UNITED STATES OF AMERICA

BEFORE THE

COMMODITY FUTURES TRADING COMMISSION

PUBLIC HEARING ON A NEW REGULATORY FRAMEWORK

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P R O C E E D I N G S

CHAIRMAN RAINER: Okay, let's call this to order. This is our second day of two public meetings to discuss our rule proposal and as I said yesterday, this is to be considered as an inherent part of our comment period, which ends on August 7. And to reiterate yesterday's comment, we look forward and encourage everyone here to supplement these hearings with your views in writing to us if you so choose. We will be paying close attention to all of those letters and papers.

Also to repeat, the format, we have two panels scheduled today. The first panel is on the topic of intermediaries and the second panel deals with the topic of clearing.

Our first panel has five distinguished panel members and we are looking forward to their comments. I think we will follow yesterday's format, which was to have each person, each witness testify for 10 minutes, preferably not longer than that, and then after you're finished with your testimonies, we'll open up for questions among the commissioners, about five minutes each.

With that, let me welcome each of you here and thank you very much for coming to help us out on this. You're all experts in your field and we will listen very carefully to your views and comments and appreciate your taking the time to help us out.

You're going to be presenting by alphabetical order, which is organized moving from your right to your left. So why don't we start with James Baer, who is president of Exchange Analytics.

STATEMENT OF JAMES D. BAER, PRESIDENT

EXCHANGE ANALYTICS, INC.

MR. BAER: Mr. Chairman and fellow commissioners, thank you for giving us the opportunity to appear before you today.

My name is Jim Baer. I am the president of Exchange Analytics, Incorporated. We're appearing here today to ask you to reconsider the elimination of Rule 334, mandated ethics training, as part of the new regulatory framework.

Exchange Analytics is a leading CFTC- and NFA-authorized provider of ethics training programs for the industry. Since 1995 we've provided over 25,000 programs

to registrants throughout the world representing most of the largest financial service companies in the industry.

In 1992, precipitated by a FBI sting operation on the floor of the various exchanges, Congress took the unprecedented step of passing legislation requiring ethics training for all registrants in the futures industry. The language of the resulting 1992 Commodity Exchange Act left little room for interpretation. It demanded direct and specific federal agency involvement to ensure compliance.

To fulfill this mandate, your Commission established Rule 334. Since implementing this rule, over 100,000 ethics training programs have been provided to industry registrants. In our written submission that addressed the deletion of Rule 334, we have included a sampling of the comments we have received from registrants regarding the value of this training. A consistent message has emerged from this direct feedback from intermediaries. Futures trading is substantially different from securities trading and registrants have welcomed the opportunity to be made aware and kept abreast of the different rules and interpretations.

Specifically now, "to provide flexibility and ease compliance for all registrants, the Commission proposes to delete Rule 334." In its place, the Commission proposes to implement congressional intent through a statement of acceptable practices, which "does not specify any particular programs or procedures" but which does do the following four items.

One, eliminates ethics training for institutional brokers. Under the new regulatory framework, individuals conducting business solely for institutional customers will not be required to take ethics training providing they are already registered with the SEC. The rationale is that they will only be dealing with institutional customers, with only a minor portion of their activities involving commodity interests.

To the contrary, specificity of futures products and their unique characteristics are precisely the reason why Congress required a specified commodity ethics training program and why the commodities and securities industries operate under different regulators. Intermediaries dealing with institutional customers should, at a minimum, be held to the same fitness standards as other registrants.

One is only to look at some of the recent financial catastrophes to appreciate the risks of the marketplace due to improper or poorly supervised behavior. Barings Bank, Sumitomo, Daiwa, Bankers Trust, Orange County all involved the institutional side of our business.

Secondly, the standards of acceptable practice eliminates the initial ethics training requirement. Congress, in the 1992 CEA, addressed this issue and specifically required that "the Commission issue regulations to require new registrants within six months of registration to attend the training session." Rule 334 provided for that by establishing an initial program to be completed within six months of registration.

The statement of acceptable practices does not. It simply leaves the frequency and duration of the training up to what the registrant deems appropriate. Not only will this create confusion and uncertainty but it raises a serious question as to how this satisfies the explicit initial training provision of the act.

Three, the Commission now proposes that registrants themselves be allowed to develop and deliver their own ethics program, training, rather than to obtain

it from an NFA-authorized provider. The format and content of such training would also be left to the discretion of registrants and the SROs. It would be permissible to require training on whatever periodic basis the registrant and the SROs deem appropriate.

The current rule provides certainty that specified topics in the public interest will be covered and that intermediaries participating in training will be exposed to those topics. The futures markets, as you well know, have unique characteristics and leverage that highly differentiate it from other markets. It is imperative and very much in the public interest that those differences are considered in an ethics-training program. Rule 334 ensures that this takes place. The statement of acceptable practices does not.

We further believe that the intermediaries' perceived sense of the importance of this program will be compromised without the definition that Rule 334 provides. Leadership by the CFTC in establishing this prescribed program led the NASD to follow suit by establishing its own regulatory element training for Continuing Ed in the securities industry.

To impress upon brokers the seriousness and importance of this training, brokers in the securities industry are required to travel to test centers to take a three-hour periodic proctored program. Ironically, now, after raising the bar for your sister industry and, in the process, providing a far more flexible and user-friendly delivery format than they have, you are proposing to ease compliance for registrants to provide a flexibility that already exists.

It is difficult to understand how one hour of ethics training every three years can be a compliance burden that needs easing or how a requirement that can be met wherever, in whatever media, whenever registrants choose does not provide enough flexibility. Eliminating Rule 334 will send an opposite message to the futures industry and the public. Without regulatory guidance, the ethics training will not be perceived as seriously as is currently the case.

Fourth and last, eliminating third-party recordkeeping by authorized providers in the NFA. Under Rule 334, authorized providers are required to maintain records and report completion data to the NFA. In turn,

the NFA has developed a highly efficient and functional system that allows them to effectively oversee and ensure that the ethics requirement is complied with.

At any given moment, the NFA can immediately advise registrants and firms of their status regarding this requirement. On the other hand, a statement of acceptable practices offers no replacement for this automated system. It simply suggests that compliance will be assessed through periodic audits. This is a major step backwards and will result in questionable compliance, verifiable only through the laborious production of each registrant's records at the time of an audit. Since the registrants themselves will be responsible for maintaining their own records, the task will be extraordinarily inefficient and potentially suspect.

In addition, eliminating ethics training for registrants conducting primarily institutional business will increase significantly the recordkeeping burden for firms and regulatory bodies. It will now become necessary to differentiate and account specifically for those individuals.

In summary, we appreciate the intent of the CFTC to reduce micromanagement of the industry. However, where Rule 334 is concerned, we believe you are eliminating a program that is very much in the public interest and are attempting to fix something that isn't broken. CFTC guidance and direction is critical to ensure that the mandated ethics training has the integrity demanded by the CEA Act of 1992. The rationale behind the statement of acceptable practices, "to provide flexibility and ease compliance for all registrants," that flexibility currently exists. Easing compliance and relying upon the statement of acceptable practices as a safe harbor risks failure to fulfill the mandates of the act, offers no resulting benefits, and sends the wrong message to the industry and the SROs of the importance of this requirement.

Agency guidance has created a system that works. It is highly efficient and ensures compliance. Rule 334 does not place any significant burden on the industry. In fact, direct demands on the firms themselves will be increased because of the elimination of the reporting responsibilities of authorized providers and the NFA.

No competitive economic or social benefits accrue to the industry or to the public from eliminating this rule. Elimination of the rule raises a host of practical issues regarding oversight and compliance. Rule 334 accomplishes the letter and spirit of the 1992 act. The statement of acceptable practices does neither. We urge you to reconsider deleting Rule 334.

Thank you for your time and consideration.

CHAIRMAN RAINER: Thank you very much.

Next we have John Damgard, who's the president of the Futures Industry Association. John?

STATEMENT OF JOHN M. DAMGARD, PRESIDENT

FUTURES INDUSTRY ASSOCIATION

MR. DAMGARD: Thank you, Mr. Chairman and members of the Commission. On behalf of the Futures Industry Association, it is a pleasure for me to be here today to discuss the proposed rules to implement the Commission's new regulatory framework and, in particular, those rules relating to intermediaries.

And I would like to say that my chairman Steve Spence had hoped to be here today but customer business has him in Chicago. And I believe also the intermediaries are

very much in the earliest stage of digesting this proposal but we certainly intend to provide our full written comments before the expiration of the comment period.

And we congratulate the Commission for undertaking this initiative and agree with all those who testified yesterday that the Commission's proposal is a revolutionary departure from the traditional approach to exchange regulation. I don't want to be out-gushed by anybody that testified yesterday. We think you really do have it right and we think also that it's a very, very positive and wonderful first step.

It is a recognition that competition may be the best regulator. Certainly all futures market participants are subjected to an unprecedented level of competition. FIA is not in a position to provide specific comments today but we're prepared to make some initial observations.

In its proposal relating to multilateral transaction execution facilities, the Commission would replace the prescriptive regulations that currently restrict an exchange's conduct for the set of core principles against which the exchange's activities will be measured. As the Commission notes, the core principles are

"tailored to match the degree and manner of regulation to the very nature of the product traded thereon and to the sophistication of the customer."

The Commission similarly proposes to adopt a regulatory scheme for recognized clearing organizations based on core principles. Without addressing the pros and cons of a particular core principle, FIA endorses heartily the Commission's approach.

However, the Commission's proposal with regard to intermediaries contrasts sharply with the proposals for multilateral transaction execution facilities and recognized clearing organizations. Although the Commission has identified core principles for intermediaries, the Commission has concluded that it will not adopt them. Instead, it has stated that it will use the core principles to develop its regulatory policy with respect to intermediaries.

FIA believes that the Commission can and should do more to replace the prescriptive regulations governing intermediaries with statements of core principles and interpretations of acceptable business practices. FIA therefore encourages the Commission to reexamine its rules

with the goal of replacing them with a set of core principles and interpretations of acceptable business practices. We expect to expand our views in this regard in our written comments.

The underlying principle that will guide FIA's comments on this and other aspects of the Commission's proposal is its belief that the form and degree of regulatory oversight of intermediaries should be consistent with the class of market participants with which an intermediary interacts. Requirements relating to registration of intermediaries, fitness and training, capital and the treatment of customer funds should be established taking into account the type of customer on whose behalf the intermediary acts. Consideration of this type of market on which the customer trades and the products traded are secondary. The final rules therefore must reflect the overwhelmingly institutional nature of derivatives market participants.

FIA therefore welcomes the Commission's decision to request comment on possible amendments to its segregation rules to permit FCMs and clearing organizations to maintain in a single customer-segregated account

positions in OTC derivatives, equity securities and other cash market positions in addition to futures and options on futures positions.

Earlier this year, FIA recommended that the Commission adopt such amendments. FIA further recommended that the Commission encourage and, where necessary, facilitate cross-margin relationships among futures clearing organizations and between futures clearing organizations and securities clearing agencies. Implementation of these recommendations will afford FCMs and their customers the ability to manage more efficiently and more effectively their cross-market risks through cross-margining or cross-collateralization of obligations.

We encourage the Commission to propose rules in this area promptly after completion of the comment period. And I suspect that that issue is our most important issue.

We agree with the Commission that in connection with the adoption of regulations to implement these recommendations, the Commission will be required to revise its regulations relating to commodity broker liquidations to assure appropriate treatment of customer cash and OTC derivatives positions, as well as securities that the FCM

holds. Our written comments will respond to the Commission's questions in this regard.

FIA is also pleased that the Commission has proposed to amend Rule 125, expanding the types of instruments in which FCMs and clearing organizations may invest customer funds. As the Commission is aware, FIA has been proposing relief in this regard for several years.

