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COMMENT

August 16, 2000

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

Re: A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries, and Clearing Organizations; Exemption for Bilateral Transactions, 65 *Fed. Reg.* 38986; 65 *Fed. Reg.* 39008; 65 *Fed. Reg.* 39027; and 65 *Fed. Reg.* 39033 (June 22, 2000)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments on the Commodity Futures Trading Commission's ("Commission's") proposed rules collectively designated "A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries, and Clearing Organizations" and the Commission's related proposed exemption for bilateral transactions (collectively, the "regulatory reform proposal"). FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 60 of the largest futures commission merchants ("FCMs") in the United States. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets.

FIA has divided its comments into three sections. The first section sets forth our views and certain structural concerns with respect to the Commission's regulatory reform proposal in its entirety. The purpose of these comments is to strengthen certain aspects of the Commission's proposal to assure that the Commission's regulatory goals are achieved. The second section compares and contrasts the Commission's proposal with those regulatory reform initiatives that FIA has identified as most important to its members. The third and final section comments on certain specific provisions of the Commission's proposal relating to intermediaries.

General Views and Concerns

FIA generally supports the Commission's regulatory reform proposal. At the outset, FIA wishes to congratulate the Commission for undertaking this initiative. The Commission's regulatory reform proposal is a revolutionary departure from the traditional approach to regulation of the futures industry. FIA generally endorses the Commission's decision to replace the

prescriptive regulations that currently restrict an exchange's conduct with a set of core principles against which the exchange's activities will be measured. The core principles for multilateral transaction execution facilities, "tailored to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer,"[1] promise to provide the derivatives markets with needed flexibility to respond to a rapidly evolving marketplace.

FIA also endorses the Commission's decision to adopt a regulatory scheme for recognized clearing organizations based on core principles. Implementation of this aspect of the Commission's proposal will implement two initiatives that FIA has endorsed previously: (1) the formation and recognition of clearing organizations separate from the facilities on which derivatives products are traded; and (2) the ability to provide clearing for over-the-counter ("OTC") derivatives products. In addition, FIA supports the Commission's proposed amendments to the Part 35 rules exempting certain bilateral transactions from the Commission's jurisdiction.

FIA does not intend to discuss the specific provisions of these portions of the Commission's proposal in detail. Rather, we will defer to those entities more directly affected.

The Commission should adopt core principles for intermediaries. FIA is disappointed that the Commission has concluded that it will not adopt a comparable regulatory approach to the intermediaries that act on behalf of customers that will trade on the several multilateral transaction execution facilities that the Commission will recognize. We see no reason—and the Commission has failed to explain—why the Commission cannot afford market intermediaries the same flexibility that it is offering the markets themselves. As the Commission has recognized, the derivatives markets are evolving at an increasingly rapid pace. None of us can predict what they will look like only a few years from now. Intermediaries, no less than the markets themselves, must have the ability to respond to this changing environment without being subject to the delays inherent in the rulemaking process.

Moreover, the Commission's regulatory reform proposal promises both to bring legal certainty to the OTC markets and to facilitate the development of less-regulated principal-to-principal derivatives markets. FIA is concerned that the Commission's decision to retain prescriptive regulations for intermediaries will result in shifting an even greater share of the regulatory burden and its attendant costs to intermediaries. This, in turn, may cause business to migrate from the organized exchanges to the OTC and principal-to-principal derivatives markets, where the cost of doing business will be less. As FIA has argued in other forums, the markets themselves, and not a particular regulatory regime, should determine the manner in which products are traded. The Commission's actions unfairly tilt the competitive balance away from intermediary-based markets.

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1 *65 Fed. Reg.* 38986.

FIA, therefore, urges the Commission to undertake an immediate examination of the Act and the Commission's rules to identify those provisions that impose prescriptive requirements on intermediaries. Once identified, the Commission should exercise its authority under section 4(c) of the Act to grant appropriate exemptions from these provisions and to adopt in their place a set of core principles governing intermediaries that reflects the overwhelmingly institutional nature of derivatives market participants.

