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STATEMENT OF JOHN M. DAMGARD
PRESIDENT
FUTURES INDUSTRY ASSOCIATION

HEARING ON
COMMODITY FUTURES TRADING COMMISSION
RULES RELATING TO INTERMEDARIES

JUNE 6, 2002

Mr. Chairman, members of the Commission, on behalf of the Futures Industry Association, it is a pleasure for me to be here today to discuss our recommendations for reform of the Commission's regulations governing intermediaries. My statement this morning is intended to supplement the views and recommendations contained in our detailed comment letter filed with the Commission on April 5. The recommendations contained in that letter are important to our membership and I commend that letter to you.

I last had the privilege of appearing before the Commission nearly two years ago, on June 28, 2000, to address the Commission's proposed New Regulatory Framework. FIA strongly supported the Commission's regulatory reform proposals then, as well as the enactment of the in the Commodity Futures Modernization Act of 2000 ("CFMA") later that year. Our endorsement of these reform proposals was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established insurmountable barriers to entry, would be the best regulator.

The proposed deregulation of the markets promised to facilitate the development of new exchanges and clearing organizations that would vie for business by offering more efficient, cost effective markets. To counter this competition, existing markets and clearing organizations, in turn, would be required to forsake

their parochialism and focus more strongly on the needs of FCMs and the customers that they serve.

Since the enactment of the CFMA, the US futures exchanges have launched a number of new products, at times in direct competition with each other. Unfortunately, we cannot say the same for existing products. With the exception of BrokerTec, we have seen remarkably little competition at either the exchange or clearing organization level. The regulatory barriers to entry may have been removed, but the vigorous rivalry that we had hoped for has not broken out. As a consequence, we have seen far less progress than we had anticipated in the evolution of exchanges. For example, the boards of directors of the major exchanges remain dominated by representatives of the floor community. As a result, the transition from floor to screen has been halted at the halfway point, requiring FCMs to carry the financial burden of maintaining two trading systems on each exchange.

It may be too soon to state with certainty why competition has failed to develop. However, having spent the greater part of the last year analyzing and commenting on the proposed rules relating to security futures products, we have identified certain characteristics of the securities markets that we believe help enable competition. Two stand out.

The first is fungibility of products across markets. It is no secret that liquidity is essential to the success of any futures contract. Market participants want to know that, once they enter into a contract, it can be offset easily and at an efficient cost. A market participant would be understandably hesitant to enter into a contract on a new exchange, therefore, without some expectation that the contract could be

offset without difficulty. Fungibility across markets would provide such assurance.

The second characteristic is common clearing. The industry has long recognized the benefits of common clearing in reducing the costs to FCMs and their customers, allowing FCMs and customers alike to make more efficient use of their risk management capital and, no less important, allowing FCMs to better monitor and manage the risks their customers are assuming across markets. Common clearing, therefore, protects customers and serves the public interest by enhancing the financial integrity of the markets. As you know, achieving this goal has been elusive. Although we have come close several times in Chicago over the years, the self interests of the exchanges have always surfaced to quash a final agreement.

The structure of clearing is still the primary concern of FIA member firms. Our members strongly believe that governance of clearing organizations should be independent of the exchanges whose contracts they clear and should be vested in the clearing organizations' members and shareholders in proportion to the risk that they are assuming.

The importance of fungibility and common clearing in the development of truly competitive markets is evidenced by the dramatic changes that have taken place in the equity options markets over the past several years. With the prodding of the SEC, the exchanges finally introduced multiple listings, with all trades cleared through The Options Clearing Corporation. The forces of competition were immediately heightened. In less than two years, the International Securities Exchange, an all-electronic options exchange has become the third largest options exchange in the US, and it continues to gain market share.

It is against this backdrop that relief for intermediaries should be considered.

Intermediary Relief

As you know, FIA was a driving force behind the provisions of the CFMA requiring the Commission to conduct this study of the Act and its rules as they relate to intermediaries. Our motive for requesting this study was simple. As the Commission itself 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, FIA was concerned that the Commission's decision to retain prescriptive regulations for intermediaries would result in shifting an even greater share of the regulatory burden and its attendant costs to intermediaries. Our point is that the myriad rules that govern intermediaries must be reduced to those that are essential to customer protection and financial and market integrity, and must be written in such a manner as to afford intermediaries the flexibility to respond to changing market dynamics. A more flexible regulatory structure, combined with an effective self-regulatory organization audit program should achieve the Commission's regulatory purpose.

