

COMMENT

Intermarket Surveillance Group

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OFFICE OF THE SECRETARIAT

September 6, 2001

Ms. Jean Webb, Secretary
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

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Re: "Listing Standards and Conditions for Security Futures"

Dear Ms. Webb:

The Intermarket Surveillance Group ("ISG") is pleased to have the opportunity to comment on the July 12, 2001 release of the Commodity Futures Trading Commission ("Commission") proposing listing standards and conditions for the trading of security futures products. This comment letter is limited to just one aspect of the proposed rules, the provision contained in Proposed Rule 41.22 that would mandate full ISG membership for all boards of trade that trade security futures products. We strongly support the goal of coordinated surveillance set forth in the Commodity Futures Modernization Act ("CFMA") that is the basis for the proposed rule. ISG stands ready to serve an active role in facilitating that surveillance coordination. However, we believe that a proposal to make mandatory ISG membership for boards of trade that trade security futures products goes beyond the requirements of the CFMA, exceeds the Commission's statutory authority, and is potentially anti-competitive.

The ISG was created in 1983 by the major U.S. securities exchanges and the NASD, to address a perceived growing need to share regulatory information related to the conduct of effective market surveillance. The exchanges and NASD felt that an organized framework was necessary to coordinate surveillance of trading activity in securities that occurred in multiple markets, and to coordinate surveillance of trading in the securities and their overlying options. In 1989, at the direction of the Commission and the Securities and Exchange Commission ("SEC"), the ISG expanded to include U.S. boards of trade that traded futures on stock indices. At the same time, the ISG admitted non-U.S. securities markets that traded securities that were also traded by the U.S. securities markets. To accommodate the addition of these futures markets and non-U.S. securities markets, an affiliate category of ISG membership was created. Currently, there are ten "core" members of the ISG, and more than a dozen affiliate members, including major U.S. futures exchanges and securities markets from around the globe.

Initially, the ISG core members limited their surveillance sharing to certain specified types of regulatory information. When the affiliate category was created, there were no limitations on the types of information that could be shared between affiliate and core members. In 1993, the affiliates agreed to share information among themselves on the same basis as they shared information with the core members. In 1994, the core members amended the ISG Agreement to permit information sharing among themselves on an “as needed” basis, eliminating the limitation on the types of information that could be shared pursuant to the original 1983 agreement. Thus, at this time, the only limitation on information sharing among and between any ISG participants, core members or affiliates, is that the information be requested and used for regulatory purposes.

In effect, the ISG is an information-sharing cooperative governed by a written agreement, formed to facilitate certain regulatory responsibilities of its members in connection with market surveillance. The ISG is essentially a committee of self-regulators. No exchange has ceded any rights or responsibilities to the ISG with respect to the sharing of information or surveillance obligations. The ISG itself is not subject to regulatory oversight, separate or apart from the participating markets. It is not required to file rule proposals with the Commission, the SEC or any other regulator. Nor does it seek or obtain approval from any regulator when it considers requests by securities or futures markets for admission to membership in ISG.

Notwithstanding this, the ISG has cooperated closely with the Commission and the SEC. In fact, representatives of both agencies typically attend meetings of the ISG. The ISG is proud of the close and effective cooperation that has been achieved among its members throughout its lifetime, as well as the working relationship it has developed with the relevant government regulators.

We are concerned, however, about the provisions of proposed Rule 41.22 that would require that all boards of trade that trade security futures products be full members of ISG. The plain language and intent of the CFMA requires that there be surveillance cooperation among the boards of trade that trade security futures products. The statute does not specify the mechanism by which that surveillance coordination be undertaken. Nor does the CFMA require that surveillance coordination arrangements be in place between the boards of trade that trade security futures products and the securities exchanges or associations where the underlying securities or related options or other derivatives are traded. Thus, nowhere does the CFMA mandate that boards of trade become members of the ISG. And it certainly doesn't specify the category of membership such boards of trade must hold in order to participate in ISG. By proposing to require that boards of trade that trade security futures products be full members of ISG, the proposed rule seeks to indirectly regulate an entity—the ISG—over which the Commission has no regulatory authority. Commission rulemaking is clearly not the forum to transform the ISG into a mandatory membership organization or to otherwise interfere with the form of association or governance adopted by the ISG. As a matter of law, the proposed rule is unsupportable.

Just as significant, it is totally unnecessary. As noted above, we strongly support using ISG and its mechanisms to ensure coordinated surveillance between the markets that trade security futures products and those markets that trade the underlying securities or related options or derivatives. And we fully expect that, should the Commission not adopt proposed Rule 41.22 with this requirement, the surveillance cooperation it seeks would occur through the ISG, just as it has in the past between the various securities and futures markets where stocks, options, stock index futures, and foreign currency futures and options are traded. Current information sharing activities have been unimpeded by the distinction drawn between core membership for the participating securities markets and affiliate membership for participating futures and non-U.S. securities markets. We would not expect any different result with respect to participation by boards of trade that trade security futures products.

We are also concerned that the proposed rule, possibly unintentionally, because of its ISG membership requirement would effectively allow any existing ISG participant to veto trading in security futures products by any interested board of trade. Under ISG by-laws, a unanimous affirmative vote of all current full members of the ISG is required to approve the application of any marketplace to become either a full or affiliate member of the ISG. Thus, as proposed Rule 41.22 is currently drafted, any current full member of ISG could block any board of trade from trading security futures products by voting against its admission into ISG.

The ISG's consensus process in evaluating new membership applicants historically has functioned quite effectively. It has not worked to the prejudice of the futures markets that are affiliate members. Indeed, the current chairperson of the ISG Membership Sub-Group is from one of the affiliated futures markets. At the same time, denial of membership in the ISG has never in the past carried the regulatory consequences that would arise from the proposed rule. The ISG takes very seriously its responsibility to screen applications for membership into the ISG. But we believe it would be inappropriate for the Commission essentially to delegate to the ISG the Commission's authority and responsibility on the issue of the adequacy of surveillance cooperation arrangements of a particular board of trade.

In conclusion, we welcome the opportunity to work with the Commission, the SEC and others regarding the role that the ISG can play in fostering effective surveillance coordination with respect to trading activity in security futures products, the underlying securities and related options and derivatives. We strongly oppose, however, the mandatory ISG membership provision in proposed Rule 41.22.

Sincerely,

Ken Meaden (ack)

Ken Meaden
Chairman,
Intermarket Surveillance Group

cc: Richard A. Shilts, Acting Director, Division of Economic Analysis, CFTC
Thomas M. Leahy, Jr., Division of Economic Analysis, CFTC
Gabrielle A. Sudik, Office of the General Counsel, CFTC
Mary Ann Gadziala, Office of Compliance Inspections and Examinations, SEC
Richard Chase, American Stock Exchange
Brian Colby, Boston Stock Exchange
Mary Bender, Chicago Board Options Exchange
Al Bretzer, Chicago Stock Exchange
Jeff Brown, Cincinnati Stock Exchange
Jim Sampson, International Securities Exchange
Steve Luparello, National Association of Securities Dealers Regulation, Inc.
Regina C. Mysliwiec, New York Stock Exchange
David Rosedahl, The Pacific Exchange