FIA has carefully considered and identified the following core principles that we believe should govern intermediaries in the conduct of their business, without regard to the market on which a transaction is executed: (1) registration of intermediaries and their associated persons;[2] (2) minimum financial requirements; (3) protection of customer funds appropriate to the type of customer; (4) prohibition against fraud and manipulation; (5) large trader reporting requirements; and (6) recordkeeping.[3] These core principles, combined with an effective self-regulatory organization audit program to assure that intermediaries have developed and are enforcing adequate internal controls should achieve the Commission's regulatory purpose. In this latter regard, FIA would like to emphasize its belief that self-regulatory organization audit programs, not disciplinary actions or Commission enforcement proceedings, are the more appropriate method of assuring compliance with core principles. An intermediary should be subject to an enforcement proceeding only in the event of an egregious failure to comply with one or more core principles.

The Commission must exercise particular care in implementing its regulatory reform proposal. Notwithstanding our support for the Commission's regulatory reform proposal, indeed because we believe implementation of the proposal is essential if US derivatives markets are to remain competitive, we are compelled to offer a few cautionary comments. The Commission's proposal vests substantial regulatory flexibility in the Commission as well as in the industry participants it regulates. In this regard, therefore, the Commission must be careful that its interpretative statements of acceptable business practices, intended to offer guidance to the industry, do not become *de facto* regulations, adopted without the procedural benefits and protections of the Administrative Procedure Act ("APA").

FIA's concerns are founded at least in part on the history of the evolution of the interpretation of Commission rule 30.7, the provisions relating to the foreign secured amount under the Commission's foreign futures and foreign options rules. As the Commission is aware, FIA has worked with the staff for the past several years to correct what we believe had been an erroneous interpretation of this rule, which was first published in a footnote in a Commission order in 1997,

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2 The determination that a person is fit to be registered is subsumed within the registration process.

3 The Commission has indicated that intermediaries as well as the various execution facilities should be required to maintain records "in a form and manner acceptable to the Commission." FIA suggests, in the alternative, that the Commission describe the purposes that the recordkeeping requirements are meant to achieve and permit intermediaries the flexibility to select the form and manner in which these records are created and maintained.

a decade after the Commission promulgated its foreign futures and foreign options rules.[4] This interpretation has imposed substantial financial burdens on US FCMs that carry a significant number of foreign futures and foreign options customer accounts.[5]

The *Federal Register* release proposing rules governing recognized clearing organizations raises the concern that interpretations of core principles could result in the same type of *de facto* regulation. Appendix A to proposed Part 39 sets out in considerable detail the type of showing that a recognized clearing organization applicant may wish to make to demonstrate that it would comply with the core principles set forth in proposed rule 39.3.[6] In the process, the Appendix appears to impose requirements on clearing organizations to which they are not subject now. For example, the Appendix suggests that, in order to demonstrate that the applicant has the ability to manage the risks associated with carrying out the guarantee function of a clearing organization, the applicant discuss "why particular margin levels would be appropriate for a contract cleared and the clearing member clearing the contract."[7] This statement implies that the Commission may approve those levels. Yet, as the Commission is aware, the Act prohibits the Commission from approving rules relating to margin except in specific, limited circumstances.[8]

FIA understands that Appendix A to Part 39 is intended only to be illustrative of the types of matters an applicant may wish to address in its application and should not be viewed as a checklist of issues that applicants are required to address. The Commission must remember, however, that this regulatory regime will be new for the staff as well as applicants. It would be only natural for both parties to look to the Appendix as a standard that must be met. Therefore, the Commission should clearly and forcefully state the limited purpose of this and other appendices. It must be clear that the interpretative statements are intended simply to provide guidance to the industry and are not safe harbors, which we fear would become *de facto* regulations. The Commission should also confirm that an intermediary would not be deemed to have failed to comply with a core principle simply because the intermediary is not acting in accordance with the terms of an

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4 The Commission stated that FCMs have the duty to assure "that funds provided by US customers for foreign futures and options transactions . . . will receive equivalent protection at all intermediaries and clearing organizations." To the extent that a foreign depository is unable to provide the written acknowledgment required under Commission rule 30.7(c), the Commission added, US FCMs must establish "mirror" accounts in the US in order to meet their secured amount obligations. 62 *Fed. Reg.* 10445, fn. 8 (March 7, 1997) [Sydney Futures Exchange]; 62 *Fed. Reg.* 10447, fn. 8 (March 7, 1997) [Securities and Futures Authority]; 62 *Fed. Reg.* 10449, fn. 7 (March 7, 1997) [Investment Management Regulatory Organization].

