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FIA

04-5
(9)

September 30, 2004

COMMENT

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

Re: The Governance of Self Regulatory Organizations
69 *Fed.Reg.* 32326 (June 9, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA")[1] is pleased to respond to the Commodity Futures Trading Commission's ("Commission") request for comments concerning the governance of self-regulatory organizations ("SROs"), 69 *Fed.Reg.* 32326 (June 9, 2004).[2] This letter expands upon the matters that FIA discussed in the position paper that we forwarded to the Commission on June 8, 2004 ("Position Paper"),[3] a copy of which is enclosed as Exhibit A. Recent developments in the futures markets, such as the demutualization of SROs, competition among organized exchanges and the move to for-profit structures, as well as the development of competing dealer markets for over-the-counter derivatives products, warrant the Commission's careful reexamination of SRO governance. The *Federal Register* release reflects careful thought about all aspects of the efficacy of self-regulation in the futures industry.[4]

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1 FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCM") in the United States. Among our approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including US and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 80 percent of all customer transactions executed on US contract markets.

2 69 *Fed. Reg.* 32326 (June 9, 2004) ("Release"). The Commission extended the comment period to Sept. 30, 2004. 69 FR 42971 (July 19, 2004).

3 Letter to Honorable James Newsome, Chairman, Commodity Futures Trading Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004.

4 FIA has had a long-standing interest in SRO governance issues and, in addition to the Position Paper, has submitted several previous comment letters to the Commission on various SRO governance matters. *See, e.g.,* Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004 (Futures Market Self-Regulation); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated July 14, 2003 (Chicago Board of Trade and Chicago Mercantile Exchange Rules); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated August 16, 2000 (A New Regulatory

Introduction

FIA believes that self-regulation, combined with effective oversight by the Commission, is in the public's best interest — by ensuring the most meaningful and effective protections at the lowest cost. Input from the industry can improve the likelihood that SRO rules will achieve their intended goals. Similarly, input from industry participants can help disciplinary panels evaluate questionable behavior with the benefit of knowledge and experience.

However, FIA is concerned that, in light of the recent developments described above, long-standing conflicts of interest existing in the current SRO structure could lead to problems that might jeopardize public confidence in the fairness of our markets.[5] For example, under the current structure, it is possible that SROs could use their regulatory authority for anti-competitive purposes or to adopt rules that benefit parochial interests at the expense of the public interest. We also believe that the Commission should more extensively evaluate certain rulemaking and regulatory processes at the SROs, and can do so without moving to a prescriptive regulatory environment.

We respectfully suggest that the Commission should take measured actions to strengthen its own oversight functions and to enhance the independence and integrity of the self-regulatory structures within SROs. By so doing, the Commission may prevent problems in the future. FIA believes that these suggestions, although significant, may be viewed as evolutionary reforms to the current system.

Recommendations

In order to minimize the potential for abuse arising from actual and perceived conflicts of interest,[6] FIA recommends that the following four goals inform the SRO governance initiative:

Framework for Multilateral Transaction Execution Facilities, Intermediaries, and Clearing Organizations; Exemption for Bilateral Transactions); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated October 9, 1999 (Petition for Exemption Pursuant to Section 4(c) of the Commodity Exchange Act).

[5] In our comments on the proposed amendments to the Joint Audit Agreement, we noted that "the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement." Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004, p. 3. A copy of this letter is enclosed at Exhibit B. As there, our comments in this letter are designed to reduce the conflicts of interest that are inherent in any self-regulatory structure.

[6] Section 5(d)(15) of the Commodity Exchange Act ("CEA") as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), requires that a board of trade "establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest." *See also* the Release at Question 14.

- Require board-level independence of SRO oversight accountable directly to the Commission;
- Accentuate the separation of an SRO's business and regulatory functions;
- Increase both the transparency of the regulatory process and industry participation in the regulatory process; and
- Better assure the confidentiality of members' proprietary information to prevent improper use.

We believe that the Commission should use its existing authority under the Commodity Exchange Act ("Act"), and in particular, its authority to ensure compliance with the core principles of Section 5(d) of the Act, to achieve these goals.[7] We also believe that these goals are in the long-term best interests of the SROs. We address each of these goals in greater detail below.

1. Independence of Regulatory Functions

FIA has previously observed that "there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses."[8] The most effective means for strengthening the independence of the regulatory functions is by focusing on SRO governance. In order to strengthen the independence of regulatory functions, the independence of SRO board members, *vis-à-vis* the current composition of SRO boards, should be strengthened.