In addition, FIA endorses the Commission's decision to consider a risk-based capital rule for FCMs. The existing minimal financial and related requirements constrain FCMs from participating in the OTC derivatives markets in a meaningful way, as either dealer or agent. Pending adoption of these rules, however, we believe the Commission should act promptly to adopt the following amendments to its regulation.

Number one, the Commission should revise Rule 1.117(c) defining the term "adjusted net capital" to recognize that futures contracts may reduce the risk of holding certain other futures contracts and OTC derivatives. Such futures contracts and derivative products should be considered inventory which may be

covered by a futures contract. This amendment will enhance the efficiency of both the OTC and the exchange markets.

Two, the Commission should remove rule 1.19, which generally prohibits an FCM from assuming financial responsibility for OTC options except in defined circumstances. Subject to appropriate haircuts, FCMs should not be prohibited from assuming responsibility for any OTC commodity option.

FIA expects to recommend that the Commission adopt more meaningful changes to its arbitration rules, in particular as they relate to the use of predispute arbitration agreements with institutional customers. The Commission's rules inhibit the ability of FCMs that are also broker-dealers to enter into a single agreement with their institutional customer. As you know, the Securities and Exchange Commission does not prohibit the use of mandatory predispute arbitration agreements for any type of customer, provided a broker-dealer furnishes a customer with the uniform disclosure regarding predispute arbitration agreements adopted by several securities SROs and approved by the SEC.

This approach contrasts sharply with the Commission's rules. FCMs that are also broker-dealers have no assurances that in the event an institutional customer has a complaint against the firm, all of the elements of that complaint will be heard in a single forum.

FIA generally agrees with the Commission's decision to base its definition of an institutional customer on the Commission's definition of an eligible swap participant. However, we had previously recommended that the Commission amend its definition of an institutional customer to include any person whose account is managed by an investment manager with at least $25 million under management.

Because an advisor is a fiduciary to the customer, we believe it is more appropriate to look only to the sophistication of the advisor in determining whether a customer should be considered an institutional customer. The net worth of the underlying customer or the aggregate value of the individual customer's assets should be irrelevant. Requiring an advisor to have a minimum amount of assets under management is a measure of the expertise of

the adviser in the level of confidence that a significant number of market participants have placed in that advisor.

Although perhaps more directly related to the rules governing multilateral transaction executions facilities, we also wish to note here that FIA has recommended the Commission confirm that exchanges may adopt rules that would permit FCMs to act as either principal or agent in dealing with regulated exchange contracts. All other trading markets, including the U.S. securities market, permit dealing away from the exchange and the subsequent entry and clearing of those transactions on the exchange.

Permitting an FCM to deal as principal or agent directly with its customers and to then enter that executed transaction onto a regulated exchange where it becomes a cleared contract subject to exchange rules would provide exchange markets with needed flexibility, liquidity and efficiency.

To deny exchanges this right, in particular those exchanges that list products that may be traded on an exempt MTEF or DTEF, may place them and the intermediaries

and customers that trade on them at a disadvantage in competing with these essentially unregulated markets.

Finally, we understand that the Commission intends to address separately certain aspects of its regulations that govern transactions in international markets. We want to take this opportunity to emphasize the importance of moving forward in this area.

The Commission's rules no longer reflect and address needs of the international marketplace. They were promulgated during a period when the Commission's regulatory focus was on protecting retail customers from sales practices and financial fraud; moreover, when the international regulation of derivatives markets was virtually nonexistent.

Today the market environment is markedly different. Institutional customers dominate and demand access to the international markets. These customers do not require the same level of protection that retail customers want and have come to expect.

Equally important, the regulation of the more significant overseas markets by their home regulators has improved dramatically. To the extent that the Commission

declines to recognize the regulations of a particular country, the Commission's rules unnecessarily impede the ability of U.S. institutions to conduct business on those markets. The Commission must be prepared to be more flexible in its approach toward the international marketplace.

In this regard, FIA has long encouraged the Commission to amend its interpretation of the provisions of Section 2(a)(1)(b) of the act relating to stock index futures contracts. It is FIA's position that this section of the act does not authorize the Commission to prohibit the offer and sale of foreign stock index futures contracts in the U.S.

To the contrary, the Commission's interpretation conflicts directly with the provisions of Section 4(b) of the act, which specifically provides that the Commission may not require that the terms and conditions of any foreign exchange contract be submitted to the Commission for approval.

We are pleased that the House Committee on Agriculture has adopted an amendment to the act for the purpose of clarifying the Commission's authority in this

regard. However, we wish to emphasize that a legislative amendment is not essential and we again encourage the Commission to act promptly to permit the offer and sale of all eligible foreign stock index futures contracts in the United States.

In closing, I want to thank you again for the opportunity to appear before you. We look forward to submitting our written comments.

And I want to say to the chairman's question as to whether or not what we've got here is something better or something worse, the answer obviously is a resounding yes. It's much, much better and we look forward to working with the Commission to work on the second step and the third step, to make sure that the same kind of regulatory relief that we support, that extends to the exchange community, can be extended to the intermediary community, as well. Thank you very much.

CHAIRMAN RAINER: Thank you very much, John.

Next we have Dan Driscoll. Dan is the executive vice president and chief compliance officer of National Futures Association. He's been with that organization, I guess, since its inception in 1982. Before that, we are

proud to say that he's a CFTC alumnus, having worked in the Division of Trading and Markets at the CFTC. Dan?

STATEMENT OF DANIEL A. DRISCOLL
EXECUTIVE VICE PRESIDENT
NATIONAL FUTURES ASSOCIATION

MR. DRISCOLL: Thank you, Mr. Chairman, Commissioners. I really appreciate the opportunity to be here today. And, as you can tell from my bio, I've been in the regulation business in the futures industry for a long time, even before there was a CFTC, because I was an employee of the Commodity Exchange Authority prior to the formation of the Commission in 1975.

And in my almost 30 years of being a regulator in the futures industry, I've never seen a proposal that was as far-reaching and as absolutely necessary as this current proposal. It is a great piece of work and I commend you all for it.

I thought it would be helpful for me to share with you some of my perspectives as a career regulator with regard to your proposal. One of the objectives of your new framework is for the Commission to become more of an oversight agency and not be a micromanager. And the

proposal also uses core principles that would be fleshed out by interpretive guidance in order to reach that objective and I think that way of accomplishing that objective is right on point.

I am a big fan of core principles and I've got to admit to you that I'm not particularly fond of specific prescriptive types of rules. And I'd like to share with you some of the reasons that I feel that way through my own experiences.

I know that there have been questions asked as to whether it would be more difficult to prosecute bad behavior or abusive behavior under the use of core principles. I don't think that that will be the case at all.

One thing to keep in mind in that regard is that core principles aren't fuzzy, feel-good suggestions; they are requirements, and registrants will have to comply with those requirements. It's just that we, as regulators, won't be telling them the one and only way to comply with the requirement.

In terms of enforcement actions, regulators need to look at whether firms and individuals are complying with

the spirit of the regulations, of the rules, of the requirements, as opposed to the letter of the requirements. In all candor, technical violations of rules make for lousy enforcement action, whether it be at a self-regulatory organization or a government regulatory organization. And core principles really do enlighten us as to what the spirit of the requirements are.

So I think that enforcement of bad behavior will not be hindered at all, either at the Commission level or at the SRO level, with the adoption of core principles. And I'd like to just again share a few observations that support my views on that that's backed up by experience at NFA.

My favorite requirement at NFA is the requirement that our members abide by high standards of commercial honor and just and equitable principles of trade. In my view, that's the ultimate core principle.

My second favorite requirement is our compliance rule 2-29, which governs the use of promotional materials by our members. Now there are parts of that are very specific and call for specific disclaimers and types of balancing statements. However, also embedded within that

rule is a core principle and that core principle is that NFA members can't use promotional material which is deceptive or misleading. And over the past 15 years we have taken well over 100 disciplinary actions charging violations of compliance rule 2-29 and I've been really wracking my brain and I can't think of one of those cases that focussed on a firm or an individual not putting those prescriptive disclaimers in the rule or those balancing statements. All of our actions are for violations of the core principle that, in fact, firms are using deceptive and misleading promotion material.

And, of course, over the years we have expanded on what we mean by misleading and deceptive through interpretative statements that, as time goes on, we add to the body of guidance there and in order to make sure that firms know what we think is misleading and deceptive, we give them the opportunity to file their promotional material with us before they use it so that we can give them our comments. And we think that this type of process works very well and that's what makes me believe the core principles are not at all hard to enforce. In fact, they

might be easier to enforce because it makes you focus on the bad conduct, rather than the letter of the regulation.

The other problem that I have with specific rules is that the tendency when you're drafting those rules is to try to think of every conceivable possibility that could come up either in the present or the future. And the almost inevitable result of going through that process is you get a rule that's very long, very complicated, goes off in several directions. And I think that it would be a great invention if someone could invent a ballpoint pen that any time that the user tried to put down on a piece of paper the words "provided, however," or "provided further," that the ink be stopped completely so that those words couldn't be put down on paper. I just think that that's what happens when you try to do those sorts of rules.

And the really sad thing is that even though you try to come up with all of the potential things that could happen and deal with them in the rule, there's always going to be something that you missed because facts are going to change and there's going to be a circumstance down the line that your rule doesn't deal with completely. And then what you have is a loophole.

And I know that all of you know from your experience of trying to do enforcement actions against foreign exchange bucket shops that the legitimate firms aren't the ones that flock to loopholes; it's the firms that are illegitimate. And that's another reason why I believe core principles, as opposed to prescriptive rules, are absolutely the right way to regulate this industry.

Having said that, I believe that like John said, with regard to exchanges and clearing organizations, I do think the Commission's proposal uses, to a great extent, the core principles that would be expanded by acceptable practices and interpretative guidance. And you could tell from the exchange representatives that were here yesterday they all very much appreciate the flexibility that that gives them and I think that that will work.

With intermediaries, however, and by intermediaries I mean FCMs, IBs, CPOs and CTAs, as John mentioned, I think the Commission took a different approach. In most cases, rather than making the core principles directly applicable to the intermediaries, the Commission appears to be taking the approach of using core

principles as guides to the staff in forming specific regulations.

Now, I just disagree with that approach. I am not taking the position that the Commission should throw away the White Book and repeal all of its rules. I do think that there are certain areas, such as segregation and capital, where there does need to be a degree of specificity. But there are other areas that I think core principles, fleshed out by interpretive guidance, would be the proper way to go.

And I'll put in a plug now for NFA. I think the NFA would be uniquely positioned to work along with the Commission to not only help figure out what those core principles should be but also to develop the interpretive guidance. We've been doing that for a number of years. Our committee structure at NFA and our accessibility to end users makes us uniquely positioned to formulate interpretive guidance and to make sure that it has industry input.

And also, the Commission, in addition to having the ability to come up with its own interpretive guidance, would also play a large role in NFA's process there because

not only would we work with you and your staff as we develop the guidance; obviously any guidance that NFA adopted would have to be approved by the Commission. So the Commission would have the ultimate control.

I don't want to go into all of the areas where I think core principles could be adopted for intermediaries but let me just mention a couple. One is in the area of recordkeeping. As far as I can tell, on recordkeeping, what you're really looking for is you want to make sure the records will be accessible and that they're going to be reasonably protected from destruction or alteration and that's really all you're looking for. If that happens, then you're happy and you're never going to have any problems.

But I think the problem with the current recordkeeping rules is they put in a lot of specific requirements that records have to be maintained in particular ways that just unfortunately, I think, creates an incentive for firms to maintain records in paper form, in hard copy form, which is ironic because in my view, not only does maintaining all of those records in hard copy cost a lot more, making it more inefficient, but I don't

think it meets the other standards as well as electronic maintenance of those records. So I would favor having a core principle that would meet the standards of accessibility and security and not have all of the prescriptive rules.