5 Although FIA and the staff appear to have reached a mutually acceptable resolution of this matter, which we understand will be presented to the Commission for approval shortly, the experience highlights the problems that can arise when interpretations that have industry-wide significance are adopted without appropriate participation of the affected parties.

6 65 *Fed. Reg.* 39027, 39031.

7 65 *Fed. Reg.* 39027, 39031.

8 See sections 2(a)(1)(B)(vi), 5a(a)(12)(A), 8a(7) and 8a(9) of the Act.

interpretative statement. Similarly, an intermediary's failure to comply with the terms of an interpretative statement should not support an adverse inference in any litigation to which the intermediary is a party.

FIA also recommends that the Commission identify in greater detail the process by which it intends to issue interpretations of acceptable business practices. We strongly encourage Commission, in appropriate circumstances, to follow the notice and public comment procedures in the APA.[9] In this same vein, FIA urges the Commission to establish a procedure, other than an enforcement proceeding, by which an intermediary (or execution facility) and the Commission can resolve disagreements concerning the implementation of core principles. We respectfully suggest that the flexibility the Commission's regulatory reform proposal promises will be meaningless, if the only forum for resolving such a disagreement is an enforcement proceeding. As discussed above, FIA believes that effective audit programs, not self-regulatory organization disciplinary actions or Commission enforcement proceedings, are the more appropriate method of assuring compliance with core principles.

The Commission should explain more fully the basis for certain decisions. The Commission's proposal raises a number of other issues, discussed below, that FIA encourages the Commission to address in the *Federal Register* release adopting final rules. By explaining in greater detail at the outset the reasons why the Commission has taken certain positions, the Commission may avoid inadvertently creating legal uncertainty or confusion at a later, and far more inconvenient, date.

FIA notes that the Commission has specifically provided that the provisions of sections 4b and 4o of the Act and rule 33.10, the antifraud provisions of the Act and Commission regulations, apply to recognized futures exchanges, derivatives trading facilities and recognized clearing organizations. In these circumstances, it is not clear why the Commission has also adopted separate antifraud rules for each type of entity or what purpose these special antifraud provisions serve.

FIA also questions why an execution facility must be a designated contract market, subject to the panoply of the existing provisions of the Act and regulations, for the purpose of trading stock index products. Section 4(c) of the Act states only that the Commission cannot grant an exemption from the provisions of section 2(a)(1)(B). Section 4(c) does not prohibit the Commission from granting a contract market (or an applicant for designation as a contract market) in stock index products an exemption from the provisions of the Act governing contract markets. We see no reason to maintain a separate category of trading facility solely for the purpose of

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[9] FIA recognizes that certain requests for interpretative guidance will not have industry-wide application. Rather, they will be meaningful only to the person or persons requesting the guidance. In these circumstances, procedures similar to a request for the adoption of a no-action position will be more appropriate. In this connection, FIA encourages the Commission to remove Commission rule 140.99, which was adopted in 1998 to establish procedures for filing requests for exemptive, no-action and interpretative statements. We believe these procedures have inhibited the informal dialogue between the Commission staff and the industry that benefit everyone.

trading contracts on stock indices. In this regard, we would support the approach adopted by the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry, which would effectively treat all contract markets as recognized futures exchanges.

Finally, although the Commission has proposed that the same legal entity may act as both a recognized futures exchange and a derivatives transaction facility, the activities of an exempt multilateral transaction execution facility would be required to be conducted through a separate legal entity. The Commission should explain why it has concluded that the activities of an exempt facility must be conducted through a separate entity. FIA is concerned that this requirement may have collateral consequences that have not been identified. Moreover, we note that the products traded on all three entities may be cleared through the same recognized clearing organization. Therefore, there would appear to be no reason why they could not be executed through the same legal entity.

The Commission's Proposal Compared with FIA's Regulatory Reform Initiatives.