In the Position Paper, FIA outlines a critical reform necessary to address our concerns about conflicts of interest. Specifically, a "Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities."[9] This reform, along with others outlined in this letter, should minimize the risk that an SRO could use its regulatory authority for inappropriate purposes, or fail to use it in necessary circumstances.

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[7] *See also* Sections 5(d)(1), 5c(d), and 8a of the Act, as well as §1.64, Appendix B to Part 38, §38.5§, and 40.6. Section 5c(a)(1) provides that "the Commission may issue interpretations or approve interpretations submitted to the Commission, of section 5(d) [exempt boards of trade], 5a(d) [core principles for registered derivative transaction execution facility] and 5b(d)(2) (*sic*)[correct statutory reference is section 5b(c)(2)) derivatives clearing organizations] of this title to describe what would constitute an acceptable business practice under such sections." This letter is devoted primarily to governance of SROs that are designated contract markets ("DCMs"). However, in light of these provisions of the Act, FIA believes that its observations should apply with equal force to SROs other than contract markets to the extent that the same issues arise with respect to those SROs.

[8] Position Paper at I.

[9] Position Paper at I.

FIA continues to have concerns about some definitions of "independent director." As FIA observed in the Position Paper, it is not convinced that current exchange and others' definitions of "independent" are adequate to achieve these objectives. Some current standards define "independence" merely as not having a relationship with the SRO as an entity. At a minimum, FIA believes that independent directors should not be currently active in the industry or too recently associated with an SRO member

In addition, the independent board committee should have direct and unfettered access to information to ensure that it is making fully informed decisions. Further, it should have the ability to retain independent outside counsel in appropriate circumstances. Finally, FIA believes that the nomination process for independent directors of SROs should be free of management or member influence. Accordingly the nominating committee for the independent SRO board supervisory committee should be comprised only of independent individuals who meet the requisite independence test for directors.

FIA believes that, consistent with Core Principles 14-16[10], the Commission should use its authority to require SROs to implement the reforms outlined above and to ensure continued compliance. These changes would ensure greater independence of the board generally and the key committee described above to screen out inappropriate appearances of bias or conflicts. As a consequence, the changes would help SROs achieve the goal of greater independence of the regulatory function.[11]

2. Separation of Marketplace and Regulatory Functions

A second aspect of any reform must focus on ensuring an effective separation of an SRO's marketplace and regulatory functions. If an SRO is allowed to "commingle" its marketplace and regulatory functions, both an incentive and a potential exist for the SRO to use its regulatory functions to promote its marketplace or the pecuniary interests of its owners.

To enhance the independence of an SRO's regulatory functions, FIA believes that, at a minimum, functional separation of compliance and business staffs is necessary. Compliance and surveillance staff should report to the independent board committee. Those who manage the business unit of an SRO should not play any role in supervising compliance and surveillance staff. If the SRO contracts out any regulatory function, the independent contractor still should not report to business managers. Any other structure creates conflicts of interest and undermines the recommended separation and the role of the independent board committee.

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[10] The Commission issued an adopting release interpreting the Core Principles. 66 FR 42256 (Aug. 10, 2001). The Commission could consider further interpretations of the Core Principles to ensure that SROs are satisfying Congress's objectives in the CEA, as amended by the CFMA.

[11] FIA also notes that it believes industry members of SRO committees, including boards of directors, should include a broad representation of different constituencies. For example, in certain instances it would not be appropriate for disciplinary committees to exclude certain segments of the futures industry. *See* discussion below.

Consistent with the Position Paper, the committee of independent directors should have responsibility for:

- reviewing regulatory budgets;[12]
- ensuring adequate staff and resources;
- hiring, firing, and compensation of compliance and surveillance staff;
- achieving the requisite degree of separation of compliance and surveillance staff from other SRO staff;
- assessing and reviewing the performance of the self regulatory programs; and
- otherwise overseeing all aspects of the exchange's institutional regulatory functions.

3. Transparency of Regulatory Process/Ability to Participate in Process

A third aspect of any reform must enhance the transparency of the regulatory and disciplinary processes and protect the ability of a broad cross-section of the industry, including FCMs, to participate in these processes. Except where there are overriding concerns of confidentiality, SROs should make their own internal structures and processes transparent to outsiders.

Rulemaking

The rules[13] that an SRO adopts and the manner in which it enforces them are critical to complying with the core principles and, as important, to properly meeting its responsibilities as an SRO. Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on DCMs the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity of transactions entered into by or through the facilities of the DCM, (3) to prevent market manipulation, and (4) to discipline members or market participants that violate such rules. To both enhance the quality of SRO rulemaking and engender confidence in the SRO rulemaking process generally, the procedures by which a DCM adopts and enforces these rules should be transparent and should assure that members and other market participants, not just one constituency, have an opportunity to express their views and otherwise participate in the process.[14]

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[12] Disciplinary fines should not be taken into account in setting budgets. Fines that are collected should be dedicated solely to enhancing the contract market's regulatory activities or expanding professional and customer education.

