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May 26, 2004

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RECORDS SECTION

Ms. Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

COMMENT

Re: **Futures Market Self-Regulation; 69 Federal Register 19166  
and 69 Federal Register 22599**

Dear Ms. Webb:

The Board of Trade of the City of Chicago, Inc., Board of Trade of Kansas City, Chicago Mercantile Exchange Inc., Commodity Exchange, Inc., Minneapolis Grain Exchange, New York Board of Trade, New York Mercantile Exchange, Inc., and Philadelphia Board of Trade (collectively, "the Exchanges") welcome the opportunity to respond to the Commodity Futures Trading Commission's ("CFTC" or the "Commission") request for comment on "Futures Market Self-Regulation," as published in the *Federal Register* of April 12, 2004, and corrected in the *Federal Register* of April 26, 2004. The importance of an effective financial surveillance system to assist in the early detection of concerns, both financial and operational, cannot be emphasized enough and is well recognized in the futures industry. As members of the Joint Audit Committee ("JAC"), the Exchanges have played a critical role throughout the years in the management of various industry financial crises, including the collapses of Stotler and Company, Griffin Trading Company and Klein & Co. Futures, Inc., to ensure the protection of affected customers. The Exchanges are very proud of our coordinated information sharing from our surveillance activities, particularly during times of market stress, and the role we have played in improving the regulatory framework for our FCM community.

In February 2004, the CFTC's Division of Clearing and Intermediary Oversight ("DCIO") announced plans to review the Designated Self-Regulatory Organization ("DSRO") system as part of its ongoing review of self-regulation in the futures industry in order to "ensure that DSROs continue to meet the needs of the markets and their participants." Accordingly, a formal review of the JAC and the effectiveness of its examination and information sharing programs is underway.

The JAC was formed in 1984 through an agreement executed by the National Futures Association ("NFA") and the futures exchanges in the United States as a means for avoiding duplicative oversight responsibilities and promoting information sharing on common member firms. Amendments to the 1984 agreement have recently been approved by the JAC to update the current signatories to the agreement as well as to codify practices that have been followed for the past two decades. While representatives from each JAC member formally meet several times a year to discuss concerns with common member firms as well as industry developments, committee members have informal discussions on an on-going basis.

The CFTC has asked for comment in eight general areas. We have responded to each of the eight areas in the order that they appear in the CFTC's request for comment.

1. Membership Criteria:

Response: All futures exchanges in the United States are members of the JAC which allows for comprehensive and effective surveillance and information sharing programs to be conducted with respect to common member firms. No exchange has ever been denied membership. To the extent that any futures exchange seeks membership into the JAC, the JAC would welcome any such exchange.

2. Decision Making Processes and Voting Eligibility:

Response: All members of the JAC participate in frequent and open discussions regarding committee issues and are invited to share their opinions, ideas and concerns. Historically, very few issues have arisen during meetings which have required a formal vote.

Originally, all of the signatories had voting rights in the JAC. In the amended agreement, all of the original parties that signed the 1984 agreement which are still in existence have had their voting rights grandfathered into the new agreement. In addition, any new exchange that has joined after the year 2000 (the first year that a new exchange joined) will have voting rights if it performs a regulatory financial auditing function. Because very few exchanges perform these functions, it would be inherently unfair to allow such non-auditing exchanges to dictate to the auditing exchanges the amount of work and resources which should be expended during a regulatory audit. The auditing exchanges are more aware of the complex financial and regulatory issues facing their member firms and the resources required to resolve those issues.

3. DSRO Assignments:

Response: The process by which futures commission merchants ("FCMs") are assigned to DSROs is straightforward: Any FCM which is not a member of an exchange has the NFA as its DSRO. When an FCM joins an exchange which conducts its own auditing function, that exchange has the right to accept DSRO responsibility for the firm. While all of the JAC DSROs conduct similar audits, the complexity and focus of those audits is not necessarily the same. For the complex audits conducted by the exchanges, the focus is on protecting the financial integrity of, and assessing the risks presented to, our clearing houses. Ultimately, this ensures that customers are also protected. The information obtained and relationships nurtured during our examinations are an integral part of our risk management processes. If an FCM joins more than one exchange, usually the first exchange that the FCM joins will become the DSRO. However, the exchanges frequently coordinate DSRO assignments based on, for example, amount of exposure to the clearing houses, resource allocations and geography.

