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April 9, 2001

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

Re: Proposed Regulatory Framework for Trading Facilities
66 *Fed. Reg.* 14262 (March 9, 2001)

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 implementing recent amendments to the Commodity Exchange Act ("Act") establishing a regulatory framework for various trading facilities subject to the Commission's jurisdiction, including designated contract markets, derivatives transaction execution facilities and certain exempt markets.[1] 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.

As indicated, the proposed rules generally affect trading facilities and their sponsors. With limited exceptions, including proposed rule 166.5, Dispute Settlement Procedures, the proposed rules do not affect intermediaries directly. Therefore, FIA intends to restrict its comments to those few issues that are of particular concern to its members and to defer to the representatives of the several trading facilities with respect to other aspects of the rules.[2]

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[1] These amendments were adopted in the Commodity Futures Modernization Act of 2000 ("CFMA"), which was passed by Congress on December 15, 2000 and signed by the President on December 21, 2000. Among other purposes, the amendments to the Act were intended to codify many elements of the Commission's earlier proposal amending its rules to establish a new regulatory framework for multilateral transaction execution facilities, which the Commission published for comment in June 2000, 65 *Fed.Reg.* 39008 (June 22, 2000), and promulgated as final rules in December 2000. 65 *Fed.Reg.* 77993 (December 13, 2000). Upon enactment of the CFMA, the Commission withdrew its rules. 65 *Fed.Reg.* 82272 (December 28, 2000).

[2] FIA has reviewed the comment letter filed by the Board of Trade Clearing Corporation. The comments and recommendations with respect to proposed Part 40, Provisions Common to Contract Markets, Derivatives Transaction Execution Facilities and Derivatives Clearing Organizations, appear to well-founded and constructive. In addition, FIA has reviewed and endorses the comments filed by @Markets Association.

Dispute Settlement Procedures (Arbitration)

Proposed rule 166.5, establishing procedures governing arbitration of claims in connection with transactions effected on designated contract markets and, in particular, the requirements of that rule relating to the use of pre-dispute arbitration agreements, is of critical concern to FIA and its members. The rule is substantially the same as the rule the Commission promulgated in connection with its earlier regulatory reform proposal and subsequently withdrew in December. The rule has been revised to implement the provisions of section 14(g) of the Act, which provide that an FCM may require an eligible contract participant, as a condition to the FCM's conducting a transaction for the customer, to waive the right to file a claim in reparations. In all other critical respects, the proposed rule continues to impose onerous requirements on the use of pre-dispute arbitration agreements in the withdrawn rule and currently set forth in Commission rule 180.3.[3]

As the Commission may recall, in its comment letter on the Commission's earlier proposal, FIA opposed the adoption of the proposed rule and specifically recommended that the Commission not prohibit the use of pre-dispute arbitration agreements.[4] For the reasons set forth below, we hereby renew our opposition to the proposed rule. The rule reflects distrust in arbitration as a forum for the resolution of customer disputes that is unfounded in fact, contrary to the law generally and the Act in particular, and increasingly impracticable in the context of the increasing overlap between the commodities industry and the securities industry.

The distrust of arbitration reflected in the proposed rule is unjustified. Various provisions of Commission rule 166.5 evidence the Commission's historic distrust of the arbitration process and an apparent conviction that arbitration provides a dispute resolution forum that is inferior to either reparations under section 14 of the Act or a private right of action under section 22 of the Act. These provisions include: (1) the requirement that a customer that is not an eligible contract participant may not be required to waive the right to file a claim under section 14 of the Act [rule 166.5(b)(3)]; the extended time period (45 days) in which a customer against whom an arbitration claim is filed may elect to proceed under section 14 of the Act [rule 166.5(b)(3)]; (3) the requirement that a registrant provide a customer against whom a claim is filed with a choice of at least three separate organizations whose procedures meet acceptable practices approved by the Commission [rule 166.5(b)(5)]; (4) the extended time period (45 days) in which the customer has to choose the organization that will hear the claim [rule 166.5(b)(5)]; (5) the text of the "cautionary language" that a registrant must include in the pre-dispute arbitration agreement [rule 166.5(b)(7)]; and (6) the requirement that a customer separately execute the pre-dispute arbitration agreement (or endorse the clause if it is part of an other agreement) [rule 166.5(c)(2)].[5]

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[3] The Commission is proposing to remove rule 180.3 in conjunction with its adoption of rule 166.5.

[4] Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated August 16, 2000, pp. 10-11.

[5] A "qualified eligible participant" or a "qualified contract participant" as defined in Commission rule 4.7 may execute or endorse the agreement in accordance with the provisions of Commission rule 1.55(d).

We acknowledge that customers whose claims are resolved in an arbitration forum may waive certain procedural benefits otherwise available under either section 14 of the Act, the reparations program, or section 22, private rights of action. However, we submit that the efficiency and expediency afforded under arbitration provides compensating benefits to customers. In addition, the more liberal evidentiary standards of arbitration proceedings and the greater flexibility accorded arbitrators in rendering decisions may well permit an award of damages to a customer when recovery would not be permitted under the more stringent standards of proof contained in section 14 and section 22 of the Act.