[13] For purposes of this comment letter, the term "rule" has the same meaning as set forth in Commission Rule 40.1.

[14] The ability of market participants to have a role in developing the four categories of rules referenced above is particularly important, since they are most directly affected by such rules. In this regard, it generally would not be acceptable if such rules were developed solely by SRO staff and approved by the independent directors of the exchange or independent members of a committee.

Neither the Act not the Commission's rules prescribe the procedures that an SRO should follow in adopting rules. Nonetheless, we believe the essential elements of these procedures are implied in Part 40 of the Commission's rules. In particular, Commission Rules 40.5(a)(1)(v) (voluntary submission of rules for review and approval) and 40.6(a)(3)(iv) (self-certification of rules) each require a DCM to "describe any substantive opposing views expressed with respect to the proposed rule that were not incorporated into the proposed rule."[15] Further, Commission Rule 40.5(a)(1)(iv) requires an SRO, in submitting a rule for approval, to include in its submission, an explanation the operation, purpose and effect of the rule, including, as applicable, a description of the anticipated benefits, any potential anticompetitive effects, and how the rule fits into the framework of self-regulation.[16] We submit that an SRO cannot comply with the provisions of these rules—and the Commission cannot properly determine whether the SRO's rules violate applicable core principles, including the requirement that the SRO endeavor to avoid adopting any rule that results in an unreasonable restraint of trade or imposes any material anticompetitive burden on trading[17]—unless the SRO's rulemaking procedures are designed to solicit input from members and affected market participants on significant rule proposals.

As noted, to date the Commission has offered little direct guidance to DCMs in meeting this responsibility. We are not yet prepared to state that formal guidance pursuant to section 5c(a) of the Act is necessary. As an initial step, the Commission should request each SRO to submit for the Commission's review the written procedures by which the SRO develops and adopts rules. Only following this review should the Commission consider whether it would be appropriate to provide guidance to SROs in this area. The Commission's Part 40 rules could provide the foundation for the Commission's review and any guidance it may subsequently elect to issue.

We recognize that the Commission's rule review procedures are not the subject of this request for comment.[18] Nonetheless, the procedures by which an SRO adopts its rules and the procedures by which the Commission reviews such rules are inextricably linked.

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15 Rule 40.5(a)(1)(v); Rule 40.6(a)(3)(iv) is similar.

16 Although an SRO is not required to include such a written explanation in self-certifying a rule pursuant to Rule 40.6, we fail to see how an SRO could certify that the rule complies with the Act and the Commission's regulations unless it prepared such a document for its own files and for consideration by the board or appropriate committee prior to the adoption of the rule. Further, the board's committee of independent directors, recommended above, should have the responsibility to make any such certification, whether mandatory or voluntary.

17 Section 5(d)(18) of the Act.

18 However, then-Chairman James Newsome noted his view that review of Commission procedures and SRO procedures should occur together. " In this regard, just as I think it's important for the Commission to review our own regulatory structure, I also believe it's equally necessary for SROs, in consultation with us, to do the same." Address by Chairman James E. Newsome of the U.S. Commodity Futures Trading Commission at the Futures Industry Association Law and Compliance Luncheon Chicago - May 28, 2003, http://www.cftc.gov/opa/speeches03/opanewsm-40.htm

In addition, to the extent that affected market participants are not afforded an opportunity to have their views taken into account when an SRO adopts rules, FIA believes they must have the opportunity to seek redress with the Commission. Transparency in the Commission's consideration of SRO rules and the opportunity for public participation in this process is no less important than in an SRO's adoption of such rules. In appropriate circumstances, a request for comment should be published in the *Federal Register* as well as on the Commission's website, and the public should be afforded a reasonable amount of time to analyze the rules and prepare comments. The Commission's decision with respect to such rule, including its analysis of the comments, received should also be made available to the public.[19] FIA urges the Commission to implement the changes described with respect to both the processes at the SROs and its own oversight function.

Disciplinary Process

Conflicts of interest and other problems can impair the fairness and efficacy of the current SRO disciplinary process. FIA notes that narrowly drawn industry participants currently dominate many hearing panels. Consequently, peers judge peers and competitors judge other competitors. In addition, when one class of market participant dominates a disciplinary panel, other classes of market participants subject to the panel's disciplinary review may perceive the process to be unfair.

