to have a very flexible system and arrangement in order to be able to address all of the issues that we face, all the different exchanges at different levels of sophistication and size.

But I guess I am a little unsettled by the overall kind of hands-off approach from most of the comments that have come in today. I mean I take a look at any sort of disciplinary proceeding or any sort of judicial proceeding or any sort of regulatory or oversight proceeding and in my mind the legitimacy for that entire proceeding comes from the process and the structure and the soundness of the overall approach and process. And it's not clear to me that we necessarily have that sort of soundness and that sort of structure within the disciplinary groups of the different exchanges to give it that legitimacy that we need.

In practice, our experience has been that there can be very high levels of concentration on the panels amongst very particular industry participants or groups, and once again, I would very much welcome any sort of empirical evidence that we can be provided by any of the exchanges that would indicate what the composition is and the turnover, for that matter, of these different disciplinary panels.

I think that would be very insightful.

CHAIRMAN JEFFERY: Thank you.

Bernie, and then we'll go down the line.

MR. DAN: It is clearly contrary to any DCM's interest, and in the case of the board of trade, our public shareholders, to allow integrity to be compromised by any conflict of interest in any aspect of our business, and so with that, anything that you have asserted before would just be in direct conflict with what we're trying to accomplish. And while I think there is probably perceptions we have to deal with, and I totally respect what Jeff is asking for and talking about, and I understand why, I can say from my experience of leading this institution, those decisions are clearly done in a very objective manner and done so in the broader interests of the marketplace. The board of trade in particular has a very long track of demonstrating that, and unfortunately, having to make difficult decisions at times in the interest of either the future or the broader market participants, and clearly in doing so we know that

we could in some way, shape, or form disappoint some users of that market. It takes a tough SRO to recognize that.

CHAIRMAN JEFFERY: Audrey.

MS. HIRSCHFELD: I echo Bernie's comments, but I would also add that I think the key is diversity and making sure that you have the proper balance of diversity and interests on your panels buttressed by your independent director participation.

MR. ROTH: Mr. Chairman, just to bring up one point that Jeff made. I have tried to describe that I don't think the Commission should by rule specify how the disciplinary process should work at each SRO. I do not mean by that to suggest that the Commission should in any take a "hands-off" approach.

To me, where the Commission's presence needs to be felt is in its ongoing oversight process of the SRO disciplinary procedure. And so I don't think prescriptive rules are the answer, but I think the Commission can and always has had a vigorous

sort of oversight role, and I would just urge the Commission to continue that effort and to continue to find new and creative ways to perform that function.

MR. OTT: Chairman Jeffery, I would just like to add that market integrity has to be the most important aspect of an exchange's business in order for them to survive. If the customer base feels that they can't trust what's going on on the floor, they won't trade your product. It's really that easy.

So, therefore, the disciplinary committees understand that, and know that again if discipline needs to be taken, then it has to be taken effectively in order to have a deterrent effect.

One thing I could point out is that our Business Conduct Committee, our rules also require that more than 50 percent of the committee members have to include persons whose primary membership interest is different from that of the person that is being considered for disciplinary proceeding.

MR. JENNINGS: Just one quick remark here. I mean the summation of most of our arguments here really comes down to the fact that no corporation has a vested interest in putting out a faulty product. I would 100 percent agree with that.

But in reality it does happen, and that's where my concern lies.

CHAIRMAN JEFFERY: So you're voting for airbags?

[Laughter.]

MR. JENNINGS: I'm voting for airbags.

CHAIRMAN JEFFERY: Okay. Any other comments from the panel or the floor before I turn to the Commissioners for some closing comments?

Yes, sir. Could you identify yourself.

MR. McCRUDDEN: Yes, my name is Vince McCrudden. I was wondering if I could have a chance to address you.

CHAIRMAN JEFFERY: Yes, if you keep it brief, please. Just for the record, could you state your name and affiliation, again, for the benefit of the court stenographer.