As the Commission is aware, in anticipation of both the Commission's proposal and reauthorization bills that are pending in both the House of Representatives and the Senate, FIA has made a number of recommendations for legislative and regulatory reform. These recommendations were designed to recognize the need to permit more consistency and efficiency in the trading of cash market positions, OTC derivatives and exchange-traded derivatives for the benefit of market participants and the markets themselves. Our comments now focus on the manner in which the Commission's proposal has addressed FIA's recommendations.

FCMs should be permitted to act as dealers. FIA has encouraged the Commission to permit FCMs to participate in exchange-traded derivatives markets as both a dealer and an agent, acting for their own accounts as well as on behalf of institutional and other market participants. The expansion into dealing activity in exchange-traded derivatives would bring these markets in line with all other traded markets. These markets, including the US securities markets, permit dealing away from the exchange and the subsequent entry and clearing of those transactions onto the exchange. Permitting an FCM to deal as principal or agent directly with its customers and then to enter that executed transaction onto a regulated exchange, where it becomes a cleared contract subject to exchange rules provides exchange markets with needed flexibility, liquidity and efficiency.

FIA is pleased that the Commission's proposal would place no restrictions on the ability of FCMs to act as dealers on derivatives transaction facilities. However, FIA is concerned that, in connection with dealer transactions, or block trades, on a recognized futures exchange, the Commission has stated that the exchange must provide a mechanism for ensuring that the trade's price is "fair and reasonable" and require that the trade be reported for clearing "within a reasonable period of time."[10] As FIA has commented in connection with the block trading rules that the Cantor Financial Futures Exchange, the Chicago Mercantile Exchange and BrokerTec

[10] 65 *Fed. Reg.* 38986, 39006.

Futures Exchange block trading rules, we are concerned that these standards are both vague and unnecessary.[11]

The prices of other trades in the same contract as executed through a trading facility may not necessarily be representative of the market for the larger orders that may be executed as block trades. FIA believes that the parties to a block trade should be free to negotiate and agree to enter into the trade at any price. The Commission should not be concerned that such an approach might lead to fraud or market manipulation, since the facility can establish other safeguards adequate to prevent abuse.

FIA would also be opposed to any requirement establishing a time by which a block trade must be reported for clearing. It is clearly in the interest of the firm executing a block trade to present the trade for clearing as soon as reasonably practical. FIA is concerned, however, that a specific timing requirement may be burdensome, especially during periods of highly active trading. Further, a short reporting requirement is not appropriate in a case in which a trader must work a large order in several parts.

Clearing organizations should be authorized to clear multiple products. FIA has recommended that the Commission take steps to authorize clearing organizations to clear multiple products. The ability of a clearing organization to net obligations across markets potentially offers a substantial benefit by permitting intermediaries to reduce systemic risk associated with holding positions in multiple clearing organizations. FIA notes that international clearing organizations and intermediaries generally are authorized to clear multiple products in a single account, and we believe US clearing organizations should have the same ability.

In this regard, therefore, FIA supports the Commission's decision to permit a single clearing organization to clear products entered into on any trading facility subject to the Commission's oversight as well as exempt multilateral transaction execution facilities.[12] For the same reasons, FIA generally supports the Commission's proposal to permit registered securities clearing agencies and clearing entities subject to the jurisdiction of a federal bank regulatory authority to clear OTC bilateral transactions and transactions executed on an exempt facility.[13] We understand, however, that the Board of Trade Clearing Corporation has argued this latter proposal would place futures clearing organizations at a competitive disadvantage. We believe the Clearing Corporation's position has merit, and we encourage the Commission to work with the Clearing Corporation to develop a mutually acceptable result.

FCMs should be authorized to carry multiple products in the customer segregated account. Similarly, FIA has encouraged the Commission to modify its rules relating to the segregation of

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11 See, *e.g.*, Letter to Jean A. Webb, Secretary to the Commission, from Ronald H. Filler, President, Law & Compliance Division, dated April 24, 2000.