In the time remaining, I would like to highlight a few of the more critical recommendations discussed in our April 5 letter. These in particular, warrant the Commission's immediate attention.

Allocation of Bunched Orders

Reform of the Commission's rules with respect to the allocation of bunched orders is essential. FCMs generally have found that existing post-execution allocation procedures, which limit the type of clients that may take advantage of the procedures—essentially eligible swap participants—and impose additional recordkeeping requirements, are unnecessarily cumbersome. As such, they inhibit the fair and efficient execution of orders, without adding customer protections.

Account managers have also objected to the requirement that they make the disclosures set forth in the rule. As otherwise regulated entities, they believe that the laws and regulations to which they are subject adequately govern their disclosure and other fiduciary obligations to their clients. Their conduct should not be subject to indirect regulation by the Commission through the imposition of recordkeeping requirements on the FCMs that carry the accounts of their clients. We agree.

We encourage the Commission, therefore, to acknowledge that the responsibility for allocation of bunched orders rests with the account manager, the originator of the allocation methodology. The account manager, not the FCM, is the person who knows and must keep records detailing the totality of each of its customers' positions, which may be held at several FCMs. The increased use of electronic order routing and execution systems, which permit account managers to place orders directly for execution, while denying FCMs the ability to monitor such transactions prior to execution and clearing, emphasizes this point and makes relief in this area all the more urgent.

To effect this change, FIA recommends that the Commission replace its audit trail rules with a core principle that would require FCMs and introducing brokers to such records of transactions as are appropriate to their respective businesses or as may be required by exchange or other self-regulatory organization rule or regulation. This principle would be consistent with the core principle applicable to recognized futures exchanges.

Single Customer Account

Commission rules generally prohibit an FCM from depositing in the customer segregated account cash and other property of such customers that the FCM holds to margin or secure OTC derivatives, equity securities or cash market positions. This prohibition interferes with the efficient use of customer capital in managing the risks associated with trading. FIA believes that the Commission should modify these rules both to permit non-futures position margin and other property to be held in the customer segregated account and to permit futures margin and other property on behalf of eligible contract participants to be held outside of a segregated account.

We appreciate that the Commission has taken some steps in this direction. For example, the Commission and the 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. More recently, the Commission issued an order authorizing the NYMEX Clearing House and FCMs clearing through the Clearing House to hold in the customer segregated account funds used to margin, guarantee or secure transactions in designated OTC transactions cleared by the Clearing House. The Commission also has adopted rules permitting qualified customers trading on derivatives transaction facilities to hold their funds in an account outside of segregation.

Expanding the circumstances in which customers could elect either 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. We further recognize that 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. FIA will be pleased to work with the Commission as it sorts through these issues.

Foreign Security Futures Products

As you know, ours is an international business. FIA's members serve both US and international customers, all of which trade on markets worldwide. As the Commission and the SEC moved forward on an agreement to permit the trading of security futures products, therefore, we were concerned that our customers would continue to have the ability to trade on those markets that offered the products they needed, wherever the markets were located. As a consequence, we worked closely with the commissions and Congress to include provisions designed to ensure that customers would be able to trade security futures products listed on non-US exchanges.

We are pleased that the Commission and the SEC have taken an important step in this regard by issuing a joint order permanently grandfathering those broad-based security index futures contracts that were approved for offer and sale to US customers prior to the enactment of the CFMA. This action provides much-needed legal certainty.

Action on other provisions of the Act remains. By letter dated July 18, 2001, FIA encouraged the Commission and the SEC to exercise the rulemaking authority that Congress granted specifically to address foreign security index contracts and adopt a regulatory standard defining a broad-based security index that takes into appropriate account "the nature and size of the markets that the securities underlying the security futures product reflects." The standard recommended by FIA was set forth in Appendix A to that letter. FIA again urges the Commission to adopt its proposal.