For these reasons, FIA recommends several reforms to the disciplinary process. Perhaps most importantly, neither the industry as a whole nor a particular industry segment should dominate disciplinary panels. However, it is important to recognize that industry participants can play a valuable role on a more balanced panel, particularly when the industry participant does not represent an industry segment that competes against the segment employing the person or entity charged. Industry participants can provide a "reality check" and industry knowledge to

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[19] An example of the importance of such procedures is the Commission's consideration of the Chicago Board of Trade and the Chicago Mercantile Exchange rules implementing the clearing link between these two exchanges. The exchanges submitted these rules pursuant to Commission Rule 40.5. Despite the fact that these rules significantly affected the rights and obligations of Chicago Board Trade clearing members and their customers, they were developed and adopted with little or no input from affected members. Yet, the Commission afforded market participants only three business days to analyze and prepare comments on the rules. As troubling, the Commission allowed itself less than one day to consider the comments that were filed before voting to approve the rules. Notwithstanding comments that raised what many considered significant questions of law, the Commission did not publicly address these questions in approving these rules.

Another example is the New York Mercantile Exchange's ("Nymex's") proposed amendments to rule 9.23, Protection of Clearing House. As the Commission is aware, as initially approved by the exchange, this rule would have significantly altered the purpose of the clearing house guarantee by authorizing the use of the Guaranty Fund and other Clearing House assets in certain instances to make whole the non-defaulting customers of a defaulting clearing member. The Nymex board approved this rule without adequate consultation with all affected clearing members of the exchange. After learning of the amendments, the members were able to convince the board to withdraw the rule amendments before they were submitted to the Commission. However, if the amendments had been submitted to the Commission, there would have been no apparent procedures by which affected market participants could have requested Commission review.

independent panelists. Furthermore, including panelists from the same industry segment as the person or entity charged can help guard against the possibility that panel members may not know enough about the behavior to judge it properly or worse, may want to punish a competitor from an alternative market.

However, FIA recognizes that including people from the same industry segment creates the risk that a panel may impose sanctions that are too light — protecting a friend; hoping that the competitor will remember the favor if roles are reversed in the future — or conversely, may impose sanctions that are too harsh — punishing a direct competitor. To address these concerns, FIA recommends the following reforms: (i) the independent committee of the board should appoint disciplinary panels; (ii) as noted in the Position Paper[20], disciplinary panels should be made up of a majority of knowledgeable independent panelists; (iii) industry members who represent a fair cross section of the industry should augment the panels[21]; (iv) at the request of non-industry panelists, the disciplinary panel should be able to seek the views of independent experts; and (v) aggrieved persons or entities should have the right to appeal to the full committee of independent directors or to a panel comprised solely of such independent committee members.

4. Preventing Unauthorized Disclosure of Confidential Information

A fourth aspect of any reform must focus on ensuring the confidentiality of information. The absence of confidentiality protections compromises other goals outlined above: independence of the regulatory function; separation of marketplace and regulatory functions; and transparency of/participation in the regulatory process.

Currently, SRO committees and in some cases the entire board of directors review disciplinary records and settlements, which may reveal confidential information. Industry personnel should not be able to use for commercial advantage information about a competitor that they obtained as a result of their service on an SRO committee or board of directors. Similarly, marketing and business staffs should never be permitted to use information obtained in their regulatory or compliance functions for business purposes. To limit the number of people who become privy to confidential proprietary information, therefore, FIA recommends that SROs modify their processes to ensure that only independent board members, relevant committees, such as business conduct and financial compliance, if applicable, and regulatory staff have access to such information.[22] The more people who know confidential information, the less the likelihood is that the information will remain confidential.[23]

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[20] Position Paper at II.

[21] *See* discussion below concerning confidentiality of information.

[22] As discussed above, we also recommend that the business and marketing staffs of an SRO be functionally separate from the regulatory and compliance staffs.

[23] In our June 18, 2004 letter to the Commission on the proposed revisions to the Joint Audit Agreement, we noted that the Commission had "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-

FIA recognizes that SROs have generally adopted codes of conduct, which include a provision prohibiting any person involved in the SRO process from disclosing or taking commercial advantage of confidential proprietary information obtained in the course of SRO activities. All such codes should be transparent and publicly available. Further, SROs should require their board members, staff, and outside consultants to sign such codes before undertaking SRO responsibilities.[24]

Conclusion

FIA appreciates this opportunity to comment on SRO governance. If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner

Division of Market Oversight
Richard A. Shilts, Acting Director
Steven B. Braverman, Deputy Director
Rachel Berdansky, Special Counsel

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regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures." FIA endorsed the Commission's request and urged the Commission to make any information submitted by the SROs publicly available. To date, neither the SROs nor the Commission has released any information in this regard.