12 Proposed rule 39.2, 65 *Fed. Reg.* 39027, 39029.

13 Id.

customer funds both to permit non-futures position margin and other security to be held in the customer segregated account. Moreover, institutional customers should have the ability to direct an FCM to hold the customer's futures margin and other securities outside of a segregated account. FIA concurs with the Commission that the second proviso of section 4d(2) of the Act vests the Commission with sufficient authority to permit any FCM that wishes to carry a customer's cash, OTC derivatives, securities and futures positions in a single account to maintain that account as a customer segregated account under section 4d(2). Correspondingly, FIA believes that the Commission has regulatory authority, pursuant to section 4(c) or otherwise, to adopt rules permitting the single account to be held outside of segregation. Allowing both of these alternatives would maximize flexibility and serve market participants' needs to operate through a single account.

We recognize that the practical and regulatory issues that would arise under this proposal may be complex, particularly if securities and futures positions are to be held in a single account. However, we also note that the Commission and the Securities and Exchange Commission ("SEC") have previously agreed on an approach by which professional traders have been authorized to carry futures on stock indices and related options on stock indices in a single "cross-margin" account. The cross-margin accounts authorized are limited both with respect to the nature of the participants permitted to take advantage of them and the positions that could be carried. Therefore, they do not constitute a perfect example of the structure that such accounts could take. However, they are an example of the ability of the Commission and the SEC to resolve difficult issues.

FIA further appreciates that, in connection with the adoption of regulations to implement this recommendation, the Commission will be required to revise its regulations relating to commodity broker liquidations to assure appropriate treatment of customer cash and OTC derivatives positions, as well as securities, that the FCM may hold in a single account. FIA would be pleased to work with the Commission on this issue following the close of the comment period.

FIA also endorses the Commission's proposed amendments to rule 1.25, which will expand the class of permitted instruments in which FCMs may invest customer segregated funds. As the Commission is aware, FIA's Operations Division has worked closely with Commission staff on this issue for some time. We believe that the proposed amendments strike an appropriate balance, affording FCMs greater flexibility in investing segregated funds, while assuring preservation of customer principal.

In analyzing the proposed rule, our members have identified a few aspects of the rule with respect to which we request further clarification. In particular, subsection (b)(1)(B) states that the securities listed in that subsection must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of a NRSRO. FIA understands that the two highest long-term ratings of a NRSRO are generally AAA and AA. We ask the Commission to confirm that we are correct in this understanding and that the securities falling within this classification would include securities that are rated AAA and all variations of AA.

We also ask the Commission to clarify its position in the event that a security has a split rating, *i.e.*, one NRSRO has rated a security AA, while another has assigned it a rating of A. In these circumstances, it is not clear if the FCM should rely on the higher or lower rating. FIA has no position on this issue. However, we would encourage the Commission, in addressing this issue, to consult first with the industry and the SEC. It is important that the Commission and the SEC are of one mind on this point.

Moreover, we ask the Commission to confirm that securities that are the subject to repurchase agreements are not required to be taken into account in calculating an FCM's aggregate investment in any one issuer. FIA understands that a firm generally does not identify the issuer of the securities that it wishes to purchase pursuant to a repurchase agreement. Rather, the firm simply states that it wants to purchase a fixed dollar amount of securities with a particular rating, *e.g.*, $20 million corporate securities with a AA rating. FIA further understands that, because these transactions are not collateralized until the end of the day, time is generally of the essence. Therefore, it would be operationally burdensome for either party to identify by issuer those securities that the FCM could purchase. An FCM and its counterparty could not easily reverse the transaction, if the FCM were to receive securities that caused the FCM to exceed the concentration limit for a particular issuer. If the Commission nonetheless determines that securities that are purchased pursuant to a repurchase agreement should be taken into account in calculating an FCM's aggregate investment in any one issuer, FIA respectfully requests that the Commission revise proposed rule 1.25 to afford an FCM sufficient time, *i.e.*, no less than 24 hours, to reverse the transaction.[14]

Lastly we note that the Federal Reserve Bank of Chicago has recommended that, to the extent a non-dollar denominated customer funds are deposited with an FCM or clearing organization, the FCM or clearing organization should be permitted to use such foreign currency to purchase foreign government securities denominated in such security. FIA concurs in this recommendation and encourages the Commission to amend proposed rule 1.25 accordingly.