FIA further encourages the Commission to continue to work with the SEC to implement the provisions of section 2(a). One subparagraph of this section is intended to extend the terms of a no-action position adopted by the Commission, after consultation with the SEC, which authorizes US FCMs to carry on behalf of non-US customers foreign stock index contracts that have not been approved for trading by US customers. This subparagraph grants this same right to FCMs carrying foreign security futures products on behalf of their non-US customers. FIA has discussed this matter with the SEC, but to date has been unsuccessful.

Another subparagraph simply provides that eligible contract participants may purchase security futures products traded on a non-US exchange to the same extent that such person may be authorized to purchase or carry other securities traded on a foreign exchange or market. The purpose of this subparagraph is to authorize US institutional customers, which are authorized to buy and sell cash securities on foreign markets, to hedge these transactions through the use of security futures products. These provisions of the Act were adopted after substantial discussion with Commission and SEC staff. There is no reason why

the Commission should not confirm the right of US FCMs to take advantage of them.

Financial and Segregation Interpretation No. 12

As the Commission is aware, FIA, along with other industry representatives, has long opposed certain provisions of Financial and Segregation Interpretation No. 12 governing the deposit of customer funds outside of the US. In particular, FIA has objected to the requirements that (1) an FCM obtain specific written authorization from a customer to maintain funds offshore in that customer's segregated account and (2) before placing a customer's funds overseas (or holding a foreign customer's funds overseas) an FCM obtain from the customer a signed subordination agreement in the form set forth in the interpretation. FIA strongly believes that the subordination agreement is unnecessary and should be eliminated. In its place, the Commission should amend Appendix B of the Commission's Part 190 rules to establish distribution procedures for FCMs that hold customer funds offshore.

FIA has worked with the Commission's staff in the past to revise the interpretation to address these and other concerns. Whenever it appears that we have made progress, another issue arises and steps taken to revise the interpretation are set aside. We respectfully request the Commission to proceed promptly to address this issue. In light of the amount of effort both sides have expended to date, we are confident that we will be able to craft an acceptable alternative to the current interpretation with little difficulty.

Use of Non-US Exchange Terminals

In a series of no-action letters issued in 1999, the Commission's Division of Trading and Markets authorized certain foreign futures exchanges to locate terminals for the execution of transactions on those exchanges in the US. Each no-action letter was subject to a number of conditions, including a requirement that specifically identified the contracts that could be executed through those terminals. The purpose of this restriction was to assure that US FCMs did not engage in transactions in futures contracts that had not been approved for trading by or on behalf of US customers, *i.e.*, futures on certain security index contracts.

Although FIA appreciates the rationale behind this restriction, it fails to take account of the fact that, in a twenty-four hour trading environment, these terminals could be used to transmit orders for non-US customers of either the US FCM or the FCM's non-US affiliates. Non-US customers are not prohibited from trading in these products.

Standardization

FIA has been very active in promoting standardization in several areas including standardization of practices and procedures, and technology protocols. The Commission's Technology Advisory Committee is currently considering a report, which includes recommendations of concern to intermediaries. "Recommendations for Standardization of Protocol and Content of Order Flow" generally creates a framework, which the industry can utilize as a base in moving forward over the next several years; however, we believe the recommendations go beyond the mandate of the Commission or a self-regulatory organization.

From a short-term perspective, industry adoption of a standard protocol by a specific date will impose significant transition costs while not providing an immediate benefit. The mandated timeframe comes during a period when the industry is already under significant financial challenges due to the surge in technology infrastructure required for an FCM to compete in these markets, implementation of security futures, implementation of more sophisticated disaster recovery and business continuity procedures in the wake of September 11, and competitive pressures to consolidate and reduce costs. Some participants questioned whether "voluntary implementation" could be truly voluntary if the Commission supports and advocates standards as a best practice.

FIA strongly urges the Commission to endorse standardization without adopting it as a best practice and to stop short of calling for standardization by a specific date.

Conclusion

FIA appreciates the opportunity to appear before you today. We welcome the Commission's study as an essential step in a process that will afford market intermediaries the same flexibility that the CFMA and the Commission have provided to the markets themselves. We have been patient as the Commission has focused its energies on the organized markets. We encourage the Commission to move forward quickly.