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August 1, 2006

Ms. Eileen Donovan
Acting Secretary of the Commission
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: "What Constitutes a Board of Trade Located Outside of the United States," 71 *Fed. Reg.* 34070 (June 13, 2006)

Dear Ms. Donovan:

The Commodity Futures Trading Commission has requested public comment on when a board of trade should be considered to be "located outside the Unites States" for purposes of Section 4(a) of the Commodity Exchange Act. 71 *Fed. Reg.* 34070 (June 13, 2006). The Futures Industry Association ("FIA")[1] is pleased to have the opportunity to comment on this important statutory interpretation issue, and related policy considerations.

In the *Federal Register* notice, the Commission correctly frames the question as calling for the application of the statute's terms to an ever-changing, global, technology-driven, electronic trading world. Generally, "boards of trade established in foreign countries and located outside the U.S." are known as foreign boards of trade or FBOTs. 71 *Fed. Reg.* 34070. In 1982, Congress enacted the statutory "located outside the United States" test under Section 4(a) of the Commodity Exchange Act in order to allow foreign futures to be offered lawfully in this country on FBOTs. At that time, trades were executed on exchange trading floors and ascertaining an exchange's location was uncontroversial. With electronic trading supplanting floor trading, however, the "location" test now must focus on other factors. The Commission has asked: is an FBOT "located outside" the U.S. if it makes its products available to U.S. customers by allowing "direct access to its electronic trading system?" 71 *Fed. Reg.* 34070.

The Commission is posing two questions: what does "located outside" mean and what is "direct access?" On the first, foreign exchanges that have been recognized for decades to be FBOTs "located outside" the U.S. have been: 1) subject to substantive regulation by a

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[1] FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 38 of the largest futures commission merchants ("FCMs") 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 U.S. and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators, other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members are responsible for more than 90 percent of all customer transactions executed on U.S. contract markets.

government body from outside the U.S.; 2) legally-organized outside the U.S.; and 3) managed for self-regulatory purposes outside the U.S. As trading floor location has become largely irrelevant to the FBOT issue, these other three factors -- overseas regulation, overseas organization and overseas self-regulation -- provide appropriate measures of whether an exchange is "located outside" the U.S. for purposes of CEA § 4(a).

As long as an exchange satisfies each of these three "located outside" factors, the exchange should continue to be an FBOT under CEA § 4(a), even if the exchange has substantial business contacts, including servers, within the U.S. or most of the exchange's trading volume comes from within the U.S. The plain meaning of CEA § 4(a) is that once an exchange is found to be "located outside" the U.S., that is the end of the statutory FBOT inquiry. For that reason, any exchange that satisfies the three "located outside" the U.S. factors would qualify as an FBOT under CEA § 4(a), even if the exchange offers "direct access" to U.S. customers.

On the "direct access" issue, the Commission should first reconfirm what is not "direct access." As it has in the past, FIA maintains that it is not "direct access" if a board of trade becomes accessible to U.S. customers through Automated Order Routing Systems ("AORS") or other means of order entry and execution intermediation provided by, or through, CFTC-registered futures commission merchants or foreign firms that CFTC Rule 30.10 exempts from such registration. FIA would ask the Commission to reaffirm its stance, at least since 1999, that any FBOT allowing U.S. customers access through such regulated intermediation, like AORS, is not providing "direct access" and its FBOT legal status remains unquestioned, whether or not the FBOT has applied in the past for a staff no-action letter or does so in the future.

Nonetheless, the "direct access" question may still have regulatory implications. In the event that a foreign-located exchange allows U.S. market participants to access its trading facility through direct order entry and execution facilities without the services of any regulated intermediary, FIA understands the Commission would consider that exchange to provide "direct access" to its facilities thereby triggering Commission regulatory interest in the solicitation and acceptance process for such U.S. customer orders. The Commission's regulatory interest would be analogous to its traditional policy that foreign firms soliciting U.S. customer business must be registered FCMs or appropriately exempted. Accordingly, any exchange that allows "direct access," as defined above, could apply to the Commission under the no-action approach the Commission began in 1999 or for an exemption under CEA § 4(c), as appropriate.

In evaluating these issues, FIA recognizes that CEA regulation may differ in material respects from regulation in foreign jurisdictions. Consistent with the Commodity Futures Modernization Act, regulatory differences are to be expected,[2] and perhaps even encouraged, in order to allow regulation to be tailored to the specific needs and practices of a specific market. Gaps in achieving core regulatory goals -- like market and financial integrity -- are to be avoided, of course. FIA is confident the Commission's longstanding leadership role among international regulators will continue to serve it well in developing policies with its foreign counterparts to avoid any regulatory gaps.