Consistent with FIA's comments above regarding the adoption of core principles for intermediaries, FIA encourages the Commission, following a period of experience with the revised rule, to consider whether the prescriptive provisions of the rule could be replaced with a core principle and, perhaps, an interpretative statement of acceptable practices. In either event, the Commission should review the list of permitted investments periodically, *e.g.* every six months, to determine whether the list should be amended in any way.

The capital rules should be amended to permit FCMs to engage in a wider range of activities. FIA supports the Commission's decision to consider a risk-based capital rule for FCMs. The existing minimum financial and related requirements constrain FCMs from participating in the OTC derivatives markets in a meaningful way, as either dealer or agent.

[14] In this latter regard, FIA also requests that the Commission clarify that an FCM will have sufficient time to adjust its holdings in the event the average time-to-maturity of the portfolio inadvertently exceeds 24 months.

Pending adoption of these rules, however, we believe the Commission should act promptly to adopt the following amendments to its regulations:

First, the Commission should revise rule 1.17(c), defining the term "adjusted net capital," to recognize that futures contracts may reduce the risk of holding certain other futures contracts and OTC derivatives products. Such futures contracts and derivatives products should be considered "inventory," which may be covered by a futures contract. This amendment will enhance the efficiency of both the OTC and exchange markets.[15]

Second, 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.

The reparations program should be eliminated and mandatory binding arbitration should be permitted. FIA is disappointed that the Commission has determined to retain its rules relating to the use of pre-dispute arbitration agreements.[16] Among other things, these rules provide that a customer may never waive the right to file a complaint under the Commission's reparations program, even if the customer signs a pre-dispute arbitration agreement. As the Commission is aware, FIA has previously recommended that Congress eliminate the reparations program entirely. Reparations served a useful purpose during the early years of the Commission and before the development of an effective arbitration program at the National Futures Association. The need for and expense of a separate federal dispute resolution forum, which has no parallel in the securities or banking laws, can no longer be justified. Alternative dispute resolution forums provide fair and equitable hearings for customer disputes against Commission registrants. At the very least, institutional customers and FCMs should have the ability to waive this requirement contractually.

The Commission's rules, which also provide that an FCM may not require a customer to sign a pre-dispute arbitration agreement as a condition to opening an account with the FCM, inhibit the ability of FCMs that are also broker-dealers to enter into a single agreement with their customers. Provided a broker-dealer furnishes a customer with the uniform disclosure regarding pre-dispute arbitration agreements adopted by the several securities self-regulatory organizations, the SEC does not prohibit the use of mandatory pre-dispute arbitration agreements.

FCMs want to know that, in the event a customer has a complaint against the firm, all of the elements of the complaint will be heard in a single forum. Under the Commission's arbitration

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15 In this regard, FIA is pleased that that Commission's Division of Trading and Markets recently adopted a no-action position granting significant relief to an FCM that manages the risk associated with its proprietary trading in the Goldman Sachs Commodity Index with offsetting positions in the futures contracts that comprise the index. Interpretative Letter No. 00-79, dated June 30, 2000.

16 Proposed rule 166.5(c), 65 *Fed. Reg.* 39008, 39026.

rules, FCMs that are also broker-dealers do not have this confidence. FIA believes that the uniform pre-dispute arbitration agreement disclosure statement that all securities self-regulatory organizations require broker-dealers to provide customers is effective in advising customers of the rights they may be foregoing in agreeing to arbitration. Therefore, we believe that the Commission's rules should be further amended permit FCMs to use the securities disclosure in lieu of the Commission's statement.

The definition of institutional customers should be expanded. FIA supports the Commission's decision to use the definition of an eligible swap participant as the basis for its definition of an institutional customer. We suggest, however, that the Commission expand the definition to include any person whose account is managed by a commodity trading advisor, registered investment adviser, or a foreign person subject to comparable regulation in a foreign jurisdiction that manages accounts in the aggregate amount of $25 million.[17] Because an advisor is a fiduciary to the customer, FIA believes it is more appropriate to look only to the sophistication of the advisor in determining whether a customer should be considered an institutional customer. The net worth of the underlying customer or the aggregate value of the individual customer's assets should be irrelevant.