The other area I would like to mention is disclosure requirements for CPOs and CTAs. I don't even know how many pages the Part 4 disclosure rules take up in the White Book but I know it's quite a few and those rules can be complex and cumbersome. And one of the results of that is you get a lot of boilerplate disclosures and disclosure documents that I'm not sure serve a real public policy objective.

And the other thing is that those rules don't really respond well to changes within the industry. One glaring example of that is notional funding, which I promised never to ever say those words again at an open Commission meeting, but that's an issue that's been unresolved for 13 years and just one thing that should have been resolved many years ago and I think could have been had there been a core principle type of regime.

Let me go into a few specific comments that NFA has with regard to the Commission's proposal. We strongly support the concept of passporting broker-dealers and banks into registration with the Commission and NFA when those broker-dealers and banks have only institutional customers trading on DTFs.

However, we think that the proposal should go even farther. We can't see a public policy reason to keep that passporting option from a broker-dealer and a bank who has all institutional customers and those institutional customers also trade on RFEs. We just don't see the public policy reasons for that, so we would suggest broadening the availability of passporting.

Going beyond that with regard to registration of associated persons, as we all know, the fitness standards for APs and for general securities reps are virtually identical. So we at NFA question why we should ever have to duplicate fitness checks on individuals that are currently registered at NASDR as general securities reps. We think that that's an unnecessary step and one that doesn't really provide additional customer protection.

With regard to proficiency testing, the Commission correctly recognizes that Congress imposed proficiency testing requirements on NFA and it's always been NFA rules that govern proficiency testing. We do understand that the Commission would favor relaxing proficiency testing requirements for those APs that would only deal with institutional customers, and that is a matter that we'll address our board and work with the Commission to come up with an appropriate resolution.

We also strongly support the concept that's embodied in your framework that makes it clear that retail customers need more customer protections than do institutional and other sophisticated customers. On the other hand, we think that it would be ironic that in the name of customer protection, that we keep retail customers or noninstitutional customers from the most liquid markets. And therefore, we're totally in agreement with your provision that would allow retail customers to participate on DTFs as long as they deal with an FCM who meets supercapital requirements and which provides additional risk disclosures which NFA will be proud to work on with the Commission to come up with those requirements.

I would add and I'm certain Susan will mention this, I know that MFA has some of the same concerns with regard to pool participants and managed account customers and doesn't want to have them precluded from liquid markets, so I would urge you to carefully consider any recommendations that MFA would have in that regard.

I'd like to speak briefly on the Commission's request for comment on two areas regarding segregation. One is should institutional customers be able to opt out of segregation? And, as John mentioned, should other funds that are therefore other types of instruments, such as securities and OTC products be allowed to be put into segregation?

My only comment on both of those proposals is really that I think that the one thing that you need to make sure is in place is that before you do those things, make sure that it's absolutely clear how those funds would be handled in an FCM insolvency. Thank goodness FCM insolvency's don't happen very often but they do happen occasionally and it's too late to start sorting that out after the bankruptcy occurs.

So I think that those are both proposals that could have some merit but let's make sure that the bankruptcy provisions are up to date and we know how those things would be handled there.

I know today we're talking about intermediaries but as you know, NFA is getting into a new business line, which is to do trade practice and market surveillance work for electronic exchanges and some of those exchanges might be RFEs and some might be DTFs. And just two points in that area.

Certainly it could be possible in the future for there to be two very similar contracts or actually identical contracts, one trading on a DTF, one trading on an RFE. And it think it's really important that the Commission strongly encourage, if not require, information-sharing agreements that would be in place so that there's not a shortage of information being exchanged between those two types of facilities that would inhibit adequate market surveillance.

And finally, and I know Commissioner Erickson asked questions yesterday about large trader reports and all of the exchange representatives sang the praises of

large trader reports and indicated that they would continue using them, even if there was no requirement. And I don't disagree with that concept. I think that large trader reports have served us well, but I also know that there are going to be new business models in the future that look different than the way that exchanges are now. You may have an exchange where all of the participants have direct access to the exchange and are only trading for their own account.

So in there, you could actually collect large trader data and position information on line, by computer, and it might be a redundancy to have large trader reports.

So I just caution you to keep an open mind and realize that there might be alternative ways for an exchange to know who their large traders are and to know what their activities are, other than historical large trader reports.

And in conclusion, I appreciate once again the opportunity to be here. I think it's a great piece of work. We totally support it at NFA and we look forward to working with you to fully implement your proposal.

CHAIRMAN RAINER: Thank you very much, Dan.

Next we have Susan Ervin, attorney with Decker, Price and Rhodes and is counsel to the Managed Funds Association and also is an alumna of the CFTC, we're proud to say. Susan?

STATEMENT OF SUSAN C. ERVIN

COUNSEL TO MANAGED FUNDS ASSOCIATION

MS. ERVIN: Thank you, Chairman Rainer and Commissioners. Thank you for the opportunity to present the views of the Managed Funds Association on the CFTC's regulatory reform proposals. MFA's Chairman, George Crapo, regrets his inability to be here today. I am accompanied, however, by John G. Gaine, MFA's president. I have some brief remarks and a longer statement for the record.

The MFA is a national trade association representing more than 700 participants in the hedge fund and managed funds industry. It is fair to say that no topic is more important to MFA and its members than regulatory reform. MFA's members are professional advisers to and managers of the funds of other persons. The goal of maximum access to markets on the fairest and most efficient terms is at the very foundation of the livelihood of MFA's members and the interests of their clients. In MFA's view,

responsible regulatory reform is key to achieving these objectives.

MFA is strongly supportive of the Commission's objectives in undertaking its regulatory reform initiative and it offers its continued assistance to the Commission in addressing these objectives in the managed funds area.

However, although the Commission's regulatory reform proposals issued to date are broad ranging and extensive, thus far, they have relegated commodity pool operators and commodity trading advisers to the status quo.

We are, of course, mindful of the burdens imposed on the Commission in this rulemaking process. However, CPOs and CTAs are affected by the same forces of globalization, technological transformation and other market trends that have swept through the futures industry and created a compelling need for regulatory reform.

The managed funds industry operates in a rapidly growing, global and increasingly competitive market. We therefore call upon the Commission to address this key part of its regulatory jurisdiction without delay.

I would also like to make some preliminary observations on two specific aspects of the Commission's regulatory reform proposals.

First, access to new markets. MFA believes that the Commission should permit the fullest access, consistent with appropriate protections, to the new types of markets that would be created under its proposed new regulatory framework. These new forms of markets, MTEFs and DTFs, will provide important new trading forums, perhaps even rivaling the more conventional markets. Undue restrictions on access to these markets will disadvantage persons excluded from them.

We support the Commission's recognition that customers trading through registered FCMs have access to DTEFs without regard to their own financial qualifications. We believe that customers trading through registered commodity trading adviser should also have such access.

When a CTA manages the assets of a customer, that customer has the benefit of the CTA's sophistication and trading expertise in selecting the most cost effective market in which to conduct transactions for that customer's account. We do not believe that a case has been made to

bar CTA clients from the choice of trading in these new markets any more than they are deprived of opportunities to participate in the growing array of other U.S. and international financial markets.

My second topic is that of core principles. The Commission's release concerning intermediaries analyzes the requirements applicable to FCMs and IBs by reference to core principles in order to determine which rules might be changed or deleted.

MFA supports the use of core principles as a basis for a more flexible regulatory approach. While we are not addressing the specifics of this part of the proposed rulemaking at this time, we note the need to consider the use of core principles or performance standards for CPOs and CTAs. In this context we believe that the role of core principles should be to establish flexible performance standards, which can be satisfied through multiple alternative approaches. This would be consistent with the Commission's objective of moving away from one-size-fits-all regulation and toward more flexible regulatory approaches.

We are familiar with the NFA's work in developing a set of core principles for CPOs and CTAs. We are fully supportive of that project and hope that we will have an opportunity to work with the Commission and NFA in bringing those concepts to fruition in the very near future.

Thank you again very much for your attention and for the opportunity to present MFA's views here and I'd be happily to respond to any questions you may have.

CHAIRMAN RAINER: Thank you, Susan.

Our last witness on this panel is Melinda Schramm. Melinda is the chairman of the board and I note a founder of the National Introducing Brokers Association and she's also president of MHS Capital Resource, Incorporated, which is a company that provides information and education to futures professionals.

Melinda?

STATEMENT OF MELINDA H. SCHRAMM

CHAIRMAN OF THE BOARD

NATIONAL INTRODUCING BROKERS ASSOCIATION

MS. SCHRAMM: Thank you, Chairman Rainer.

On behalf of the National Introducing Brokers Association, I want to thank the Commission and

particularly Chairman Rainer and Commissioner Spears' offices for inviting the NIBA to this meeting to discuss the proposed rulemaking to implement a new regulatory framework for the futures industry.

The NIBA congratulates the Commission and specifically its staff task force for its thoughtful endeavors toward modernizing regulation of our marketplaces.

I am Melinda Schramm, chairperson of the board of directors of the National Introducing Brokers Association, which is a trade organization whose members include introducing brokers, futures commission merchants and exchanges. Founded in 1991, last week we delivered our ninth annual membership conference. Introducing brokers or IBs are the field salespersons of the futures industry and referred to as intermediaries in the proposed regulation.

The mission of our association is to keep introducing brokers in business and at a highly professional level. Our goals include representing the concerns of the IB community to each regulatory or governmental agency which affects the IB's business, offering substantial and useful ideas for an IB and his

continued growth and prosperity, and providing a forum where IBs and other futures professionals can communicate with one another.

Unless specifically referred to in our comments today, our member FCM and exchange views on these proposed changes are not included in these remarks. Only IBs have contributed to this oral statement from the NIBA. We will submit a formal written statement within the allotted time frame.

While the association believes that most of the CFTC's proposals go a long way toward modernizing our regulatory scheme and keeping our marketplaces globally competitive, we want to comment specifically on the following issues.

Number one, using the electronic means to deliver purchase and sales monthly and other account statements to customers who request them seems to be both cost-effective and timely. The association would support such a proposal.

Following FCMs, allowing them a broader range of instruments into which a customer's funds can be invested serves many purposes and ultimately should benefit the

customer. Our association believes this proposal should be allowed.

Number three, with respect to professional ethics providers, some of which are our best friends, changing or deleting the current ethics training requirement is a proposal which is universally embraced by the IB community. While the association wholeheartedly supports adhering to and maintaining high professional standards with regard to contact with customers and other professionals, substituting a standards of the industry practice and/or a continuing education requirement would better meet congressional intent that IBs and the sales force be and remain fit.

The National Futures Association or other designated self-regulatory organization is capable of deciding on these ethics or so-called ethics programs, with periodic reports to the CFTC as to the method, the content and the duration of the training or the requirement. Professional providers could still be used to implement the requirements, as decided upon by the NFA.

Number four, reducing the number of signatures required on account documents is another very popular

proposal with the IB community. One or two signature lines should be sufficient.

Number five, electronic signatures is also a very popular idea with most IBs but our members, including two FCMs, have some concern in that area. Since account documents are still our legal contracts with the customer and as such, as subject to state law, will the CFTC regulations supersede state law or vice versa in those states without electronic signature statutes? No IB or FCM wants to have to implement two account opening processes.

Number six, now this is the sort of meat of the concern of our association. Again including two of its FCM members, we'd like to comment on the sanctioning of derivatives transactions facilities or DTFs, as you have labeled them. We feel that it is a move toward bringing us very close to the promarket proposals of just a while back.

In that regard, the NIBA wants to be very clear. While DTFs may provide a forum for trading of many types of commodities, our association has had experience with what happens when entities are allowed to approach the public under the guise of dealing only with commercial transactions.