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2 The CFMA's acceptance of differing levels of regulation is illustrated by many provisions, ranging from derivatives clearing organizations to security futures.

The Statutory Issue

With some exceptions, Congress requires all futures contracts to be traded through the facilities of a designated contract market or a derivatives transaction execution facility. CEA § 4(a).[3] One exception to this rule is for futures contracts "made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions." *Id.* This language was enacted in 1982 and is referred to as the FBOT exemption.[4]

The FBOT exemption has the potential to raise serious legal certainty concerns, both for foreign exchanges and any intermediaries that are offering, executing, or confirming foreign futures transactions. Futures contracts traded on an FBOT are legal; the same futures contract traded on an exchange found <u>not</u> to be located outside the U.S. are illegal unless otherwise exempt from CEA § 4(a).[5] If the law is interpreted to treat an already operating FBOT as no

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[3] Section 4(a) provides:

"Unless exempted by the Commission pursuant to subsection (c) of this section, it shall be unlawful for any person to offer to enter into, to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States, its territories or possessions, for the purpose of soliciting, or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery (other than a contract which is made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions) unless--

(1) such transaction is conducted on or subject to the rules of a board of trade which has been designated or registered by the Commission as a contract market or derivatives transaction execution facility for such commodity;

(2) such contract is executed or consummated by or through a contract market; and

(3) such contract is evidenced by a record in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery: Provided, That each contract market or derivatives transaction execution facility member shall keep such record for a period of three years from the date thereof, or for a longer period if the Commission shall so direct, which record shall at all times be open to the inspection of any representative of the Commission or the Department of Justice."

In this letter, the term "board of trade" is often used as short-hand for the statutory phrase "board of trade, exchange or market" in CEA § 4(a).

[4] Section 5 of the Securities Exchange Act offers a strikingly different statutory formulation of much the same issue. There Congress wrote:

> "It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 6 of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration."

As this language illustrates, it is a very different statutory question whether an exchange is "located outside" the U.S. than whether any facility of an exchange is "within or subject to the jurisdiction of the United States."

[5] Futures on non-agricultural commodities are not illegal under Section 4(a) to the extent they qualify for other statutory exclusions and exemptions, including those applying to institutional trading on electronic trading facilities. See CEA §§ 2(c), 2(d), 2(e), 2(f), 2(g), 2(h).

longer being located outside the U.S., then trading that was once legal would become illegal. Moreover, if the law is not clear when an FBOT is safely "located outside" the U.S., exchanges, intermediaries and market participants assume increased legal risk. It is hard to imagine a greater recipe for legal uncertainty.

Providing clarity on when an exchange is located outside the U.S. also has important regulatory considerations. Under CEA § 4(b),[6] Congress has drawn a sharp line: intermediaries "located in the United States" for foreign futures transactions are subject to CFTC regulation; exchanges "located outside the United States" are not. The 1982 legislative history confirmed this distinction and even supports applying the statute to avoid competitive disparities for foreign futures transactions. In that regard, the 1982 Senate Committee Report stated that the Commission should not use its authority "to place the solicitation or acceptance of orders in the United States for bona fide foreign futures contracts at a comparative disadvantage with similar solicitation or acceptance of orders for domestic futures contracts." S. Rep. No. 97-384, 97th Cong. 2d Sess. 46 (1982). The House Report reaffirmed that the CFTC may have no role in the "internal affairs" of an FBOT and may not require Commission approval of any FBOT action. H.R.Rep. No. 97-565, Pt. 1, 97th Cong., 2d Sess. 85 (1982).

Subsequent to the 1982 legislation, the CEA has been substantively amended three times: 1986, 1992, and 2000. With each of these legislative efforts, Congress has become more aware of the growth of electronic futures trading and the globalization of markets, but has never suggested that the FBOT "located outside the U.S." definitional standard needed further clarity or should be changed to a "principal place of business" test[7] or a "no substantial contacts within the U.S." test. Instead, in 2000 Congress amended the statutory "board of trade" definition to be: "any organized exchange or other trading facility" (CEA § 1a(2)). Both terms also have new

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6 Section 4(b) provides:

"The Commission may adopt rules and regulations proscribing fraud and requiring minimum financial standards, the disclosure of risk, the filing of reports, the keeping of books and records, the safeguarding of customers' funds, and registration with the Commission by any person located in the United States, its territories or possessions, who engages in the offer or sale of any contract of sale of a commodity for future delivery that is made or to be made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions. Such rules and regulations may impose different requirements for such persons depending upon the particular foreign board of trade, exchange, or market involved. No rule or regulation may be adopted by the Commission under this subsection that

(1) requires Commission approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market, or

(2) governs in any way any rule or contract term or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market."