[24] The Position Paper recommends that "the FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions." The Position Paper explains that "given the number of exchanges that have SRO and DSRO responsibility, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges." Position Paper at IV. We suggest that the development and review of codes of conduct for confidentiality and other purposes could be the first such project.

EXHIBIT A

CFTC Study of Self-Regulation
Position Paper of the FIA
June 8, 2004

Summary

FIA supports the important role that exchanges and clearing houses perform as self-regulatory organizations (SRO) and designated self-regulatory organizations (DSRO). Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure.

FIA believes there is merit in the existing structure worth preserving and that more extreme alternatives are not desirable and are less efficient. Nevertheless, the existing structure can be improved through greater transparency and oversight that will minimize any potential conflict of interests. To be fully effective, there must be an increased degree of confidence in the integrity and objectivity of the SRO. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the CFTC in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure.

The CFTC has been progressing with its review of the effectiveness of self-regulation in the futures industry. To facilitate this review, FIA has prepared this Position Paper to highlight key areas of concern in the hope that the CFTC will recognize the merits of these positions and take them into account in its assessment and recommendations for change in SRO responsibilities. In this regard, there are four broad issues that FIA recommends the CFTC address in its SRO Study. For each of these issues, FIA provides recommendations for specific changes to current SRO structures.

I. Potential Conflict of Interests - There should be a division between the business and SRO/DSRO functions of exchanges and clearing houses.

The exchanges provide a public good and public service through price discovery and a well-defined marketplace yet there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses. This problem potentially is exacerbated by demutualization and the move to for-profit structures. FIA recognizes that shareholders of for-profit structures are motivated in the long run to ensure market integrity and their failure to do so should ultimately reduce revenues and profit; however, there may be times when specific events will override the longer-term objectives of the exchange.

Recent legislative and regulatory actions against public companies, including the enactment of the Sarbanes-Oxley Act, suggests that without specific safeguards for-profit companies may not always act in the public interest. The possibility that exchanges or clearing houses can abuse

their SRO responsibilities to the detriment of market participants and the public good cannot be dismissed. FIA believes that a more formal separation between the business and SRO functions of exchanges and clearing houses is essential to overall marketplace integrity. In that regard, we have the following recommendations.

- **A Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.**

FIA recommends that each exchange/clearing house have such a Board Committee of independent, non-industry directors and that the Committee have the responsibility to oversee the SRO/DSRO budget, hire and fire compliance staff, ensure adequate staff and resources, review cases, audit SRO/DSRO performance and otherwise oversee all aspects of the SRO/DSRO function. In addition, it is absolutely critical that there be a definition of "Independent" that avoids any appearance of bias, conflict or any lack of independence. FIA is not convinced that current exchange and others' definitions of "independent" are adequate in these regards. In addition to being independent, these directors should not be currently active in the industry.

- **The Board Committee should be responsible to the CFTC for its oversight of the SRO/DSRO functions**

Like independent audit committees of public company boards under Sarbanes-Oxley, this Board Committee should have real accountability. Its activities, its responsibility for the budget and the audit all should be reviewed by the CFTC at least annually.

- **There should be a more formal separation between the business and compliance/surveillance staffs of exchanges and clearing houses.**

Compliance and surveillance staff should report to the Board Committee. They should not be involved in the business activities of the exchange or clearing houses and should not be in a supervisory chain that includes managers on the business side of the exchange or clearinghouse. To the extent the SRO function is contracted out, it still should not report to business managers. Any other result creates conflicts of interest and undermines the recommended separation and the role of the independent Board Committee.

II. **Appearance of Bias – A majority of the members judging proceedings should be disinterested parties.**

FIA recognizes that its concerns about SRO fairness will be reduced with the adoption of its recommendation of Board Committees of independent, non-industry directors overseeing SRO/DSRO functions. However, additional measures must be taken to address related issues of fairness and confidentiality and to ensure SRO decision-makers will be independent of business pressures. In particular FIA is concerned that disciplinary panels dominated by peers judging peers has an inherent appearance of bias. Equally, disciplinary panels consisting of only one category of market participant can be seen as unfair especially from the viewpoint of other categories of market participants subject to the panels' disciplinary review. Market participants are entitled to a fair hearing. In this regard, FIA has the following recommendations.

- **A majority of the members of disciplinary panels should be made up of knowledgeable independent panelists.**

While FIA respects the experience and judgment of interested panel members, an appearance of fairness and the avoidance of bias are enhanced when a majority of disciplinary panel members are independent. Consideration should be given to permitting parties subject to discipline to request panels made up entirely of independent members.