MR. McCRUDDEN: My name is Vincent McCrudden. I'm a small independent trader. I've been on Wall Street my career for 20-plus years in every asset class. Over my career I have executed or traded in principle hundreds of billions of dollars of financial transactions.

I have gone through, as Commissioner Lukken has said, a real-life experience going through the NFA process, and I just want to share with you that I think it is a very unfair process. I had to reregister, take my series three, and reregister with the NFA. I went through the registration process and was denied registration by the NFA. I was told by a friend of mine who was a former officer at the CFTC and the NFA, Joseph LaCaccio, that the NFA in particular, Dan Driscoll routinely stacks committees to get decisions.

I informed Mr. Dan Roth, Mr. Michael Schaefer, Gregory Mocek at the CFTC, and the Commission about Mr. LaCaccia's allegations, and there was no investigation. You know, there was nothing.

Lo and behold, when I had to go in front of a committee, subcommittee member, I'll have you know I have been compliant my whole career, and when I had to go in front of a subcommittee, lo and behold, Charles Nastro, the former chairman of the NFA, was the subcommittee chairman in charge of deciding whether or not I was being granted registration.

They have denied my registration, obviously, and I believe it's an unfair process. Besides Charles Nastro, there was another attorney and there was another COO from another I guess FCM or regulated entity. I doubt any of those three gentlemen ever traded a futures contract in their life.

The reason they denied me registration was I guess an end-all rule in the Commodity Exchange Act 883M, which is for good cause, which I guess is their back-end rule to just basically do whatever they want.

I could tell you through the process that speaking to attorneys and accountants, the general consensus is that the NFA is completely corrupt and

just abuse of power, and a lot of the attorneys don't even try to fight it.

So I wanted to share my real-life experience with the Commission and the Chairman, and I am grateful for the opportunity to do so.

CHAIRMAN JEFFERY: We thank you for your comments, and I should note for the record that you used some pretty strong language, and that we want to be very full and open and fair and transparent in this hearing, and I want to give everybody a chance to be heard. But I would urge to the extent you have an issue, a specific issue related to your situation, that you pursue it through appropriate channels.

But, again, thank you for your comments, and we appreciate your standing up. Thank you, Mr. McCrudden.

With that, why don't I turn to Commissioner Lukken for any closing comments.

COMMISSIONER DUNN: Mr. Chairman, could I do one follow-up on my question?

CHAIRMAN JEFFERY: Yes, please.

COMMISSIONER DUNN: About public disclosure of what takes place. And particularly, are there minutes kept of the disciplinary committees, and are they made public? Are they archived? What happens to those?

MR. ROTH: At NFA, and I'm sure it's this way at every other SRO, there are minutes kept of the Business Conduct Committee, our Hearing Committee, the record of the Hearing Committee's deliberation is its written decision. But for the Business Conduct Committee, there are minutes kept, and they are certainly available to the CFTC, and they are routinely provided to the CFTC as part of the rule enforcement review process.

MR. DAN: They are at the board of trade as well, Commissioner.

MS. HIRSCHFELD: Yes.

CHAIRMAN JEFFERY: Okay. Closing comments. Commissioner Lukken.

CLOSING STATEMENTS **

COMMISSIONER LUKKEN: I have no formal comments, but just want to thank all the witnesses

who testified today. I know personally, I was very much educated on the different issues that we are going to have to deal with over the next couple of weeks. So I just want to publicly thank everybody, and I look forward to further dialogue on this issue later.

COMMISSIONER BROWN-HRUSKA: I guess I'm next. I don't have any formal comments, either. However, I just want to make some observations.

A comment that John Damgard made earlier was that the CFTC has an important role as an adjudicator of the decisions that are made by the self-regulatory organizations, how they affect competition, and how they affect disciplinary actions, and otherwise. As an outcome of all these discussions, we realize that the burden is on the CFTC.

Certainly I know that in cases like the gentleman mentioned before, there was an opportunity and there was an appeal to the CFTC and I'm sure it was properly considered to ensure that the issue was fairly and reasonably handled.