Since the registration status of agricultural trade merchant or ATM was created, no entity has ever registered, yet various unregistered and CFTC-unregulated entities continue to offer trading strategies and contracts based on futures prices to farmers and producers. They present themselves to the public as if they are registered, but they do not adhere to any requirements of registration--no margin, no risk disclosure, no account documents, no transaction statements, no ethics or other professional training requirements, no disclosure of the actual costs associated with such strategies and, in some cases, no disclosure that only a portion of the option premium collected is being passed through to the customer; the other part is being retained by the entity offering these strategies.

Because of these current abuses, it is important that the Commission does not allow all farmers and producers to be qualified as commercial customers and therefore approached for service by entities who only qualify under the DTF regulatory category. These abuses are flagrant, continuing, and largely unfettered by CFTC regulation in the grain industry and recently several of

our members have become aware and are investigating the possibility of the same possible practices in the dairy industry, which would circumvent the proposed change and have the additional effect of destroying the CFTC-USDA-implemented dairy option pilot program.

While it could be said that an arbitrating process will naturally keep the marketplaces and the prices in line, it can be perceived by individuals transacting business exclusively on an RTF market, which is the general public, that the commercial market is setting the price for all. The RTF market then becomes a marketplace of price-takers rather than a part of the price discovery mechanism.

At this point the NIBA would answer Commissioner Erickson's specific questions about the Commission's ability to deter and detect abusive trading practices by saying it will have to do a better job under the new regulatory framework than it is currently doing under the present one when it allows products and strategies to be presented and delivered to the public with none of the usual safeguards surrounding futures transactions.

And finally, the association believes that the comment period for this important regulatory framework

change proposal is outrageously short. While we're aware that the Commission is endeavoring to meet the needs of users of our marketplace and it may also be trying to implement these changes in conjunction with its reauthorization process, every registered futures entity is being forced to make some decisions with regard to these proposals which will affect the rest of our professional lives.

When I spoke to various IBs and FCMs in order to gather information for today's hearing, many did not want to comment because they felt ill prepared due to the time squeeze. We urge you to consider expanding the time period.

Thank you, Commissioner Rainer and the entire Commissions for soliciting and including the views of the National Introducing Brokers Association on this very important subject. We'd be pleased to continue this conversation and offer our help and support in building the new regulatory framework.

CHAIRMAN RAINER: Thank you very much, Melinda.

Let's move now to the question portion of the meeting. Commissioner Holum?

COMMISSIONER HOLUM: Thank you, Mr. Chairman.

I have a question for Mr. Driscoll. Two members of the panel have differing views on the needs for ethics training. I'd like you to talk a little bit about that and what the NFA's position might be.

MR. DRISCOLL: Well, NFA would support, like with most of the other Commission rules, going to a core principle type of approach as it relates to ethics training. I know that I agree that ethics training is important and ongoing education about the markets is important and I don't see the Commission's proposal as doing away with those requirements. I think it gives a little bit more flexibility.

I believe that there would probably be a need for more interpretive guidance that could be worked on between NFA and the Commission, because I don't think it would be proper in the long run to say well, you have an ethics requirement but it's totally up to you firms whether you want to do that every 20 years or every three years.

I do think there probably needs to be more guidance and NFA would be willing to work on that.

With regard to the issue about recordkeeping, it's true that NFA does have a recordkeeping system where the currently authorized providers give us information on an ongoing basis as to the individuals who have attended ethics and NFA as an organization would be happy to continue maintaining that recordkeeping procedure whether or not it's pursuant to a CFTC rule or pursuant to the core principles. So we would be glad to do that as a service for our members and the ethics provider.

COMMISSIONER HOLUM: Thank you.

Yes? John.

MR. DAMGARD: Jim reminds me that I'm a competitor in that the Futures Industry Association has a sister organization called the Futures Industry Institute and we support the Commission's approach. We believe frankly that we're going to see an awful lot more business based on the self-interest of the firms making sure that their employees are properly trained across the board.

And to the extent that some of the broker-dealers are now gearing up to be able to sell futures, no firm wants to have someone accused of being uneducated in a product and we believe that most of the firms are going to

decide that ethics training ought to be a very important component of their ongoing educational materials for new employees and employees that will be frankly offering for sale products that are more sophisticated and more arcane than what they've been used to.

COMMISSIONER HOLUM: Thank you, John.

Susan, did you have your hand up?

Okay, no further questions.

CHAIRMAN RAINER: Commissioner Spears.

COMMISSIONER SPEARS: Thank you, Chairman Rainer. A couple of quick questions, if I might. I'd probably address the first question to John and then the entire group if they would care to comment.

As you know, under the proposal, if you want to trade on a DTF or if you're a retail customer and want to trade on a DTF, you have to go through an FCM with $20 million of capital or more. I'd be curious as to your thoughts concerning the impact on the rest of the FCM community of that requirement and your thoughts as to--I know that Dan mentioned NFA supports that provision but what are your thoughts as to how it would impact your industry, John?

MR. DAMGARD: Well, I think we've seen consolidation in our industry, just like every other industry, and the small undercapitalized FCMs have either joined forces or dropped by the wayside. I think that's probably a pretty good requirement and that's about the right number.

Do I think that there will be as many members of the FIA 10 years from now as there are today? Not in the same category. I think that the business of being an FCM and introducing customers to markets becomes more and more capital intensive and more and more sophisticated all the time. And that doesn't mean that there won't be niche businesses where grain elevators, for instance, that probably will not be interested in qualifying as FCMs will provide advice and counsel to customers and probably enter the marketplace through a larger clearing member whose capital basically backs up the financial integrity of the system.

COMMISSIONER SPEARS: Would any other panelist like to comment on the $20 million figure or on that requirement?

MR. DRISCOLL: Well, I don't think there's anything magical about $20 million but I do think that it makes some sense to first of all, not preclude those customers from participating in DTF markets.

Also, I think that it does make regulatory sense to have some sort of supercapital requirement because those types of retail customers are going to be less likely on their own to ask questions about how much capital does my firm have? I think as time goes on, the capital wherewithal of the brokerage firm you do business with will become an even more important question and so I think it would be appropriate in this particular circumstance to have the supercapital requirement.

COMMISSIONER SPEARS: Thank you.

Finally, Mr. Chairman, one question for Melinda.

You mentioned that a large percentage of your membership deals with the agricultural community or producer farmers. And as you're aware, the Commission treats the enumerated commodities, the ag contracts, somewhat differently as far as the RFE status.

Do you have any thoughts as to that requirement? Should it be that way or should they be treated like the rest of the RFE contracts or even at the DTF level?

MS. SCHRAMM: The National Introducing Brokers Association met last week and for the first time as a body, discussed these issues and we're still bringing in information to address that specific question. We will address that in our formal written statement. I think the answer is going to be yes, we definitely have a view and I want--

[Laughter.]

MS. SCHRAMM: --before we put it together. Thank you for giving me the opportunity, though.

COMMISSIONER SPEARS: Do the other panelists have any thoughts in regard to the agricultural contracts?

Okay, thank you, Mr. Chairman.

CHAIRMAN RAINER: Commissioner Newsome.

COMMISSIONER NEWSOME: Thank you, Mr. Chairman.

I just wanted to start off by thanking the panel for some excellent testimony. I think you guys did a good job and I appreciated listening to your viewpoints.

Mr. Baer, back to your point on the ethics training. Do you feel like the intermediaries will continue to include ethics training even if it's not required, as in our proposed rule?

MR. BAER: I agree with Mr. Damgard that there will be continuing education that will cover probably and touch upon ethics. It's an important area. The industry respects the training, for the most part.

I think that the hardest issue that I see in this proposal is the perception of the importance of the training. The SEC has gone to extremes to ensure that their membership appreciates the importance of that training by making them travel, sometimes by plane, to proctored centers to take a test that's proctored.

This Commission has been enlightened enough and progressive to allow registrants anywhere in the world to take a program over the Internet in the comfort of their home 24 hours a day whenever they so desire.

It's the perception of the training that is going to be greatly diluted when you tell people that they can take it whenever, that the programs can be established by whomever. This isn't typical or similar to firm element

training in the securities industry that is pretty much voluntary on the part of the firms to conduct their own programs. This was a congressional mandate and the core principle, in effect, was set by Congress. Congress set a general guideline that they passed to the CFTC to implement. I read this as the CFTC, again through respecting the core practice principle, passing that on to the next organization.

I don't read the congressional act as giving that latitude and I don't see how you're going to improve the training, as Melinda mentioned, by having anybody provide the training with whatever materials they so desire. That wasn't specified in Section 4(b) of the congressional act.

COMMISSIONER NEWSOME: Thank you for your thoughts.

Mr. Damgard, appropriately you centered the majority of your testimony upon intermediaries and I know we have a clearing panel next but while you're up here, do you have any thoughts upon our clearing proposal?

MR. DAMGARD: Yes, I think--thank you, Jim, for the question--I think it's very enlightened of the Commission to take up clearing as a separate subject.

Historically, as I understand it, clearinghouses have been subject to CFTC oversight only through the execution facility.

And our business at the moment is really comprised of two things--execution, which is certainly the purview of the exchanges, and clearing, which is the purview of the clearing members that put up the capital that guarantees the integrity of that trade. And there may come a time when these large liquidity providers may someday feel like they need to have a selection, a choice of clearinghouses for the purpose of cross-margining or cross-collateralization and if that clearing facility is not necessarily connected to the exchange, it seems to me there ought to be a choice.

And I don't know if that day's coming right away but I mention in my testimony the benefits, the real benefits of changing the way in which regulation is being administered is so that the firms can treat, as Tom Russo said yesterday, all that stuff in a customer's account as not without some connection to another product. And it's a more effective use of capital. It will make the markets

much more effective and much more efficient, particularly here in the United States.

I mean there are some real benefits, it seems to me, that we have separate regulation in the United States but there are some difficulties, as well, that we need to lick. And one of those that I identified in my testimony is this whole international question. And it seems to me if you're the least bit embarrassed by all the praise that you've been receiving, you might want to consider a panel of the airlines because if you address the international question, the airlines are going to get very badly damaged. All these guys that are having to fly off to London from New York and Chicago every day are going to be able to stay in the United States. I'm not sure it's going to affect the economy section necessarily but I think the first class sections will be empty.

COMMISSIONER NEWSOME: That's all, Mr. Chairman.

CHAIRMAN RAINER: Commissioner Erickson.

COMMISSIONER ERICKSON: Thank you, Mr. Chairman.

Dan hit on a point that I think is kind of interesting and that is the recognition that things are

changing very dramatically and exchanges are going to be different than what we see.

And in this intermediary area that we're talking about, if exchanges want to be intermediaries themselves at the RFE or DTF level, can that be accomplished through this proposal? And if so, how do they comply with these kinds of core principles? Because it seems to me that they would have to be registered, I guess, as an exchange entity first and then also meet the standards for intermediation. If you could comment maybe on that because I think that may be a reality sooner than we think.

MR. DRISCOLL: Certainly, not unlike the securities industry, the distinctions between being an exchange and being an intermediary are blurring all of the time and you have organizations that have traditionally been exchanges that are trying to get into the intermediary business and vice versa.

I don't have all of the final answers to that but I think that this framework works better in that regard than the old framework. And I just think it's something--that's an area that the Commission is going to have to be very much involved in because you have issues about

competition, about regulating your competition, about being regulated by your competitors, and I think that that's a very proper role for the Commission, as a government oversight agency, to make sure that those particular issues are dealt with appropriately. But I do think that the current proposal is definitely a step forward to ease that process.

COMMISSIONER ERICKSON: John?

MR. DAMGARD: I agree with everything that Dan said. I think that everybody is everybody's competitor now and the fact that the exchanges are changing their structure in order to attract partners and some of those partners may be Oracle and Microsoft and those people are all over Wall Street offering technical advice to consortiums of Wall Street firms, I think everybody regarded everybody else as a potential competitor and I think it's doubly important that core principles, for instance, not be just extended to exchanges but extended to intermediaries who may, in fact, become exchanges just as quickly as exchanges become intermediaries.