7 In other regulatory contexts, Congress has employed the "principal place of business" outside the U.S. test. See 7 U.S.C. § 3508(3)(B) (discussing agricultural foreign investment disclosures and defining the term "foreign person" as "any person, other than an individual or a government, which is created or organized under the laws of a foreign government or which has its ***principal place of business located outside of all the States.***")(emphasis added); 26 U.S.C. § 217(h)(2) (discussing tax deductions of moving expenses for individuals who move in connection with the commencement of work and defining the term "foreign move" as "the commencement of work by the taxpayer at a new ***principal place of work located outside the United States***.")(emphasis added); 26 U.S.C. § 6230(j) (assessing tax treatment of partnership items and stating that for partnerships having a principal place of business outside the United States, "a ***principal place of business located outside the United States*** shall be treated as located in the District of Columbia.")(emphasis added); 26 U.S.C. § 6255(c) (discussing treatment of electing large partnerships and stating that "a ***principal place of business located outside the United States*** shall be treated as located in the District of Columbia.")(emphasis added).

statutory definitions. An "organized exchange" is a trading facility that permits trading by persons who are not eligible contract participants, allows for intermediated trading or has self-regulatory powers, including disciplinary sanctions. CEA § 1a(27). A trading facility is defined to be a "person or group of persons that constitutes, maintains or provides" a "physical or electronic facility or system" where multiple market participants may execute trades based on bids or offers from other market participants. CEA § 1a(33).

The CFMA amendments to the "board of trade" definition slightly alter the FBOT "located outside" statutory issue. After the CFMA, the Commission must look at whether an "organized exchange" or "electronic trading facility" is "located outside" the U.S. under CEA § 4(a). Given the new statutory definitions of those terms, it would be natural and logical to place emphasis on where an "organized exchange" is "organized" or where the persons "maintaining" or "providing" the electronic trading facility are found in order to establish whether an FBOT is "located outside" the U.S. Dunn v. Commodity Futures Trading Commission, 519 U.S. 465, 475 (1997) (Court adopts "quite natural" reading of CEA's Treasury Amendment exemption).

The CFMA amendments therefore buttress interpreting the statute to confirm that a board of trade is located outside the U.S. under Section 4(a) of the CEA if: 1) the board of trade is subject to direct substantive government regulation outside the U.S.; 2) the board of trade is legally organized outside the U.S.; and 3) the board of trade's self-regulatory functions, including its management, are being provided and maintained outside the U.S. FIA believes the Commission should confirm through a safe harbor, statutory interpretation that any board of trade satisfying these three factors is "located outside" the U.S. under CEA § 4(a).[8]

These three factors are not new; each should have had relevance to prior determinations about an FBOT's location. After all, CEA § 4(a) never provided that the location of an exchange's trading floor alone determined where the exchange was located. For example, any regulator in a foreign country is only going to exercise direct supervisory and regulatory jurisdiction over an exchange that is located within that jurisdiction.[9] An exchange that submits, and is subject, to a foreign regulator's jurisdiction therefore should be located in that jurisdiction. Similarly, businesses are often found to be located, as a matter of law, where they are legally organized and incorporated.[10] The CEA's longstanding focus on effective self-regulation makes the location of an exchange's self-regulatory personnel and management another logical factor for determining whether the exchange is located outside the U.S.[11]

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[8] FIA appreciates that it might be possible for a board of trade to show that it is located outside the U.S. under CEA § 4(a) without meeting each of these three factors. However, any board of trade that does meet these three factors should fit comfortably within any Commission-issued interpretative safe harbor on "located outside."

[9] Some have expressed concern that a form of sham regulatory arrangement could be constructed by unscrupulous operators to avoid CFTC scrutiny of trading operations. Interpreting the statute to contemplate substantive foreign regulation of an FBOT would seem to eliminate that concern.

[10] Judicial precedent supports finding an entity to be "located," for jurisdictionally purposes, in its state of incorporation. See Federal Power Commission v. Texaco, Inc., 377 U.S. 33, 39 (1964) (natural gas company found to be "located" in its state of incorporation); Firstar Bank, N.A. v. Faul, 253 F.3d 982, 994 (7th Cir. 2001) (national bank found to be "located" in the state listed in its organization certificate).

[11] The statutory "organized exchange" definition also underscores that self-regulation is integral to the concept of an exchange. CEA § 1a(27).