We also have embedded in the Commodity Exchange Act a number of authorities -- I think someone mentioned core principle 18 today about the anticompetitive issues that may concern us. We have the core principle that is regarding conflict of interest. My closing comment is we realize that the burden is on us, that we have to, having taken your good advice, act upon it, and we intend to do so for the benefit of the public interest and to ensure that markets are fair and efficient as they have been.

Thank you.

CHAIRMAN JEFFERY: Thank you, Sharon.

Commissioner Hatfield.

COMMISSIONER HATFIELD: Mr. Chairman, thank you very much for calling the hearing, and I have to say I thought it was a wonderful opportunity to hear from all of you. I think it was a good day well spent for us to listen to the people who are on the front lines dealing with these issues.

So thank you, those of you who have been here all day.

I would also say that, as Sharon just said, these are not easy issues for us to resolve, but they are important issues that we address, and it is the Commission's responsibility to do so.

Taking one of the issues that we discussed today, one of the important ones, I would note that of the new contracts that have been certified by the Commission or have been self-certified since CFMA, there have 1,014 of those self-certified. And of substantial amendments to terms and conditions of existing contracts, there's been 661 of those self-certified that we have reviewed, and there are two or three of those that have raised some issues.

So I would suggest 1672 out of 1675 is not bad. Can we do better? That's the importance of this hearing today, and that's the importance of you being here, and I thank you very much for it.

CHAIRMAN JEFFERY: Commissioner Dunn.

COMMISSIONER DUNN: Mr. Chairman, again I would like to thank you for holding these hearings. It's been extremely beneficial. I firmly believe that in the regulatory process, it is best to go to

those that are most affected by regulations to find out what really happens, those that are in the trenches that are operating day to day, and that's what we have been trying to do today.

I appreciate the sincerity, the civility, and the wealth of information that was presented here today. All of the panels have been excellent, and I thank each and every one of you.

CHAIRMAN JEFFERY: Thank you.

I can only echo the thanks of my fellow Commissioners to all of you, particularly the panelists who participated in today's session, and to those of you in the audience who were here before and had to leave and those who stuck with it over the course of the day, your thoughts and comments and your participation alone means a lot.

I would be remiss were I not to recognize the laboring oars in this whole operation, that is Commission staff, who has done an incredibly thoughtful and thorough job over the course of not just several weeks, but several years, as this project has been percolating internally.

Specifically I would like to recognize the director of market oversight, Rick Schiltz, Steve Braverman, Rachael Berdansky, and Sebastian Pujol-Schott, who have spearheaded this effort. No doubt I am leaving out others and I apologize for doing that, but they are all recognized equally. We couldn't function but for the professionalism and the dedication of the people who labor long and hard at the Commission day in and day out.

In terms of next steps, in case you were wondering, first of all, the comment period, as we indicated at the outset, any additional comments you all would like to add or anybody else would like to add in the community is open for the next business.

Secondly, lest those of you who participated thought the reward for good work was not more work, certain of my fellow Commissioners indicated that they might like to come back to you with additional questions. You are not obligated to respond, but we would hope you would indulge them, provided their questions are clear, concise, and

asked of you on a timely basis so you can respond accordingly.

In terms of final work product, our next steps -- I don't want to commit -- that's one of the things they told you when you became a regulator, never commit as to a time schedule! But suffice it to say this process has been ongoing for some period of time and we are kind of well beyond the end of the beginning of the process. Whether at the beginning of the end, I'm not so sure. But over the course of the next several weeks we will be working on an internal work paper which we would hope to have for industry comment some time this spring with a view to finalizing anything that needs to be finalized, if anything needs to be finalized, by way of suggestions, recommendations, fine-tuning, or other adjustments to the current structure some time later this spring, early this summer.

So with that, by way of general guidance as to time line, I would again reiterate our collective thanks to all of you and for your participation and encourage your ongoing involvement in this process

to the extent you are interested and want to stay involved.

Thank you. With that, the proceeding is adjourned.

[Whereupon, at 4:36 p.m., the hearing was adjourned.]