COMMISSIONER ERICKSON: Would anyone else care to comment?

Okay. Not to pick on Dan, if I may have one more question, one of the things that the Commission has a mandate to do is look at the overall integrity of markets. And I think the window on the world really is this large trader reporting issue.

I understand what you're saying and it fits in with the dramatic changes in markets. But absent any kind of requirement for these commercial markets to be sending some kind of a report on concentration of positions to the CFTC, how would we say that we're fulfilling that mandate to look out for market integrity?

And second, I wonder if--in the U.K., it was different. They didn't have the ability with Sumitomo to get the information in the first place. And in this kind of marketplace, we have the authority and we are potentially willingly giving that information up. And that is a concern I have, that we end up with those kinds of situations where we don't have the window on the world and an event like Sumitomo comes along.

MR. DRISCOLL: Actually, I share the same concern. So I'm not suggesting to open things up so that neither the Commission or the involved exchanges wouldn't

have the market tools in place to be able to ensure orderly markets and to avoid manipulations and squeezes.

I guess all I'm really saying is that there maybe other ways to get the same information, maybe even get it quicker and do it in other ways other than what traditionally we think of as large trader reports. I'm not suggesting at all that the Commission should divorce itself from that information, but maybe it doesn't need to get it daily. Maybe the reporting levels could be different. There's just room for flexibility there. I'm not suggesting to do away with the concept altogether.

COMMISSIONER ERICKSON: I appreciate that follow-up. I agree, as well. I think there are a lot of ways to add some flexibility to our current regime that would allow the markets to have a greater role in setting those levels.

John, did you have any--okay, that's all, Mr. Chairman.

CHAIRMAN RAINER: Thank you. I have two questions.

Dan, you made some comments on the passporting topic, which I find very intriguing but I'm not sure I

followed everything that you were talking about. Would you mind fleshing that idea out a little further?

MR. DRISCOLL: Sure. It was really two. One reason why it was confusing is I mixed a couple of concepts together.

The first issue, and this is a pretty definite type of issue, is under the proposal now, a banker, a broker-dealer, can passport in with the notice provisions, as long as all of their customers are going to be institutional clients under the proposal and those customers limit their activities to DTFs.

And we agree that it may be important in this context to make sure that it's only institutional customers that are involved, but it's hard for us to understand what's the meaningful distinction between it's okay to passport these people if those same customers, who are sophisticated, trade on DTFs but if they're going to trade on an RFE or maybe they just trade a little bit on an RFE and mostly on a DTF, why isn't the passporting appropriate there?

My second issue was really beyond passporting to the point that I think we have to recognize that there are

a large group of people out there that get registered on both the securities side and the futures side and the regimes to do fitness background checks and to meet the fitness standards are not identical but they're pretty close to identical, and we're just questioning the basic premise as to why there has to be duplication of effort there.

So that one really goes beyond passporting to the issue of doing duplicative background checks for AP security reps.

CHAIRMAN RAINER: Thank you.

I'd like to engage in a discussion on the CTA piece of the testimony. CTAs advise customers and, different from CPOs, where the investor cannot lose more than he puts up because presumably he's a limited partner or some form like that, with a CTA, it is the case that the investor could lose more than he puts up?

MS. ERVIN: To the extent that a customer of a CTA is investing through an account that is not a limited liability vehicle, that is certainly true. I think the point that we would make is that distinguishing between pools was generally, although not exclusively, our limited

liability vehicles and managed accounts, uses a blunt instrument and one that is not consistent with the one-size-fits-all, getting away from the one-size-fits-all approach that the Commission is moving toward.

Looking to financial assets of the professional is a way that the Commission has used in a number of regulatory contexts to determine whether there is a basis for exemptive relief or greater flexibility from a regulatory perspective. And we would suggest that in this case, use of a figure such as $25 million of net assets under management is a very ample proxy for sophistication and professionalism of the CTA that assures a level of expertise and sophistication, which the CTAs are, in any event, called upon to exercise now in determining which markets they will suggest and recommend to customers.

So I think that the short answer is yes, there is a difference in the way managed accounts work. However, there are a number of factors in addition to the legal structure of the entity through which customers invest that might be looked to determine both the risk and reward of the investment and the suitability for the customer of a particular investment.

CHAIRMAN RAINER: You mentioned in your testimony, Susan, that CTAs have a fiduciary responsibility, or did I mishear that?

MS. ERVIN: I didn't exactly say that in the testimony. I think that in many contexts they would be deemed to be forms of fiduciaries but I think it would depend on the context.

CHAIRMAN RAINER: Okay. This is a very important area and I think we're all very mindful of your concerns. We note that there's a structural difference between CPOs and CTAs because in the one case you can lose no more than you put up, generally speaking, and on the other, there's this other element that makes us want to think at least twice about making sure that we understand the differences and go through all the possibilities because there is a difference. There's a structural difference that someone putting some money up can actually lose more than he puts up. So we'd want to think of all the various elements and implications of that.

So we're very interested in MFA's views on how we should look at that because there is a difference. There's a substantive difference.

MS. ERVIN: We appreciate the Commission's concerns and would welcome the opportunity to have a dialogue and work with the Commission on this subject.

CHAIRMAN RAINER: We also fully, or at least I do, speaking for myself, acknowledge the importance of access, so there is a balance here that we have to worry about.

Anybody else want to jump in on that one?

Well, I'd like again to thank the panelists for donating your time and wisdom and we are very appreciative.

It is 11:26. Why don't we take about a 10-minute break before we resume? Thank you very much, everyone.

[Recess.]

CHAIRMAN RAINER: Okay, let's get started. This is the panel on clearing organizations. We'll follow the same script; that is to say allow each of you to have about 10 minutes for your testimony and then we'll go with questions from each of the commissioners for about five minutes each.

To start us off we have John Davidson. John is managing director of the Institutional Securities Division of Morgan Stanley Dean Witter. I should point out also

that prior to his experience at Morgan Stanley he spent 10 years and was senior vice president of the Clearinghouse Division of the Chicago Mercantile Exchange.

John, thank you for coming and we look forward to your remarks.

STATEMENT OF JOHN P. DAVIDSON

MANAGING DIRECTOR, MORGAN STANLEY DEAN WITTER

MR. DAVIDSON: Thank you very much, Mr. Chairman, Commissioners, members of the staff of the Commission. Thank you for the opportunity to present my views on Part 39 rules that form an important component of the Commission's bold new regulatory framework. I should state that these views are my own, not necessarily those of Morgan Stanley Dean Witter.

In general, the proposed regulatory framework is a very positive step toward the Jeffersonian goal of that government is best that governs least. With regard to the regulation of clearing organizations, I would offer the following points for your consideration.

Proving a clear set of core principles governing the operation of clearing organizations is highly desirable. Clearing is a fundamental characteristic of

futures markets. Indeed, it is not an oversimplification to state that all the world's clearing organizations owed their origins to an innovation of the Minneapolis Grain Exchange in 1873. Codified regulatory guidance for clearing organizations has long been difficult to extract from the corpus of CFTC regulations. Until this time, securities regulation in the United States in the clearing area has been comparatively more transparent.

The 14 core principles set forth in Section 39.3 are generally both sound and complete. As noted below, however, I take issue with some of the interpretive guidance provided in Appendix A to Part 39 with respect to certain of those principles.

Section 39.4 is more troublesome. In essence, the first part of this section stipulates that the existing U.S. clearing organizations comply with the 14 core principles and grandfathers their existing rules, procedures and processes. While I would not take major issue with that stipulation with respect to the first 12 core principles, I have a serious difficulty with principles 13 and 14 as applied to U.S. clearing organizations today.

Principle 13 speaks to the need for clearing organizations to both enter into information-sharing agreements and to utilize the information so shared with their risk management programs. The only information that is routinely shared among U.S. clearing organizations today concerns the flows of daily settlement variation, the magnitude of margin calls, and the level of so-called access collateral.

This information-sharing, which dates to the early 1980s, is not sufficient for robust risk management. It is analogous to having the local branches of the Weather Service exchange information on wave heights and expect from that to glean some meaningful information about storms at sea.

U.S. clearing organizations need to routinely share full position information about at least mutual clearing members and their affiliates. The fact that they do not speaks volumes about their historic role as instruments of the unreasonable restraint of trade, which brings me to principle 14, which speaks to competition.

The current institutionalized practice for there to be one and only one clearing organization responsible

for the credit enhancement of specific futures contracts cannot by any stretch of the imagination be said to "avoid unreasonable restraints on trade."

Forcing Morgan Stanley Dean Witter to clear its Eurodollar futures contracts exclusively at the Chicago Mercantile Exchange clearinghouse, its Treasury bond futures contracts exclusively at the Board of Trade Clearing Corporation, and its crude oil futures contracts exclusively at the NYMEX Clearing Division is unambiguously a restraint of trade and it is as unreasonable as the millennium is long.

The Commission stipulates in this document that all existing U.S. clearing organizations meet the minimum standards of the 14 principles. Therefore, it is neither a public policy nor a safety and soundness rationale for preventing a clearing member from selecting the clearing organization that it desires for credit enhancement services on any futures contract.

Finally, the single post-execution process that is inherently exchange-specific, that of trade comparison, is very clearly and very correctly omitted from the

definitions of a clearing organization and its functions in Section 39.1.

Section 39.2, permitted clearing, is more universal than it needs to be. Clearing which features risk mutualization inherently gives rise to public policy issues if any of the participants are regulated financial intermediaries. This is because an event of mutualized risk is inherently exogenous to the regulated intermediary and is not subject to that intermediary's internal controls.

This may cover most of the types of participants and most of the products in the troika of facilities set forth in the new regulatory framework.

However, one can conceive of a clearing arrangement in which none of the participants are regulated financial intermediaries, in which there is no mutualization of risk and which lacks direct access to the payment system. In such a situation, it is hard to understand from a public policy justification why there needs to be regulation by one of the very able regulators of financial intermediaries delineated in Section 39.2.

Lacking any expertise in legal matters, I would nonetheless argue that Section 39.6 is unnecessary. Fraud and manipulation are bad but a transaction or a collection of transactions is no more nor less fraudulent or manipulative by virtue of being cleared.

Appendix A to Part 39 is very useful in taking the broad outline of the 14 core principles in Section 39.3 and making them real in the context of our current understanding of business practices. The focus on current practice, however, is a material shortcoming. I would offer a few suggestions.

Make clear in the opening paragraph of the appendix that the "matters" to be addressed are illustrative of the approaches to the core principles, not necessarily exhaustive. This will be particularly useful in guiding future generations of Commission staff not present at creation.

With respect to core principle 2 in the appendix, other bodies of regulation impose a standard to the effect that participation in the clearing organization may not be unreasonably withheld. The Commission may wish to consider such approach.

With respect to core principle 5, "segregation" is a very high standard to impose on the operation of a clearing organization for the entire range of derivative products contemplated in the new regulatory framework. Indeed, this section appears not to have been informed by the discussion in the Commission's proposed rules related to intermediaries of commodity interest transactions of the possibility of opting out of segregation. If the word "segregation" were replaced with "separation," these paragraphs would provide a more appropriate level of flexibility.

Inherent in any clearing organization that holds positions in funds ultimately attributable to customers of clearing members and that neutralizes risk is a conflict between the interest of those customers and the interest of the clearing organization and its clearing members. Recent events in New York would appear to provide stark evidence of that conflict.

The Commission should consider with respect to the appendix text both in core principle 6, default rules, and core principle 12, disclosure, the potential utility of a more explicit treatment of this issue of conflict between

the mutualization of the clearing organization and the interests of customers of those intermediaries.