Moreover, we are aware of no empirical data that would support a conclusion that customers generally fare less well in arbitration. We further note that the Commission itself has found that the arbitration programs of the various self-regulatory organizations and the National Futures Association ("NFA") in particular, the forum in which most customer claims are heard, are fair and equitable as required under the Act. Yet, proposed rule 166.5, whose essential provisions remain unchanged since they were adopted as Commission rule 180.3 in 1976, only encourages and perpetuates the misperception that industry-sponsored arbitration forums may be unfair. For this reason alone, the rule should be substantially revised.

The prohibition on mandatory pre-dispute arbitration agreements is contrary to law. A far more important reason for amending proposed rule 166.5, however, is that its provisions fly in the face of the law and established federal policy. As the Commission is aware, the Federal Arbitration Act establishes a federal policy favoring arbitration. Specifically, the Arbitration Act provides that an arbitration agreement "shall be valid, irrevocable, and enforceable save upon such grounds as exist at law or in equity for the revocation of any contract."[6] The congressional policy in favor of arbitration was endorsed by the US Supreme Court in *Shearson/American Express, Inc. v. McMahon*. In that case, the Court, effectively rejected its 1953 decision in *Wilko v. Swan,* and held that an agreement to arbitrate claims under the Securities Exchange Act was enforceable "in accord with the explicit provisions of the Arbitration Act."[7] In adopting this position, the Court emphasized that the Securities and Exchange Commission's "expansive power to ensure the adequacy of the arbitration procedures employed by the [securities self-regulatory organizations]" lent additional support to its decision. We can conceive of no reason why the Court's analysis in *McMahon* supporting the use of pre-dispute arbitration agreements in the securities industry would not be equally applicable to agreements to arbitrate claims under the Commodity Exchange Act.

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[6] 9 USC §2.

[7] 482 US 220, 238. In *Wilko v. Swan*, the Court had refused to enforce a pre-dispute agreement to arbitrate claims under the Securities Act of 1933, finding that the effectiveness of the provisions of that Act "is lessened in arbitration as compared with judicial proceedings." 346 US 427, 435. In 1989, the Supreme Court formally reversed its opinion in *Wilko*. See, *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 US 477

Nothing in the Act supercedes the established federal policy favoring arbitration. Certainly, no provision of section 14 may be read to preserve a customer's right to proceed in reparations in the face of the customer's agreement to arbitrate claims. Moreover, section 22 of the Act may be read to endorse the use of pre-dispute arbitration agreements. Specifically, section 22(a)(2) provides in relevant part that, notwithstanding the private right of action afforded by section 22, "[n]othing in this subsection shall limit or abridge the rights of the parties to agree in advance of a dispute upon any forum for resolving claims under this section, *including arbitration*." [Emphasis supplied.]

FIA acknowledges that the provisions of former section 5a(11) of the Act, which provided that the use of exchange arbitration procedures by a customer "shall be voluntary," lent support to the underlying principle of Commission rule 180.3, prohibiting mandatory pre-dispute arbitration agreements.[8] However, as the Commission itself acknowledges in the *Federal Register* release accompanying the proposed rule, the CFMA repealed section 5a(11). In lieu of this provision, Congress adopted section 5(d)(13) of the Act, which provides that a designated contract market "shall establish and enforce rules regarding and provide facilities for alternative dispute resolution *as appropriate for market participants and any market intermediaries*. [Emphasis supplied.] The Act does not require that a customer's use of such dispute resolution facility be voluntary. Notwithstanding this express change in the law, the Commission, without explanation, has elected to retain the requirement that the execution of a pre-dispute arbitration agreement must be voluntary.

We respectfully submit that section 5(d)(13) vests with the exchanges on which transactions are executed the initial responsibility for developing rules governing dispute resolution procedures. The Commission obviously has the right to conclude that such procedures are inconsistent with the Act. However, the Commission no longer has the statutory authority to establish such detailed procedures at the outset.[9]

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[8] We would still disagree with the terms of the rule implementing this principle.

[9] For these same reasons, we would oppose the adoption of the guidance contained in proposed Appendix B to Part 38 of the rules, which provides that a contract market dispute resolution procedure should be voluntary. 66 *Fed.Reg.* at 14282.

The proposed rule is impracticable in the context of the increasing overlap between the commodities industry and the securities industry. As the Commission is aware, 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 Securities and Exchange Commission does not prohibit the use of mandatory pre-dispute arbitration agreements.[10] As FIA noted in its comment letter on the Commission's proposed new regulatory framework, this divergence in regulatory philosophy inhibits the ability of FCMs that are also broker-dealers to enter into a single agreement with their customers. 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 rules, FCMs that are also broker-dealers do not have this confidence.[11]

The difficulties in coordinating between securities regulations and commodities regulations FIA discussed in its August 16 letter have only been exacerbated by the amendments to the Act adopted in the CFMA. In particular, the applicability of the proposed rule 166.5 to claims involving transactions in security futures products is unclear. At the very least, it would appear that notice-registered FCMs would not be required to comply with the rule 166.5. However, we

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[10] Securities industry rules require that the following statement be set forth in bold print immediately before the pre-dispute arbitration provisions in the customer account agreement:

Arbitration. The following is a required disclosure for all brokerage agreements containing a pre-dispute arbitration provision:

(a) Arbitration is final and binding on the parties.