In addition, regardless of DSRO allocation, other self-regulatory organizations ("SRO") are always entitled to conduct their own reviews at a member firm if they deem it necessary. It should be noted that an exchange will likely conduct its own review of a member firm unless the DSRO is another exchange which could be expected to have similar concerns regarding protection of its clearing house. Therefore, unless exchanges are DSROs for mutual exchange member firms, there could potentially be

significant duplicative auditing, which would burden FCMs in exactly the manner that the CFTC sought to avoid by encouraging the development of a DSRO plan.

4. Delegation versus Outsourcing of Examination Services:

Response: The JAC agreement provides a mechanism for the SRO parties to "delegate" their responsibilities to conduct financial examinations of mutual member firms to appropriate DSROs. At the time when the JAC was constituted in 1984, all of the SRO parties performed auditing functions. Over the ensuing years, certain of the original JAC member exchanges ceased performing any of their own audits, and instead, "outsourced" their responsibilities to conduct financial examinations with respect to all of their FCM member firms to the NFA. As a result of the Commodity Futures Modernization Act of 2000, a number of new exchanges have emerged and joined the JAC. Because these new exchanges generally have outsourced not only their auditing responsibilities, but also their responsibilities for trade practice and market surveillance, they have entered into comprehensive outsourcing agreements with other exchanges, the NASD, or most commonly, the NFA.

The amended JAC agreement continues to apply the same principles for the assignment of DSRO responsibilities that have worked well for two decades, whether the SROs conduct their own audits, or whether they have outsourced their examination functions, in order to ensure that audits are shared equitably and performed in a manner that will effectively protect customers and the exchanges' clearing houses.

As noted above, when an FCM joins an exchange, that exchange has the right, via the JAC agreement, to accept DSRO responsibilities. The JAC contract also permits the exchanges to subcontract their DSRO responsibilities to another party while retaining ultimate responsibility for the function. However, a DSRO may not subcontract its responsibilities to an entity that is not a party to the JAC agreement, unless it has obtained the written consent of all SROs of which the FCM is a member.

5. Distinctions Between RFAs and Non-RFAs:

Response: The NFA is the only registered futures association that is a party to the JAC agreement. As the Commission notes, all FCMs are required to be members of the NFA. Generally, exchanges are DSROs for those FCMs that are members of exchanges and NFA is the DSRO for those FCMs that are not exchange members. NFA could also potentially be the DSRO if there were an FCM that was a member of an exchange that had outsourced its auditing function to NFA, where the FCM was not also a member of any exchange that conducts an auditing function. As discussed above, if an FCM for which the NFA is the DSRO subsequently joins an exchange which conducts its own audits, that exchange has the right of first refusal to become the DSRO in order to protect its clearing house.

6. DSRO versus SRO Responsibilities:

Response: As required by CFTC Financial and Segregation Interpretation 4-1, every SRO has the responsibility to monitor its own member firms. Such responsibilities include assessing an FCM's risk management policies and procedures, reviewing daily payments to and from the clearing organization for unusual trading patterns, stress

testing member firms' positions, etc. While the regulatory auditing and review of routine financial statements can be performed by the DSRO with the information shared with other SROs, this does not excuse an SRO from ensuring its exposure to its member firms is adequately monitored. Indeed, the DSRO does not have the information needed to conduct comprehensive risk monitoring on a day-to-day basis for other SROs because it does not have the relevant position information. These daily procedures cannot wait for a formal audit and must remain the responsibility of the particular SRO.