- **Interested parties should not review the records of disciplinary proceedings and settlements.**

Currently, exchange committees and in some cases the entire Board of Directors reviews disciplinary records and settlements. These records reveal confidential information that should not be shared with competitors or other interested parties. The use of independent committees and the Board Committee of independent directors should address this problem.

III. **Enhanced Transparency – The CFTC should establish clear standards for DSROs and the allocation of firms among them.**

The efficiencies of the DSRO approach are widely recognized. At the same time, providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function. The CFTC should establish clear standards for qualification as a DSRO including a process to approve new providers wishing to perform financial compliance audits. Each of these providers should be subject to periodic CFTC review of their DSRO functions. This oversight should include detailed review of DSRO audits. A mechanism should be established to make the choice of DSRO cost neutral to exchange members. Subject to CFTC adopted standards, a member firm should be able to change its DSRO within the narrow band of CFTC pre-approved providers.

IV. **Sound Practices – The FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions.**

Given the number of exchanges that have SRO and DSRO responsibilities, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges. These sound practices should follow the model of core principles in the Commodity Futures Modernization Act. In particular, directors who serve on the independent Board Committee with oversight responsibilities over SRO and DSRO activities should be trained to apply these industry-wide sound practices.

Conclusion

FIA believes that this is an ideal opportunity to improve a process that has largely been successful but may have certain conflicts and biases. FIA's hope in raising these issues and making these recommendations is to promote a dialogue that will lead to a fairer and more efficient SRO structure for the futures industry.

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EXHIBIT B

June 18, 2004

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

Re: Futures Market Self-Regulation, 69 *Fed.Reg.* 19166 (April 12, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations ("Proposed Agreement").[25] FIA supports the important role that exchanges and the National Futures Association ("NFA") perform as self-regulatory organizations ("SROs") and designated self-regulatory organizations ("DSROs").[26] Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, as explained in detail below, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure that would be ratified in the Proposed Agreement.

Before addressing specific aspects of the Proposed Agreement, however, FIA notes that the Commission recently issued a *Federal Register* release requesting comment on a series of questions relating to the structure and governance of self-regulatory organizations. 69 *Fed.Reg.* 32326 (June 9, 2004). The latter release, which was issued in connection with the Commission's review of SROs, requests comment on such matters as the composition of boards of directors, issues arising from different forms of ownership, regulatory structure,

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[25] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[26] Pursuant to Commission rule 1.3(ee), an SRO is defined as a designated contract market or a registered futures association. A DSRO is defined under Commission rule 1.3(ff) as an SRO assigned responsibility for monitoring and auditing an FCM in accordance with a plan approved under Commission rule 1.52. Significantly, designated clearing organizations are not self-regulatory organizations under the Commission's rules.

including the structure of disciplinary committees, and potential conflicts of interest generally. FIA recently filed with the Commission a position paper outlining several broad areas of concern in this area and will be preparing a more detailed response to this release.[27]

In our view, the Commission's review of the Proposed Agreement cannot be considered separately from the Commission's more general review of SROs. Certainly, FIA's comments below might well change depending on the Commission's response to our broader concerns. Therefore, we recommend that the Commission defer any decision with respect to the Proposed Agreement until its SRO study is complete.

A Changed Industry

The derivatives industry has undergone significant change in the twenty years since the original Joint Audit Agreement was entered into in 1984 and, in particular, in the years following enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"). Legal uncertainty surrounding over-the-counter ("OTC") derivatives transactions among qualified eligible participants has been resolved, and a burgeoning OTC market in swaps and other derivatives instruments both competes with and complements the exchange traded markets.[28] Many FIA member firms, either directly or through affiliates, are active participants in the OTC derivatives markets. Concurrently, the clearing divisions of the Chicago Mercantile Exchange ("CME") and the New York Mercantile Exchange ("Nymex") both offer to provide clearing facilities for OTC derivatives.

Moreover, exchanges have entered into direct competition with each other. BrokerTec Futures Exchange and, more recently, the U.S. Futures Exchange ("USFE"), an indirect subsidiary of Eurex Frankfurt AG, have challenged the Chicago Board of Trade's ("CBT's") dominance in futures on US Treasury instruments, leading the CBT to counter by offering futures on the German Bund, Bobl and Schatz.[29] Meanwhile, Euronext.Liffe recently began offering futures on Eurodollars, in direct competition with the CME.

Finally, not all clearing organizations are as tied to futures exchanges as they once were. The CBT has terminated its relationship with The Clearing Corporation and has been clearing transactions through the CME since late 2003.[30] The Clearing Corporation now provides

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[27] Letter to James Newsome, Chairman, from John M. Damgard, President, FIA, dated June 8, 2004.