The Commission has already included these customers in the class of customers that are permitted to take advantage of the Commission's recently adopted foreign order transmittal rules.[18] Moreover, both the Cantor Exchange and the Chicago Mercantile Exchange have included customers whose accounts are managed by certain advisers in defining the class of customers that may enter into block transactions. FIA recommends that the Commission adopt this amendment with respect to the definition of institutional customer generally.

FIA further notes that, in its consideration of the pending reauthorization legislation, the House Committee on Banking and Financial Services adopted an amendment to the definition of an "eligible contract participant" to include a natural person with total assets of $5 million, who enters into a transaction in order to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by such person. FIA believes that this amendment has merit and encourages the Commission to amend its definition of an institutional customer to include such individuals.

The Commission should revise its procedures with respect to stock index contracts traded on foreign markets. We understand that the Commission did not intend to address regulatory issues related to foreign exchange transactions in this rulemaking. Nonetheless, the Commission has previously indicated that one purpose of its regulatory reform proposal is to eliminate

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[17] Requiring an advisor to have a minimum amount of assets under management is a measure of the expertise of the advisor and the level of confidence that a significant number of market participants have placed in the advisor.

[18] *65 Fed. Reg.* 47275 (August 2, 2000). This rule provides that the investment manager must have $50 million under management. Although FIA previously endorsed this higher amount, we now believe that $25 million is more appropriate.

requirements that impede the ability of US customers to engage in transactions on *bona fide* exchange markets and the ability of US FCMs to compete in the international marketplace. Therefore, we believe this is an appropriate time to request the Commission once more to revise its procedures relating to the offer and sale of stock index contracts traded on foreign exchanges.

As the Commission is well aware, FIA does not believe that Congress ever intended to preclude a foreign futures exchange from offering futures on foreign stock indices or foreign government debt instruments to US customers. Nor do we believe that Congress intended to require such foreign exchanges to apply for and receive Commission approval before doing so. As clearly reflected in the provisions of section 2(a)(1)(B), the sole regulatory purpose that Congress sought to achieve was to protect the integrity of the underlying US securities markets by assuring that trading in a particular stock index futures contract "is not being used in the manipulation of the price of any underlying security [or] option on such security."[19] With respect to futures contracts on foreign securities offered on a foreign exchange, we respectfully suggest that this determination appropriately resides with the regulatory authorities that oversee the markets on which the relevant securities are traded, not with the Commission or the SEC.

No public policy is served by excluding certain foreign contracts from trading by US customers, especially institutions. This is particularly true since these same customers, including US pension funds, can freely trade in the underlying foreign securities and in OTC derivatives instruments that can be used as substitutes for these contracts.[20] For these same reasons, we can discern no US regulatory purpose to be served by preventing US customers from using foreign futures on single securities or narrow-based indices, provided that the US is not the primary trading market for such securities.[21] US customers who invest in the underlying foreign securities are deprived of a valuable hedging tool by being precluded from trading foreign futures contracts on the same securities.

FIA notes that, in connection with the Commission's reauthorization, the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry have approved provisions in their respective bills that would recognize that the Commission should have no authority to review or approve any futures contract (or option thereon) on a security listed for trading on a foreign exchange, unless the US is the primary trading market for the underlying securities. FIA urges the Commission to adopt the approach these committees have endorsed without delay.

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19 Section 2(a)(1)(B)(ii)(II).

20 In this regard, it should be noted that emerging countries, in particular, may find it difficult to meet the standards that the Commission employs in approving the offer and sale of foreign stock index products. The inability to hedge investments in the securities of emerging country companies inhibits the flow of US capital to these countries.

21 Foreign exchanges, of course, should not be prohibited from trading futures and options on futures contracts on securities and narrow-based indices for which the US is the primary trading market or from offering those products to US customers. In this regard, therefore, the Commission should adopt procedures to authorize the offer and sale of such products in the US.

Comments on Specific Provisions of the Commission's Proposal Relating to Intermediaries.