(b) The parties are waiving their right to seek remedies in court, including the right to jury trial.

(c) Pre-arbitration discovery is generally more limited than and different from court proceedings.

(d) The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of rulings by the arbitrators is strictly limited.

(e) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

A customer is not required to separately endorse the either the pre-dispute arbitration clause itself or the prescribed disclosure. However, a statement indicating the paragraph which contains the pre-dispute arbitration must immediately precede the signature line as follows:

This Agreement contains a Pre-dispute Arbitration Provision at paragraph __ on page __.

[11] Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated August 16, 2000, pp. 10-11.

believe an argument can also be made that full service broker-dealer/FCMs would not be required to comply with this rule in connection with claims relating to security futures products transactions either.

The Commission cannot allow this dichotomy between the securities and commodities industries' approach to arbitration to continue. 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. The Commission's rules should permit FCMs to use the securities disclosure in lieu of the Commission's statement. As indicated, we believe that such procedures should include appropriate disclosure to all customers.[12] For all of the above reasons, FIA respectfully recommends that the Commission remove Part 180, as the Commission has proposed, and decline to adopt proposed rule 166.5.

Other Comments

Foreign Currency Transactions. FIA supports the Commission's proposed rule 1.1, prohibiting fraud in connection with transactions in foreign currency subject to the Act. We believe the antifraud rule appropriately focuses on conduct over which Congress has vested the Commission with exclusive jurisdiction and with respect to which the Commission has not already adopted an antifraud rule. A rule of more general applicability would not appreciably enhance the Commission's ability to deter misconduct by persons subject to its jurisdiction, or the public's ability to recover damages as a result of such misconduct.

Trading Procedures. FIA generally supports the provisions of Appendix A to Part 37 of the proposed rules, which provides that a derivatives transaction execution facility that authorizes block trading should adopt rules that "ensure that block trading does not operate in a manner that compromises the integrity of the prices or price discovery on the relevant market." 66 *Fed.Reg.* at 14275. As the Commission may recall, in its comment letter on the Commission's regulatory reform proposal, FIA had expressed concern regarding the proposed requirement that a market's block trading rules should 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." 65 *Fed. Reg.* at 39006. The current guidance more accurately reflects the concerns that should guide a trading facility in developing block trading rules.

Commission Interpretations. Proposed rule 40.5 establishes the procedures that a registered entity must follow if it elects to submit rules to the Commission voluntarily. Rule 40.5(a)(1)(vi) provides that the entity should "identify any Commission regulation that the Commission may need to amend, or sections of the Act or Commission regulations that the Commission may need to interpret in order to approve or allow into effect the proposed rule." Rule 40.5(b) provides a

[12] In making this recommendation, FIA wishes to emphasize that we have no reason to expect every FCM to include a pre-dispute arbitration provision in its form customer account agreement. To the contrary, certain of our member firms have indicated that they have no plans in this regard.

45-day review period. We request the Commission confirm that in appropriate circumstances, the Commission will use this 45-day period to solicit public comment on any such interpretation.[13]

Relief for Intermediaries. FIA welcomes the Commission's statement that it will soon republish for comment that portion of the Commission's regulatory reform proposal that provided certain regulatory relief for intermediaries. We also are sensitive to President Bush's directive that, except as the Director of the Office of Management and Budget may allow, federal agencies should not propose or adopt new regulations until and agency head appointed by the President reviews and approves the action. In the interim, we respectfully request the Commission to consider whether, in light of the President's directive, the Commission could adopt a no-action position for the benefit of intermediaries that elect conduct their activities in accordance with certain amendments to Part 1 and Part 3 of the Commission's regulations promulgated on December 13, 2000. These amendments (1) expand the list of disclosures and consents that could be provided in a single document acknowledged with a single signature under rule 1.55(d); (2) amend the definition of the term "principal" found in rule 3.1, and (3) delete the specific ethics training requirements currently contained in rule 3.34 and adopt in their place a Statement of Acceptable Practices with Respect to Ethics Training. As the Commission is aware, these amendments received wide support when they were published for comment.

Conclusion

FIA appreciates the opportunity to submit these comments on the Commission's proposed regulatory framework for trading facilities. 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

cc: Honorable James E. Newsome
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable Thomas J. Erickson

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[13] Proposed rule 40.5(a)(1)(vi), therefore, does not implement the provisions of section 5c(a) of the Act, which authorizes the Commission to "issue interpretations, or approve interpretations submitted to the Commission, of sections 5(d), 5a(d) and 5b(c)(2) [describing the core principles with which registered entities must comply] to describe what would constitute an acceptable business practice under such sections." Nonetheless, FIA requests the Commission to take this opportunity to reaffirm its position that, "when issuing interpretative guidance having industry-wide application, the Commission will follow the notice and public comment procedures of the Administrative Procedure Act, as appropriate." 65 *Fed.Reg.* at 77973.