Thank you very much for the opportunity to bring these issues to your attention. I am most appreciative of the direction in which the Commission and its staff are moving and very respectful of the difficulty of the journey.

CHAIRMAN RAINER: Thank you very much, John.

Next we have Phupinder Gill. He is managing director of the Chicago Mercantile Exchange and president of the Clearinghouse Division of the CME.

STATEMENT OF PHUPINDER GILL

MANAGING DIRECTOR, CHICAGO MERCANTILE EXCHANGE

MR. GILL: Thank you, Mr. Chairman and members of the Commission.

The principles underlying the Commission's proposal for a new Part 39 regulatory framework are generally sound and forward-looking. The Commission's proposed rulemaking respecting clearing organizations is founded on a high level of trust and respect for existing derivative clearing organizations. We believe that the CME clearinghouses earn that trust and respect through hard

work and sound investment and we welcome the opportunity to provide our view on the Commission's proposed rulemaking respecting clearing organizations.

We support wholeheartedly the Commission's efforts to reinvent the regulation of clearing organizations but believe that the jurisdictional basis for Part 39 needs to be clarified. The Commission's proposal appears to reflect jurisdictional accommodations and claims that are not discussed in the proposal. We are concerned that the proposal raises a number of controversial issues that may disadvantage Commission-related clearing organizations.

There are some technical drafting issues that we have included in our written testimony that I will not address here and these are mostly around the issue of scope. What I would like to address are a couple of jurisdictional and competitive concerns that the CME has.

If a recognized clearing organization or an RCO would deem the contract market in respect of every bilateral agreement described by revised Part 35, significant jurisdictional concerns might be raised. While the exchanges consistently argue that all swap contracts

are contracts of sale of a commodity for future delivery within the Commission's jurisdiction, neither the Commission nor other interested participants in the derivatives industry has accepted that interpretation.

In fact, the Commission created the Part 35 exemption consistent with congressional demands without determining whether or not it had jurisdiction over the transactions exempted. The Commission's statement of policy concerning swap transactions is often interpreted as support for the proposition that many swaps are not governed by the act.

The proposed language makes it seem that the Commission is attempting to expand its jurisdiction to include any OTC transactions that are submitted to an RCO. If the Commission does not intend that result, the solution is to deem an RCO the be a contract market only to the extent that it clears a transaction that involves a contract of sale of a commodity for future delivery.

This is not an academic distinction. The OTC market has expended substantial resources to avoid subjecting itself or its transactions to the jurisdiction of the Commission. If an OTC market has the choice of

clearing through a foreign clearing house or a bank-regulated clearinghouse rather than an RCO, which will be deemed the contract market in respect of every transaction described by Part 35, then that RCO will be placed at a devastating competitive disadvantage.

The submission of a transaction otherwise outside the CEA to a CFTC-regulated clearinghouse does not logically bring the transaction within the Commission's exclusive jurisdiction. Designated contract markets can trade spot commodities without implicating the Commission's jurisdiction.

If use of a clearinghouse brings transactions otherwise outside the scope of the CEA within the Commission's jurisdiction, then there's no reason to differentiate between transaction submitted to a CFTC, SEC or a bank-regulated clearinghouse. If clearing is the hook, then all clearinghouses are equal in terms of converting transactions into futures contracts.

The foregoing would suggest to us that the Commission has not explained why its fraud, manipulation and Shad-Johnson proscriptions apply when a transaction is

cleared by an RCO but not when the same transaction is cleared by an SEC, bank or foreign-regulated clearinghouse.

The Commission has not made the required finding to support waiver of the act's fraud, manipulation and other proscriptions for OTC futures transactions that are cleared under the supervision of other regulators.

In summary, the Commission cannot deem RCOs to be contract markets in respect of every transaction they clear without facing serious jurisdictional questions and creating competitive concerns for RCOs.

With respect to the allocation of jurisdiction, the Commission asserts exclusive jurisdiction over clearing of transactions originating through designated contract markets or RFEs and derivatives transactions facilities.

A clearing organization governed by another regulator or a clearinghouse which has no regulator is prohibited from clearing such products. We wholeheartedly agree with this allocation.

Transactions effected pursuant to Part 35, the swaps exemption, and Part 36, the exempt MTEFs, have a choice of clearing. Hybrid transaction subject to Part 34 regardless of whether they are subject to the act are not

explicitly discussed. The omission suggests that transactions exempted under Part 34 might be treated differently than those governed by Parts 35 and 36. If there is a distinction, it is not explained in the proposal.

Many swaps involve securities and bank deposits. We believe that additional work is necessary to rationalize these distinctions.

The proposal imposes no explicit limitations on the transactions that might be cleared by RCOs. Again we strongly support this position. Presumably, any limitations on the right of an RCO to clear subject to the Commission's exclusive jurisdiction will be imposed by law and regulation apart from the CEA.

Unfortunately, silence on the issue of whether equity swaps and swaps involving other securities, such as government bonds, are or are not contracts of sale of a commodity for future delivery within the exclusive jurisdiction of the Commission may create a problem. The Department of the Treasury and the SEC have given strong signs that clearing of swaps involving such products should be subject to the SEC regulation.

If the Commission's laudable deregulatory efforts led to a joint regulation of our clearinghouse or forced us to split the clearinghouse into separate parts, the benefits of the new regulatory framework would be lost.

Mr. Chairman, members of the Commission, thank you again for the opportunity to respond to this proposal.

CHAIRMAN RAINER: Okay, thank you very much, Gill.

Our next witness is Ken Rosenzweig. Ken is a partner of Mayer, Brown and Platt. He's outside counsel to the Board of Trade Clearing Corporation and I would like to point out that he was a member of the staff of the CFTC between 1978 and 1987.

Welcome, Ken, and thank you for coming.

STATEMENT OF KENNETH M. ROSENZWEIG, OUTSIDE COUNSEL BOARD OF TRADE CLEARING CORPORATION

MR. ROSENZWEIG: Thank you, Chairman Rainer, members of the Commission. This testimony is being submitted by me on behalf of the Board of Trade Clearing Corporation, which appreciates the opportunity to appear here today to make its views known on the Commission's important initiative.

I would add that I've submitted for the record written testimony that elaborates in greater detail upon the subjects that I'm going to address here today at this hearing.

At the outset, the Clearing Corporation wishes to commend the Commission for taking steps to modernize and transform the regulatory structure that is administered by the Commission. The Commission also is to be commended for recognizing the vital importance of clearing facilities to the organized markets and for taking steps to ensure that clearing organizations are afforded appropriate recognition under the new regulatory framework.

The Clearing Corporation nonetheless has profound reservations regarding four aspects of the Commission's proposal. Point number one, the Part 39 requirements are overbroad. The Commission has stated its intention to replace the one-size-fits-all model it currently has in place with broad, flexible core principles, but it surely cannot have escaped the Commission's attention that the Commodity Exchange Act and the Commission's regulations have historically been focussed narrowly in their application to clearing organizations.

It is therefore somewhat surprising to us that the Commission has proposed an array of new obligations for the clearinghouses. That these obligations would be established under the guise of core principles does not change their effect. Clearing organizations will be subject to far greater regulatory compliance burdens than at any time in the past.

The clearinghouses in this country have an admirable record of safety and soundness. The Board of Trade Clearing Corporation has in its history cleared more than 1 billion contracts but has never failed to perform its obligations to clearing members in full and on time.

BOTCC's sterling record is attributable to numerous factors, including its strict management standards and risk management practices. BOTCC's success in this area is also attributable in no small part to its ability to respond flexibly, promptly and appropriately to a member firm's insolvency and to other developments in the markets.

The Clearing Corporation therefore is apprehensive about any new regulatory regime that would inhibit its ability to respond as necessary to the exigencies of the marketplace.

The Clearing Corporation accordingly urges the Commission carefully to evaluate whether it is necessary or appropriate to graph a new layer of regulation on the futures clearinghouses. To the extent that the Commission believes that additional across-the-board regulation, as opposed to case-by-case remedial action, is warranted, we would respectfully suggest that any new rules be focussed on new clearing organizations that seek to provide clearing services for existing futures exchanges or for over-the-counter derivatives markets and exempt MTEFs that have not previously had the benefit of clearing facilities.

Point number two, the Part 39 core principles are unduly prescriptive. The level of specificity envisioned by Part 39 goes far beyond anything that is currently required by the Commission's regulations. It's wholly inconsistent, in our view, with the Commission's intention to transform itself into an oversight regulator and most importantly, has the potential to inhibit the flexibility and adaptability that enables the clearinghouses successfully to manage risk.

The 14 core principles for clearinghouses and, in particular, the "guidance" that is provided by Appendix A,

are far more intrusive and detailed than anything that now applies to clearing organizations. The Commission should have no illusions. While characterized as broad and flexible, there can be little doubt that the core principles will take on the force of law and that all clearinghouses, whether applicants for recognition or an existing clearinghouse, will be required to demonstrate their compliance or satisfy the Commission staff that the core principles should not apply.

In light of the foregoing, we urge the Commission to reevaluate the applicability of the core principles. As a first step, the Commission should recognize that not all of the core principles will be applicable to all clearing organizations and to all products.

Similarly, we would urge the Commission to emphasize that the guidance to applicants that is provided by Appendix A is simply that and is not a checklist of steps that need to be taken in all cases.

Point number three, the Commission's proposal would inappropriately expand the scope of the Commodity Exchange Act and Commission regulations. Proposed Regulation 39.5 would, for the first time, make

clearinghouses subject to various provisions of the act and regulations that simply do not and in our view should not apply to clearing organizations.

The incorporation by reference of these provisions of the act and regulations is particularly problematic because their inclusion in Regulation 39.5 implies that a clearing organization is somehow responsible for enforcement of these requirements.

This is by no means a trivial matter. Holding a clearing organization accountable for acts or omissions that have nothing whatsoever to do with trade matching and credit enhancement unnecessarily and inappropriately creates the potential for liability, both in enforcement proceedings and in private civil litigation, for conduct that was never previously thought to be actionable. The clearinghouses should not be made subject to these requirements without a careful and thorough evaluation of their relevance and the consequences of their applicability to a regulated clearinghouse.

The Clearing Corporation also wishes to register its vigorous opposition to proposed Regulation 39.6. That regulation should punish anyone who cheats or defrauds any

other person or who willfully makes a false report or statement "in connection with any transaction cleared by a recognized clearing organization."

It is difficult, if not impossible, to envision circumstances in which a clearing organization could itself engage in conduct that violates Regulation 39.6. The adoption of that regulation would nonetheless result in the assertion of the Commission's enforcement authority over otherwise exempt transactions simply because they're submitted to clearing. We therefore urge the Commission to reevaluate this aspect of its proposal.

Point number four, Part 39 would confer an inappropriate competitive advantage on non-futures clearinghouses. The markets are converging. Market participants are demanding and receiving real-time access to the cash, futures, securities and options markets. The Clearing Corporation accordingly supports the Commission's determination to unshackle the markets and to allow market participants to adapt to rapidly changing circumstances.

The futures, cash an option markets are inextricably intertwined so that every clearinghouse has a

stake in the financial and operational integrity of every other clearinghouse.

There is only a superficial resemblance between the services offered by the futures and securities clearinghouses, however. There's even less of a resemblance between a clearinghouse and the funds transfer and netting systems that are subscribed to by banks, thrifts and trust companies. As to the proposed exemption for foreign clearinghouses, many of them operate under legal systems that are simply incompatible with the bankruptcy and other laws that govern clearing organizations in this country.

It is for this reason that the Clearing Corporation has profound reservations about the Commission's proposal to exempt securities clearinghouses, banks and bank affiliates, and foreign clearinghouses from the substantive requirements that otherwise would apply to recognized clearing organizations as long as the clearinghouse in question clears futures contracts only for exempt MTEFs and their members.

