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DEPARTMENT OF THE TREASURY  
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OFFICE OF THE SECRETARIAT

Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

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RECORDS SECTION

**COMMENT**

Re: Regulatory Reinvention

Dear Ms. Webb:

We appreciate the opportunity to comment on the Commission's recent regulatory reform proposals published in the *Federal Register* on June 22. These proposals are far-reaching and are a new approach to the Commission's regulatory role in response to a rapidly changing marketplace. We commend the Commission for its thoughtful evaluation of the appropriate level of regulation for futures exchanges.

We do, however, have particular concerns about aspects of the Commission's proposal that have implications for the regulation of the government securities market. Broadly, our concerns are related to the regulation applicable to contracts for future delivery (and options thereon) of government securities. We have two specific recommendations: (1) the proposal should be amended to make government securities futures ineligible for trading on exempt Multilateral Transaction Execution Facilities ("MTEFs"); and (2) if government securities futures are permitted to trade on Derivatives Transaction Facilities ("DTFs"), certain safeguards must apply.

- I. **Government securities futures should be ineligible for trading on exempt MTEFs because such an exemption would: (1) create a regulatory gap allowing opportunities for significant undesirable regulatory arbitrage; and, (2) undermine the Government Securities Act and the integrity of the underlying markets by exposing government securities to potential manipulation and fraud.**

Regulatory Arbitrage

Under Part 36 of the proposed rules, government security futures could trade on an MTEF, as long as access to the MTEF is limited to eligible participants. The futures contracts eligible to trade on an exempt MTEF could be on a single government security, such as the existing Treasury bill futures contract, or could be based on a basket of government securities meeting certain criteria, such as the existing Treasury bond and note futures contracts.

The Commission recognizes the potential concerns with this arrangement. In the preamble to proposed Part 36 of its regulations, the Commission asks: "In light of the significant regulation of government securities markets under the Government Securities Act of 1986 (as amended) and other securities laws, would granting a broad exemption to contract markets for futures on government securities give rise to significant and undesirable opportunities for regulatory arbitrage?"<sup>1</sup> The Treasury believes that allowing government security futures to trade on exempt MTEFs would produce a regulatory gap that could create the opportunity for regulatory arbitrage and strongly recommends that the Commission amend the proposal before its final adoption to ensure this does not happen.

Since the introduction of futures contracts on government securities in the late 1970s, the trading of these instruments on futures exchanges has always been subject to Commission regulation, and all dealers and brokers in the cash market for government securities have been subject to regulation since the enactment of the Government Securities Act. If government security futures were allowed to trade on an exempt MTEF, there would be no regulation of this portion of the market, except for the Commission's retention of authority to take enforcement actions against fraud or manipulation. Although the Commission retains this residual authority under the proposed rules, it gives up many of the tools needed to uncover cases of fraud and manipulation and to effectively pursue enforcement actions. In addition, because of the exclusive jurisdiction provision of the Commodity Exchange Act, other regulators would not be able to regulate this portion of the market. This creates the potential for regulatory arbitrage.

#### Undermining the Government Securities Act and the Integrity of the Government Securities Markets

Prior to 1986, not all government securities brokers and dealers were subject to regulation. Problems with these entities led to the passage of the Government Securities Act of 1986, which was amended in 1993 to address issues related to auction irregularities, short squeezes, and unfair sales practices that came to light in the intervening years. The Government Securities Act, with its amendments, has been effective in maintaining the integrity of the market. Allowing government securities futures to trade on exempt MTEFs, where they would not be subject to the Government Securities Act or any other regulatory framework designed to address potential problems, could undermine the integrity of the government securities markets.

Although there is currently a large supply of outstanding marketable Treasury securities, there have been a number of attempts to manipulate individual securities within the broader market. Additionally, fraud and mistreatment of customers has in the past also been a concern in the government securities market.

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<sup>1</sup> *Federal Register*, Vol. 65, No. 121 (June 22, 2000), p. 38988.

Again, as we have previously stated, the regulation of government security futures does not have to be identical to the regulation of the securities themselves. The current system has worked effectively. The basic protections currently provided under the Commodity Exchange Act, as well as those provided under the Government Securities Act, must be maintained to ensure that we do not weaken the measures that have been taken to address past problems in the government securities markets.

**II. If government security futures are permitted to trade on derivatives transaction facilities, certain safeguards must apply, including required segregation of customer funds, adjustments to capital requirements for futures commission merchants ("FCMs") executing trades for retail customers, and appropriate large trader reporting.**

Segregation of Customer Funds

The Treasury believes that a continuation of the segregation of customer funds in connection with government security futures transactions is appropriate.

Problems in this area in connection with repurchase agreement transactions were some of the issues the Government Securities Act was designed to address. For example, in one particularly noteworthy incident, which occurred prior to the enactment of the Government Securities Act, an unregulated government securities dealer used the same government security to secure multiple repurchase agreement transactions. When the dealer failed, this caused severe problems for the state-insured thrift industry located in another state.

Additionally, we recommend that the Commission explore the Bankruptcy Code implications of any changes to regulations concerning segregation of funds. It is important that the Commission and affected market participants understand the full ramifications of any changes to segregation requirements.

Capital Requirements

Concerning capital, we have comments on two related issues -- the \$20 million adjusted net capital requirement for FCMs transacting business for smaller customers on DTFs and the interaction of the segregated funds issue with capital requirements.

In its DTF proposal, the Commission indicates it would allow customers that do not meet the definition of eligible participant to access DTFs through FCMs that have in excess of \$20 million in adjusted net capital. In general, we suggest that a more appropriate measure of an

intermediary's soundness is the amount of adjusted net capital in excess of the minimum required by regulation.

However, the Commission's adjusted net capital requirements are based on the amount of segregated funds. Consequently, whether excess adjusted net capital would be a relevant measure in addition to total adjusted net capital depends on what the Commission ultimately decides about segregation of funds for FCMs transacting business on a DTF for eligible participants.

We would suggest that the Commission consider the segregation of funds issue in connection with its capital rules and determine what modifications are appropriate to both sets of rules. The decisions on these issues should be taken into account in reaching a judgment on what capital requirements should be required of FCMs executing transactions for retail customers on DTFs.

#### Large Trader Reporting

We also have some concerns about how large trader reporting would work on DTFs. Currently, FCMs are required to report futures positions held by their customers that exceed certain thresholds separately determined for each particular contract. Since eligible participants could, under the Commission's proposal, execute trades on a DTF without using the services of an FCM, it is unclear how any large positions that result in such a circumstance would be reported. We do not have a preferred mechanism for requiring large trader reports. However, we believe that large trader reporting requirements have worked well in the market for Treasury futures, both for the information they reveal to regulators and their deterrent effect. Consequently, we recommend that the Commission establish a mechanism for large trader reporting for government securities futures trading on DTFs.

In summary, we strongly urge the Commission to amend its proposal so that government security futures are not eligible for trading on exempt MTEFs. Implementing the proposed rule without this change has the potential to create a regulatory gap which could ultimately undermine the integrity of the government securities market. We also suggest that, in connection with DTFs,

the Commission maintain its segregation of funds requirements in connection with government security futures transactions, consider the Bankruptcy Code implications of any opt-out provisions from segregation of funds requirements, and review its capital and large trader reporting rules.

Sincerely,

A handwritten signature in black ink, appearing to read "Lee Sachs", with a long horizontal flourish extending to the right.

Lee Sachs  
Assistant Secretary  
(Financial Markets)