[28] The International Swaps and Derivatives Association ("ISDA") estimates that, as of December 31, 2003: (1) the notional principal outstanding volume of interest rate derivatives, which include interest rate swaps and options and cross-currency swaps, was $142.31 trillion; (2) the notional value of outstanding credit derivatives, including credit default swaps, baskets and portfolio transactions was $3.58 trillion; and the outstanding notional value of equity derivatives, consisting of equity swaps, options, and forwards, was $3.44 trillion.

[29] As a result of its purchase of BrokerTec Futures Exchange, several of the larger FCMs own a significant interest in USFE.

[30] The Clearing Corporation, of course, has always been an independent legal entity.

clearing services for USFE and other exchanges. In addition, the London Clearing House has been approved as a designated clearing organization ("DCO"), but does not yet provide clearing services for any designated contract market ("DCM"). Although not represented on the Joint Audit Committee ("JAC"), independent clearing organizations have a clear and undeniable interest in the financial integrity of member FCMs.[31]

As the above summary indicates, the derivatives industry is anything but static. More important, the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement. Further, we submit that the Proposed Agreement should provide the flexibility necessary to accommodate the inevitable changes the industry will experience in the years ahead.

Voting Eligibility

Paragraph 3 of the Proposed Agreement provides that "[o]nly those Parties which were members of the JAC prior to the year 2000 or which conduct their own auditing activities as a DSRO (rather than subcontracting such responsibilities) shall be eligible to vote." Neither the Proposed Agreement nor the *Federal Register* release requesting comment explains the reasons underlying this provision. On its face, it appears to have no rational basis.

What regulatory purpose is served by granting voting privileges to AMEX Commodities Exchange and the Philadelphia Board of Trade, neither of which currently list products for trading, while denying voting privileges to USFE? Certainly, the distinction cannot be based on the decision of USFE to subcontract certain of its self-regulatory responsibilities to NFA. A review of the Commission's *Selected FCM Financial Data* as of May 31, 2004, indicates that, with a few exceptions, DSRO responsibilities are performed by only three self-regulatory organizations—CBT, CME and NFA.[32] Without further explanation, the provisions of paragraph 3 relating to voting eligibility appear to have no purpose but to assure the continued dominance of the "old exchanges" over the "new exchanges."

Under the Commodity Exchange Act ("Act"), all DCMs have self-regulatory obligations that they are required to meet. Further, although the Act clearly contemplates that DCMs may

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[31] As noted in footnote 2 above, DCOs are not self-regulatory organizations under the Commission's rules. Nonetheless, DCOs have an obvious interest in the financial integrity of their member FCMs. Therefore, procedures should be developed to assure that DSROs provide independent DCOs the same access to financial and other relevant information obtained by a DSRO with respect to a member FCM as the DSRO now makes available to DCOs that are divisions of a DCM. In addition, consideration should be given to inviting independent clearing organizations to participate, if not vote, in meetings of the JAC.

[32] Of the 178 registered FCMs: NFA is the DSRO for 97 FCMs; the CBT is the DSRO for 40 FCMs; the CME is the DSRO for 29 FCMs; Nymex is the DSRO for 10 FCMs; and the Kansas City Board of Trade and New York Board of Trade are the DSRO for one FCM each.

delegate these obligations to a registered futures association, such as NFA, or another registered entity, the Act also provides that that DCM "shall remain responsible for carrying out" these obligations.[33] As long as a DCM has statutory self-regulatory obligations that it is required to meet and, consequently, may be held responsible for the manner in which a DSRO performs these obligations on its behalf, FIA believes that each DCM should have an equal voice in matters that become before the JAC.[34]

Allocation of Firms Among DSROs

As noted earlier, the CBT, CME and NFA serve as the DSROs for essentially all registered FCMs. Further, either the CBT or the CME is the DSRO for all but two of the twenty largest FCMs by amount of segregated funds held.[35] FIA is not concerned that these three entities perform the majority of DSRO activities on behalf of other DCMs. To the contrary, particularly in the area of financial audits, we believe that the expertise demanded of audit staff effectively requires that these responsibilities be exercised by a small number of qualified SROs. Nonetheless, two aspects of the Proposed Agreement cause concern.

First, the Proposed Agreement provides no means by which an FCM may participate in the selection of its DSRO. In addition, once assigned to a DSRO, an FCM may not be reassigned, except with the consent of that DSRO. As we discussed at the outset of this letter, exchanges and their FCM members are increasingly engaged in activities that appear to compete with each other. Consequently, an FCM may find that its activities are being audited by an exchange that is, or at least appears to be, its competitor. In these circumstances, and in order to avoid even an appearance of a conflict of interest, an FCM should have the ability to change its DSRO.[36]

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[33] Section 5c(b) of the Act.