The Commission should, in any event, be aware that futures clearinghouses will find it difficult to

survive in this new competitive environment if the Commission unilaterally cedes the field to securities clearing agencies, foreign clearinghouses and banks by giving them the right not only to clear OTC derivatives but also to clear futures and options contracts that are traded on exempt MTEFs.

If, as expected, trading volume in financial futures and other products migrates to the exempt MTEFs, traditional futures clearing organizations will be left with declining revenues and diminished capital with which to support agricultural futures and other traditional contracts. The Clearing Corporation accordingly urges the Commission to reconsider this exemption.

In conclusion, I would say only that clearing organizations serve a vitally important role in the safe and efficient functioning of the markets. It is, after all, the clearing organizations that stand behind every trade made on the exchanges as the "seller to every buyer and the buyer to every seller." We urge the Commission therefore to proceed with the utmost caution before superimposing about new and, in our view, unwarranted regulatory regime on the nation's clearinghouses.

The Board of Trade Clearing Corporation thanks you for the opportunity to express its views on this important subject. We welcome the opportunity to work with the Commission and its staff to refine this proposal and to ensure the continued integrity of the clearing system. Thank you.

CHAIRMAN RAINER: Thank you, Ken.

Next, participating in a double-header, I guess, we have Pat Thompson, who testified yesterday very effectively. He's the president of the New York Mercantile Exchange and I will say today--I didn't say yesterday; he had to do it for me--he is an alumnus of the CFTC.

Pat, your turn.

STATEMENT OF R. PATRICK THOMPSON, PRESIDENT
NEW YORK MERCANTILE EXCHANGE

MR. THOMPSON: Thank you, Mr. Chairman. I'll try to keep my comments brief.

Generally, we support the proposal by the Commission for recognized clearing organizations. Our experience has been that clearing, credit enhancement, guarantees, netting and the like perform very valuable functions in the marketplace. They increase transparency,

reduce systemic risk, and increase the liquidity of the market overall.

So I think the attempt to broaden and bring under one system of regulation the clearing rules and the clearing approach is a very valuable addition to the regulatory structure that we have here.

Permitting the clearing of regulated instruments, as well as the clearing of instruments under Part 35, 36, hopefully 34--I understand that there was an omission on that--we think will also increase and enhance transparency, risk monitoring, and will lower the cost of the participants in the marketplace overall, making the markers more efficient.

The scheme as a whole and how it appears to be envisioned, certainly from the 50,000 foot level, we think is really very admirable and we think will be a tremendous advancement on how business is done today.

The core principles we think are generally appropriate and with very minor exceptions would support them overall. We do think, though, and this is a level of criticism that I think we're going to have to get into more detail in our written comments and I think there may be a

need for a little bit more debate on them, we think this may be an area because clearing and the financial obligations, netting and those things, are really the issues where the rubber meets the road in terms of the transactions that we're doing now. And I think the industry needs to have those types of obligations, because they really involve an assessment of the risk of the clearing organization, not only as--well, mainly as a financial matter.

Those participants in the market who are going to submit their trades for clearing are going to want to know precisely what their rights are, what their rights of offset are, what the rights in bankruptcy are, what the procedures are, what the rights of priority will be. So I think it's very important in this particular area, more so than what we discussed yesterday, that the clearing rules be very, very precise because they do, in essence, establish the risk that a participant in the market is taking, beyond just the market risk that exists in the instruments that they're trading.

The issues of segregation we think need to be expanded upon. We ourselves were recently involved in a

case where questions about the extent of segregation and the implications on the obligations of clearing organizations, the obligations of FCMs, the expectations of customers who are involved in a segregated account, those are areas where we think at this point Commission regulations need elaboration and need the development of more precision.

That's a threshold matter that exists today in today's regulatory scheme. I want that very clear. But as we get into the definition of regulation, moving forward in the new deregulated regime that we're envisioning, we need to realize that that threshold issue of definition of the segregated obligations must be undertaken.

Issues of how to treat instruments that are regulated with instruments that are exempt from regulated within the same legal entity are areas that I think we need to have more precise definition and it's not usual that you will hear an exchange ask for more precise definition in this era of deregulation. But, as I said, these obligations are very clear legal obligations that bear very directly on the risks of the clearinghouse and the risks of the participants beyond the market risk that they take in

the instruments that they're actually trading, and precision is something that I think if you recall some of the remarks yesterday made on our first panel, particularly by Tom Russo, that that kind of precision, that kind of uniformity of industry practice is a measure of risk that the participants in the marketplace really desire definition on.

I think we need to go beyond the core principles that we have here and try to establish those principles clearly. A lot of them already exist today, such as financial requirements and things of that nature, but we do think that it's important that these risks, particularly where we are, in a sense, bringing together a deregulated instrument potentially with regulated instruments and terminology and practices such as segregation that only apply to regulated instruments today, because this is a new regime and truly a new step forward for us, it's important to take the time to try to make sure that we get it right. And I think the market participants overall would be thankful if we do undertake that.

It should not take a great deal more time. There are existing analogies in the OTC world, in the exchange-

traded world today that can, I think, quickly be analyzed and brought to bear, but I do think that it's important that we take the time to make sure that we've got it right this time through. We've gotten too far to leave that--because I think it's probably one of the most important things that we are going to do--we've gotten too far to leave that aside and not attend to it. Thank you.

CHAIRMAN RAINER: Thank you very much.

Moving to the question portion, Commission Holum?

COMMISSIONER HOLUM: I have no questions, thank you.

CHAIRMAN RAINER: Okay, Commissioner Spears.

COMMISSIONER SPEARS: Thank you, Mr. Chairman.

A couple of quick questions for the panel as a whole and any of you can comment if you would, please.

First question, do you believe the benefits of being recognized as a clearing organization under the proposed rules will be sufficient to attract a significant number of new applicants as RCOs?

MR. DAVIDSON: I think the key determinant in that regard is whether or not one has the ability to freely disassociate the credit intermediation of a futures

contract and the exchange on which that particular contract is traded.

I think if one is permitted--one meaning a regulated financial intermediary--is permitted to have that disassociation and I can, for example, clear Eurodollar futures at the Board of Trade Clearing Corporation or Treasury bond futures at the Chicago Mercantile Exchange Clearinghouse independent of where they trade them, then I think it is indeed conceivable that people will be attracted to participate in this business.

However, if the current monopsony practice that exists in the industry, which is clearly anti-competitive, in my opinion, is allowed to continue, there's not a lot of point in getting into this business.

MR. DAVIDSON: Any other comments? Mr. Gill?

MR. GILL: I have to go back to what Mr. Driscoll talked about this morning when you're talking about the changing business models that we will be seeing in the coming years. I think at the end of the day, what would determine whether more of these RCOs will be formed would be whether they could clear an extensive number of products. I don't think it's as important to be entirely

independent of the trade captured platform and, as you can appreciate, I have a very biased view here. But I think what would be more important is the umbrella of products and services that they can offer.

Speaking specifically for the CME, I think we will be concerned if others would be allowed to trade cash, securities and futures under a single umbrella while the CME would still be not permitted to do the same.

MR. ROSENZWEIG: Commissioner Spears, I would add that if the Commission is going to give, in effect, a free pass to the securities clearing organizations, the banks and trust companies, thrifts or the foreign clearinghouses that have passed muster under another regulatory scheme, I think you immediately remove a large pool of applicants. And not that we should be counting heads and view this program as being a success or failure by the number of new applicants, but I think the Commission should recognize that there will be a competitive disparity and that, for example, the Government Securities Clearing Corporation or the Option Clearing Corporation will not voluntarily subject themselves to an additional scheme of regulation

and will certainly take advantage of the gift that's being bestowed upon them by the Commission.

COMMISSIONER SPEARS: Go ahead, Pat.

MR. THOMPSON: I just want to take a moment on this because John referred to it in his main testimony and also in his answer.

The purported monopoly that exists between exchange-traded products that are traded on a contract market, as is understood today, and then cleared through its organization, while I think in general one would agree that possibly extending some freedom for where the clearing destination might be for that trade, there are a number of consequences that flow from that, remembering that that exchange-listed contract carries with it obligations between the members that have actually executed the trade, the members that will be financially responsible for it, the delivery obligations that exist with respect to that contract. There are a lot of inherent measures that are assumptions within the contract terms and conditions that it will be enforced and its terms and conditions will be applied by the organization that wrote the contract.

Now, bilateral contracts between two counterparties, which will be permitted but not proscriptively permitted, will be permitted under this proposal, will allow for precisely what John was talking about earlier in that exchange look-alike contracts or contracts that have many and probably all of the important provisions of an exchange contract can be executed between the counterparties, can be either given to the exchange clearinghouse under this proposal, which we think is a good one, or to another clearinghouse.

I think the world he's looking at may come to pass over time but at this point the existing exchange contracts have with them certain assumed provisions that relate to the enforceability of many of their inherent terms.

I think when that day comes, we will see greater competition and new applicants for RCO status.

COMMISSIONER SPEARS: Ken?

MR. ROSENZWEIG: If I could follow up on Pat's observations, the Board of Trade Clearing Corporation I think would have real trepidation as at nation's only--the world's only futures clearinghouse that's AAA rated, would

have real hesitancy about being, in effect, conscripted by its members' choices or as to an exchange member's choice as to where they intend to clear because John's proposal, as I understand it, necessarily involves an interlinkage amongst these different clearing organizations.

I mean after all, if positions are to be meaningfully offset, as they would have to be in an open outcry market, and if there's to be innovation, the clearinghouses are going to have to link. And I think it's ironic that John is raising this proposal. When one looks at the history of securities clearing, virtually all of the exchanges had their own clearinghouses and, over time, they've all gone away. They've all been consolidated into what was then the NSCC and the DTC, which is now itself consolidated into a single organization.

So I think the trend is toward consolidation, which brings with it certain virtues. It brings with it greater capitalization, greater operational efficiency.

So I don't disagree with John's point that clearing has to be tethered to a single exchange but I don't understand if this is, in fact, John's point, how you

could have multiple competing clearing organizations for the same product.

COMMISSIONER SPEARS: Go ahead, John.

MR. DAVIDSON: If I could respond, I think that Mr. Rosenzweig should check out the 1975 amendments to the Securities Act, which essentially set up the national market system with respect to the operation of the securities markets, which indeed required linkages among all of the clearing organizations that existed at that time in the securities markets and indeed gave broker-dealers who were members of any of those organizations the ability to freely transfer their obligations among the different organizations with respect to the credit enhancement feature, which is essential to clearing.

I think that it is certainly the case that over time, freely acting competitive forces did cause the consolidation of the clearing organizations in the securities industry in the United States and certainly I would anticipate that freely acting competitive market forces could cause very similar outcomes in the U.S. I don't think that's something that the government has an obligation to protect existing clearing organizations from.

I think the notion that all of the contract enforcement and trading enforcement and other rule enforcement obligations that are associated with an exchange necessarily need to be tied up with the credit enhancement feature of clearing is more a coincidence of the way the rules at the Chicago Mercantile Exchange and the New York Mercantile Exchange are written than is a necessary feature of the economic organization of these different functions.

So I don't see anything particularly troublesome about organizations which acknowledge that they all have a high level of credit-worthiness linking with each other. I think if they are reluctant to link with each other, that probably sends a message to their participants that they, in fact, maybe don't meet all of these principles and that failure ought to be exposed to public scrutiny. And I think it's clearly in the best interest of a competitive marketplace and the participants in the process to provide for such linkages.

MR. ROSENZWEIG: If I could, at the risk of belaboring the subject, I'm glad to say I do agree with John on one point, and that is that the government should

not be in the position of picking winners and losers and we're much in favor of free competition and free entry into the markets.