Activities on exempt multilateral transaction execution facilities and derivatives transaction facilities. In a footnote in the *Federal Register* release accompanying the proposed rules relating to intermediaries, the Commission states that, except for the prohibitions against fraud and manipulation, intermediaries would not be subject to regulation in connection with transactions effected on an exempt multilateral transaction execution facility. Moreover, to the extent that a derivatives transaction facility may permit trading only on a principal-to-principal basis, intermediaries generally would not be subject to regulation with respect to transactions on those markets as well.[22] FIA welcomes this statement of the Commission's position. Nonetheless, we are concerned that it may only be found in a footnote to the proposed rules, where it may be lost over time. FIA respectfully requests the Commission to reconfirm this position in the *Federal Register* release accompanying the final rules in this regard.

Simplified registration for broker-dealers and banks. The Commission has proposed to amend rule 3.10 to permit a simplified registration procedure as an FCM or introducing broker for registered,broker-dealers or banks that wish to limit their activities to acting as intermediaries with respect to transactions on derivatives transaction facilities. FIA does not object to this proposed rule. However, we believe the Commission should make clear in the *Federal Register* release accompanying the final rules in this regard that the simplified procedure is available to banks only, and not to any affiliate of a bank. Moreover, once registered with the Commission, such broker-dealers and banks would be subject to the same rules and regulations that govern all FCMs and introducing brokers.

The Commission also states that it will encourage the SEC to consider granting reciprocal registration to FCMs for certain products. FIA would urge the Commission to go further and undertake to work with the SEC to this end.

Definition of "principal." FIA supports the revised definition of the term "principal" contained in its proposed amendment to rule 3.1(a)(1). FIA agrees that the current definition captures far too many individuals, imposing an unnecessary burden on applicants and registrants.[23]

Change in control. FIA suggests that the provisions of rule 3.32 relating to change in control of a registrant be further amended. Even as proposed to be amended, the rule is tremendously difficult for registrants to meet, especially if the registrant is also registered as a broker-dealer or is a part of a holding company structure. In these circumstances, an FCM frequently is not aware

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22 Footnote 1-3, 65 *Fed. Reg.* 39009.

23 FIA understands that, in its comments, the National Futures Association has encouraged the Commission to streamline further the registration process by (1) permitting NFA to register as an associated person an individual who is currently a registered representative of a broker-dealer without conducting a separate background examination and (2) eliminating the requirement that an applicant disclose his or her employment, residential and educational background. FIA supports these recommendations.

of changes requiring Commission notification until just prior to or some time after the change occurs. FIA suggests that the Commission adopt procedures similar to those in the securities industry. Under these procedures, except in defined circumstances in which there is an effective change in complete ownership of the registrant, the registrant should be able to notify the Commission promptly after the change occurs, rather than prior to such change.

Ethics training. FIA supports the Commission's proposal to remove the specific regulatory requirements for ethics training. FIA agrees with the Commission that each registrant should be responsible for implementing an ethics training program that addresses the registrants business activities.

Risk and other disclosure statements; arbitration. FIA generally supports the Commission's proposal to permit non-institutional customers to acknowledge receipt of the various disclosures required by Commission rules with a single signature.[24] However, FIA opposes the Commission's preliminary decision to continue to require a separate signature if a customer account agreement contains a pre-dispute arbitration provision. We see no reason why the Commission should continue to require a separate signature in this one area. As noted above, the SEC does not prohibit the use of pre-dispute arbitration agreements and does not require a separate signature. Rather, the several securities self-regulatory organizations have adopted a uniform disclosure that immediately precedes the customer signature line.

Offsetting long and short positions. FIA supports the proposed amendments to Commission rule 1.46 governing the procedures by which a customer offsets long and short positions. We ask, however, that the Commission confirm that the instructions the FCM receives from a customer may be transmitted orally and do not have to be transmitted in writing.

Conclusion

FIA appreciates the opportunity to submit these comments on the Commission's regulatory reform proposal. If you have any questions regarding this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

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[24] With respect to Commission rule 1.55(d)(1), FIA requests the Commission make clear that an FCM may obtain an acknowledgment or receipt of the risk disclosure statement contemporaneously with opening an account, not prior to opening the account.

cc: Honorable William J. Rainer
Honorable Barbara Pederson Holum
Honorable David D. Spears
Honorable James E. Newsome
Honorable Thomas J. Erickson
C. Robert Paul, General Counsel
John C. Lawton, Acting Director, Division of Trading and Markets
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