[34] Paragraph 3 of the Proposed Agreement also provides:

> If two or more Parties become commonly owned through a merger or acquisition, the surviving Party is entitled to one representative on the JAC; provided, however, that any Party which maintains a separate legal entity after an acquisition, will retain their representative on the JAC.

FIA agrees that, if two or more DCMs become commonly owned, they should be entitled only to one representative and one vote on the JAC in all instances. The fact that a DCM is maintained as a separate legal entity following an acquisition should not entitle that entity to representation or a vote.

[35] Based on the Commission's *Selected FCM Financial Data* as of May 31, 2004, these twenty firms hold in excess of 85 percent of all customer segregated funds. Of these firms, the CBT is the DSRO for 12, the CME is the DSRO for six and Nymex is the DSRO for two.

[36] We want to be clear that we are not asserting that any DSRO has acted, or would act, in a way that would constitute a conflict of interest. Nor would we anticipate any rush by FCMs to change their DSRO. To the contrary, in our discussions with FIA member firms, they are by and large satisfied with the DSRO to which they have been assigned. Nonetheless, as we noted in our June 8, 2004 position paper on self-regulation, "providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function."

We have considered various means by which an FCM could be permitted to change its DSRO and suggest that an FCM should be able to change its DSRO on a periodic basis, *e.g.*, every five years.[37] The FCM could request this change for any or no reason. Although an FCM could participate in the selection of its DSRO, the FCM would not have the unilateral right to choose the DSRO that would assume responsibility for the firm. Rather, the DSRO would be chosen from among those SROs that the Commission has determined meets clear and objective standards. Any procedure should assure and prevent any appearance that the FCM was engaging in regulatory arbitrage among DSROs.[38] Separately, FIA believes the Commission should establish procedures in rule 1.52 by which an FCM may petition the Commission to request a change in the FCM's DSRO in the unlikely event that the DSRO has engaged in egregious misconduct conduct with respect to the FCM.

Second, we believe that the exchanges should not have the unquestioned right of first refusal with respect to the allocation of DSRO responsibilities among exchange member firms. As discussed above, in light of the potential appearance of conflict of interests between an FCM and its DSRO, FIA believes that procedures should be considered to permit NFA or another non-exchange entity to serve as an FCM's DSRO, *provided* that entity meets Commission approved standards.

Confidentiality

The information that DSROs obtain in the course of their examinations of member firms and the records they prepare obviously contain confidential proprietary and business information that an FCM would not otherwise disclose. FIA is concerned that the confidentiality provisions set forth in paragraph 8 of the Proposed Agreement do not provide sufficient assurance that such information will not be shared with other divisions of the DSRO or with other SROs except for appropriate cause. Since FCMs are not parties to the Proposed Agreement and otherwise appear to have no cause of action against an SRO that may improperly disclose confidential information, it is particularly important that the responsibilities of SROs in this regard be clearly circumscribed.[39]

In a press release dated February 6, 2004, the Commission announced that it has "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-

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[37] No FCM, however, would be required to change its DSRO under this procedure.

[38] As noted in our June 8 position paper, FIA believes that a mechanism should be established to make the choice of DSRO cost neutral to exchange members.

[39] Again, FIA is not asserting that the audit staffs of any exchange or other SRO have inappropriately shared otherwise confidential business information.

regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures."[40]

Consistent with the Commission's recommendations, FIA respectfully submits that the Proposed Agreement governing confidentiality of FCM proprietary and business information should be revised to describe specifically the limitations on the use of such information. In addition, FIA believes the Commission should consider adopting a rule requiring the confidential treatment of all proprietary and confidential information collected during an examination. Such a rule would assure that violations of FCM confidentiality would be subject to appropriate penalty.

Commission Review

In light of the constant change that is the hallmark of the derivatives industry and the potential conflicts of interest that are inherent in any self-regulatory structure, FIA encourages the Commission to play a more active role in overseeing the activities of the Joint Audit Committee.

Conclusion

FIA appreciates the opportunity to submit these comments on the Proposed Agreement. If you have any questions concerning 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, Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Sharon Brown-Hruska, Commissioner

Division of Clearing and Intermediary Oversight
James L. Carley, Director
Thomas J. Smith, Associate Director

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[40] FIA supports the Commission's request that SROs examine their policies and procedures designed to protect the confidentiality of member information and make these policies and procedures public. FIA is not aware that any SRO has responded to the Commission to date. We recommend that this information be made publicly available as soon as possible in order to afford FIA and others an opportunity to submit comments in response to the Commission's June 9, 2004 *Federal Register* release.