I would disagree with John as to the relevance of the process that was set in motion by the '75 amendments to the securities laws and I think the far more useful analogy here is the experience of the Securities and Exchange Commission, which told the American Stock Exchange, which at that time was an upstart in seeking to trade securities options, it told the AMEX that no, it cannot form its own clearinghouse. And it told the Chicago Board Options Exchange, which at the time controlled something called the Chicago Board Options Exchange Clearing Corporation, that they were to work out an arrangement whereby all securities options were to be cleared through a single clearing organization and we have today, now almost 30 years later, the Options Clearing Corporation as a single issuer of securities options, exchange-traded securities options in this country.

Enough on that subject.

COMMISSIONER SPEARS: I have a quick follow-up, Mr. Chairman, to comments that Ken made earlier--regarding

the free ride comments that you made Ken regarding other participants potentially.

Do you see potential problems with, for example, banking regulators doing appropriate oversight over banks if they choose to get into clearing or do you have some concerns in that regard?

MR. ROSENZWEIG: I would be reluctant to criticize the Federal Reserve Board or the Department of the Treasury. They obviously do an excellent job, at least in general, of bank supervision.

I would caution, however, that the processes with which they're concerned are different than those with which the Commission is concerned. For example, the payment netting systems to which all the banks subscribe, Chips being the best known, have really no resemblance or only the most superficial resemblance to the clearing facilities offered by a futures exchange. And I think it is, while well intentioned, I think the Commission makes a mistake by giving the banks this carte blanche to enter into this market, particularly as to the clearing futures contracts.

I express no view as to the clearing of, for example, swaps. In fact, it may be appropriate to allow

for a well capitalized financial institution to act as a credit enhancement facility for swaps. But when you have what are today known and recognized as futures contracts and you take them and you transpose them from a designated contract market overnight to an MTEF, an exempt MTEF, and now say to the banks, "Be our guests; come in and provide clearing services," I think the Commission introduces an unnecessary element of systemic risk by giving that carte blanche.

COMMISSIONER SPEARS: Any other comments in regard to that point?

If not, then Mr. Chairman, I want to thank you for the time and thank the participants for their comments and their testimony.

CHAIRMAN RAINER: Thank you.

Commissioner Newsome.

COMMISSIONER NEWSOME: Thank you.

I, too, want to thank the panelists for the thoughtful testimony that you provided. Listening to your comments, it appears that we have some work to do on clearing. Obviously even as panel members, you disagree on some of the points.

At the Technology Advisory Committee meeting in April we had a very lively discussion on clearing and I think that dialogue needs to continue and I look forward to working with you on constructive comments, as you've made today, as we try and reach a consensus.

Mr. Chairman, Commissioner Spears asked a line of questioning that I intended to follow so I'll yield my time.

CHAIRMAN RAINER: Commissioner Erickson?

COMMISSIONER ERICKSON: Thank you, Mr. Chairman.

I would just echo previous comments. This has been quite informative on this subject. It's just one part of a broader proposal, but clearly you've given us a lot to think about.

And echoing what Jim was just talking about, there seems to be at least an element of tension here, but if I might just follow up with John just one moment because we are looking at a marketplace that's changing--with demutualization of exchanges--and clearly the Commission has already gone down the road of contemplating contracting out for services. Clearing is certainly one of those

things that exchanges may contemplate contracting out for in the future.

But you seem to be suggesting that we could have in the future also just free-standing clearing, unaffiliated with any exchange marketplace potentially, or even potentially self-clearing. Is this something that you see coming down the road? How would that work? Maybe parse it out for me a little more.

MR. DAVIDSON: Sure. I would certainly envision a potential future in which there is freestanding clearing. That is, in fact, the existing case in a number of markets around the world, including parts of the securities markets in the United States. The London Clearinghouse is an example of clearing that is essentially apart. Although there is partial ownership in the London Clearinghouse by exchanges, clearing is apart from the execution and contract development functions of an exchange.

Clearing is inherently different from trading and it involves a different set of risks; it involves a different set of oversight with respect to the financial condition of direct participants. It is different in kind

from those activities which go on at an exchange, those activities which may even go on off-board at an exchange.

So I think there is a historical coincidence that there is in this country a one-to-one relationship among exchanges and clearing organizations but there's no need for that to occur. And indeed, it is very functional from the exchanges' perspective that it is impossible for a new entrant to start trading contracts. And here we're talking about generic contracts, such as interest rate futures, currency futures, conceivably even some sort of agricultural and natural product futures. Generic products cannot be easily traded by a new entrant or even an existing entrant because transactions in those economically fungible contracts are not allowed by the current structure of the clearing organization.

So the question a new market participant always asks is not what's my cost of getting in; it's my cost of getting out. And if I can't offset my new Eurodollar contract on exchange A with the existing Eurodollar contract on exchange B and indeed I can't even cross-margin it without getting the permission of that entity which has the most to lose from my new success, then indeed trade has

been restricted and there's no inherent necessity from a credit enhancement perspective for that to occur.

COMMISSIONER ERICKSON: Thank you. If I might just have one follow up on this point, you mentioned the London Clearinghouse as an example. Whose choice is it to use the London Clearinghouse? Because one of the things we've got here, and I don't know the answer, quite honestly, but is it the market participant's choice to use the London Clearinghouse for any and all transactions on markets throughout Europe or is it the marketplace's choice, I guess, of venue as to who will be clearing those contracts?

MR. DAVIDSON: It is the marketplace's choice of venue. It is not the choice of a participant. So although I'm a member of the London Clearinghouse, I do not have the right to choose which of the contracts I clear there.

COMMISSIONER ERICKSON: Okay.

MR. DAVIDSON: Nor may I take London Clearinghouse-cleared contracts and move them somewhere else. I was using that as an example of independence of clearing from one-to-one relationship with exchanges.

COMMISSIONER ERICKSON: Thank you. I appreciate that.

No further questions.

CHAIRMAN RAINER: Thank you.

I have two questions. They're probably more comments than questions.

Gill, you touched on this jurisdiction issue where a clearinghouse now is able to take in, say, OTC bilaterals and what's going on there with the Commission. The question I have is are you saying that--because we're interested in safety and soundness of these organizations; that really would be our oversight role in many ways, essentially--that if there's a systemic problem, a major event pops up, that we're supposed to go in and if it's a bond futures contract, not to pick on any particular instrument but if it's a futures instrument that is the source of the event, we should respond, but if it's an OTC issue that's the source of the event, we say, "Sorry, we don't have responsibility, so we don't have anything to say about that."

That's where I get a little confused about your argument or whatever it is that you're driving at on jurisdiction.

MR. GILL: Mr. Chairman, I made several comments on jurisdiction but if I can start with the overall point, in plain English, the point that we're driving at is if you had two entities that were competing and providing products and services and yet only one of these entities felt the need to comply with a set of regulations, you're putting the other entity at a significant competitive disadvantage.

I think, coming back to the example that you raised, a very short while ago we had a very potential disaster in our markets with respect to long-term capital. I think it was of significant interest to every single one of the clearing organizations because every single one of us had some exposure or some concern and we worked extremely well with the members on the other side of the pond to control the issues that were at hand.

But I was addressing the jurisdictional issue from the point of the competitive disadvantage, that we may not have the right to list the cash product.

CHAIRMAN RAINER: I see. That's something we need to work on. I agree.

Pat, I was listening carefully to your recommendations related to the precision of language definitions. Do you have a recommendation, and you don't need to answer now but maybe think about it if you don't have a recommendation; I'd be interested in how you would approach some kind of formalized assistance for the Commission to deal with these issues that you're talking about.

We're about to leave and everybody's going to go get busy doing their own thing. We've got a comment period that ends on August 7. We've been encouraged by virtually everyone to move ahead on this.

What you raise is incredibly important. I agree with Commissioner Newsome; it looks we've got a little more work, a little more thinking on the clearing side of all of our releases.

Do you have any idea as to how we can proceed from here on a more formal--

MR. THOMPSON: Well, I think a lot of the answers exist in what is in the marketplace now but then just

trying to make them compatible. For instance, the rights and obligations of the parties to an over-the-counter instrument today are fairly well defined and we need to be able to make sure that those instruments are compatible with exchange procedures in times of potential default so that we understand who has what right to what asset.

If, for instance--I'll give you an example. If we were to permit, which we hope to make a submission to the CFTC soon to ask for such permission, to allow for an over-the-counter instrument to serve as, in effect, collateral against an existing futures position, as opposed to what is traditionally margin today, yet there were to be a default by a clearing member holding a position that is margined by an over-the-counter asset, as opposed to cash or a Treasury bill or something of that nature, which is a bilateral obligation. Remembering the opposite side of that particular asset that has real economic financial value, it also has rights that flow directly to a single market participant and whether or not what obligations can be imposed upon that particular instrument.

Does the FCM have some kind of subrogated right to exercise the rights of the defaulting party? Does the

clearinghouse, are they able to substitute rights to the residual rights of the FCM? And how does one value that? How does the clearinghouse and what are the standards applied to valuing that instrument, which clearly is not as valuable as cash but it's valuable in some way, shape or form as a financial asset?

And I do think that it's important that we understand that those issues are lurking there and that when such a thing as a default occurs is not the time to begin thinking about what does all this mean? And that's why I think precision is really important.

When I say rubber meets the road, in the clearing situation where you actually have to exchange cash quickly, exchange assets quickly, and there are flow-down kinds of impacts of any kind of interruption of that process, it's hard to be making up the rules at the time that that's all going on.

So when it comes to clearing, I have to say that while core principles are very good, it's important to really get it right.

I do think the analogies are out there with the netting agreements and different things of that nature that

we can try to bring to bear on it. We might want to set up a small task force of the clearinghouses and over-the-counter participants and I stress the word small, but try to get those interests involved in a fairly formal way to flesh these issues out because as I said, we had a very small clearing member have financial difficulties about a month ago and as simple as the problem would appear to be on the surface, there were layers and layers of issues that had to be decided very quickly.

CHAIRMAN RAINER: Thank you very much.

John?

MR. DAVIDSON: If I could offer a slightly different view, it seems to me that, as I noted, a number of these core principles are very good and are sufficiently robust that with a little clarification about the appendix, that it's illustrative rather than exhaustive, I think you could fairly quickly move along those sections, with the exception of what I remarked about in my comments.

I think the other area that does need a great deal of focus, both with respect to futures contracts, as well as with respect to other contracts that may be cleared, either by an ROC or otherwise, is the issue of

bankruptcy. And I do think that that is a very complex area that we do need a greater level of certainty and a greater amount of clarity and precision.

With respect to the generic case of what went on in New York and obviously I'm not privy to the facts in the case, it needs to be very well understood that clearing members, such as Morgan Stanley Dean Witter and I'm sure all of our competitors do not, by virtue of becoming clearing members in a clearing organization, sign up to write a blank check for all of the bad credit decisions that may be made by customers of a single clearing member. That is not an insurance policy which any of us have an interest in writing.

On the other hand, we do have a very strong interest in making sure that customer funds and customer property is appropriately safeguarded, that credit decisions are clear as to when you're making a credit decision and what credit decision it is that you're making and that there isn't any uncertainty about the operation of the process of unwinding an insolvent FCM and making sure that its customers are treated in the appropriate manner.

So I do think that that specific area--and there's certainly nothing Brave New World about it. It goes back to the existing body of regulation. It's been an issue that's been out there for a considerable period of time. There are very different interpretations of exactly what the law says in that regard. We do need to get this clarified in advance and I think you could partition that and work on that separately from the administration of the general precepts of how clearing organizations ought to be regulated.

CHAIRMAN RAINER: Okay. Well, we've come to the end. I want to thank you very much, each of you panelists. It's been very helpful to the Commission.

If there's nothing further, we'll adjourn. Thank you very much.

[Whereupon, at 12:55 p.m., the hearing was adjourned.]