7. Review of the JAC's Governance:

Response: The JAC generally meets three times per year with CFTC staff participation at every meeting. While the JAC welcomes the CFTC staff's review of our operation, we note that, because CFTC staff has participated in the JAC's meetings, the staff is well aware of the issues discussed during our meetings, the determinations that the JAC makes and the initiatives that the JAC promotes.

8. General Transparency of DSRO System:

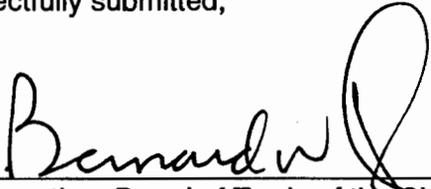
Response: The DSRO program is fully transparent. Indeed, as the CFTC notes in Footnote 20 of the request for comment, the JAC submits its examination programs to the CFTC's DCIO every year for review. Of course, because the programs are considered the proprietary information of the JAC, they are not available for public distribution to other third parties, including non-CFTC regulators and FCMs. The JAC believes that such confidentiality is necessary and appropriate to ensure the integrity of the auditing process. We note that the CFTC has recently distributed the updated draft of the JAC contract via its web site; therefore, we believe that the JAC's operation is transparent to all interested parties.

Over the past two decades, the Exchanges have fostered a spirit of cooperation among themselves in sharing information obtained during their regulatory oversight programs. The primary auditing exchanges are in weekly, if not daily, contact regarding issues of industry interest. The Exchanges have always been proactive with respect to difficult issues that have arisen from financial situations involving member firms that affect contract markets and clearing organizations. In addition, we have been instrumental in reviewing and contributing to the development of CFTC regulations and policies to ensure they address the business concerns of FCMs, while preserving customer protections, such as adopting risk based capital requirements, allowing risk based examinations to focus on areas representing the greatest risk exposure and promoting amendments to Regulation 1.25 governing appropriate investments of customer funds. We are especially proud of this role we have played in communicating industry interests.

The DSRO system has worked phenomenally well in avoiding duplicative auditing efforts and we are proud of our efforts to serve the industry and the public interest. We appreciate the opportunity to comment on the futures industry self-regulatory program and applaud the CFTC for its efforts to showcase the successes that we have achieved.

Ms. Jean A. Webb  
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Respectfully submitted,



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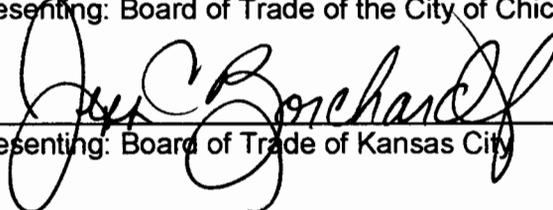
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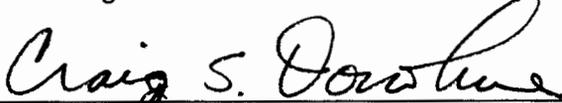
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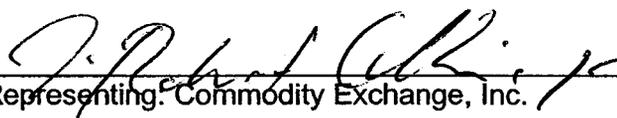
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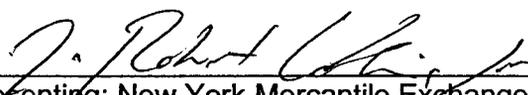
  
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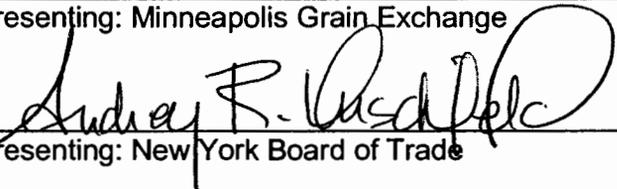
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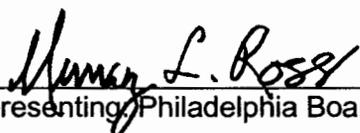
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