This multi-factor test does allow an exchange to be "located outside" the U.S. and considered to be an FBOT, yet still have substantial business ties to the U.S., because the statute's language and structure compel that result.[12] An FBOT could be both located outside the U.S. and engaged in substantial business activities in the U.S., including the placement of servers or trading terminals in the U.S. to allow for better, quicker service for U.S. customers. Congress, however, has provided in CEA § 4(a) that the only inquiry should be whether the FBOT is "located outside" the U.S., not whether the FBOT has no substantial contact with the U.S. Once an FBOT reasonably determines it is "located outside" the U.S., FCMs and other market participants should be able to rely on the FBOT's representation. No further action is required.

The CFMA provides further support for interpreting CEA §4(a) in a manner that would allow electronic trading exchanges regulated, organized and operated overseas to qualify as FBOTs. Section 126 of the CFMA itself contains specific congressional findings and a "sense of the Congress" which are directly related to the statutory interpretation question the Commission has posed.[13] As the Commission well knows, in Section 126 of the CFMA Congress found that

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12 The statute's terms, rather than the agency's policy views, govern. See Goldstein v. SEC, No. 04-1434, slip. op. at 14 (D.C. Cir. June 23, 2006) ("the Commission's interpretation of the word 'client' comes close to violating the plain language of the statute"); American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986)(in defining "broker" statutory terms control).

13 SEC. 126. INTERNATIONAL ACTIVITIES OF THE COMMODITY FUTURES TRADING COMMISSION.

(a) FINDINGS -- The Congress finds that --

(1) derivatives markets serving United States industry are increasingly global in scope;

(2) developments in data processing and communications technologies enable users to risk management services to analyze and compare those services on a worldwide basis;

(3) financial services regulatory policy must be flexible to account for rapidly changing derivatives industry business practices;

(4) regulatory impediments to the operation of global business interests can compromise the competitiveness of United States businesses;

(5) events that disrupt financial markets and economies are often global in scope, require rapid regulatory response, and coordinated regulatory effort across international jurisdictions;

(6) through its membership in the International Organization of Securities Commissions, the Commodity Futures Trading Commission has promoted beneficial communication among market regulators and international regulatory cooperation; and

(7) the Commodity Futures Trading Commission and other United States financial regulators and self-regulatory organizations should continue to foster productive and cooperative working relationships with their counterparts in foreign jurisdictions.

(b) SENSE OF THE CONGRESS -- It is the sense of the Congress that, consistent with its responsibilities under the Commodity Exchange Act, the Commodity Futures Trading Commission should, as part of its international activities, continue to coordinate with foreign regulatory authorities, to participate in international regulatory organizations and forums, and to provide technical assistance to foreign government authorities, in order to encourage --

(1) the facilitation of cross-border transactions through the removal or lessening of any unnecessary legal or practical obstacles;

derivatives markets are increasingly global, that regulatory policy must be flexible, that regulatory impediments to global business could compromise the competitiveness of U.S. business, and that the Commission should continue to foster strong relationships with its foreign counterparts. Based on those findings, Congress advised the Commission to facilitate cross-border transactions, avoid unnecessary legal obstacles, develop international best practices, and strengthen international market protection. These congressional findings and guidance offer further support for interpreting the "located outside" the U.S. language in Section 4(a) to allow exchanges regulated, organized, and operated overseas to continue to be FBOTs.

One of the major purposes of the CEA now is to "promote responsible innovation and fair competition among boards of trade, other markets and market participants." CEA § 3(b). FIA's plain meaning application of the "located outside" test fulfills the fair competition statutory purpose by allowing FBOTs to compete among themselves and directly with U.S. DCMs for U.S. customer business. Facilitating that kind of direct competition will be essential to achieving the promise of the CFMA. Vigorous direct competition through multiple market choices will create the right kind of incentives to spur the development of more and better markets, with more and better self-regulation. In contrast, a "located outside" interpretation that could force FBOTs to eschew U.S. contacts and business, unless they subject themselves to duplicative CFTC regulation,[14] could cause FBOTs to cease or curtail doing business in the U.S. Many U.S. market participants would then be denied access to products offered by those FBOTs on what could be liquid and cost-efficient trading facilities. FIA member firms favor the development of as many liquid markets as possible in order to serve all customer needs by sparking innovations, shrinking bid-ask spreads, and reducing trading/clearing fees. The statutory interpretation FIA has recommended for the Commission's consideration is well-grounded in the pro-competition philosophy Congress adopted in the CFMA.

<u>The "Direct Access" Issue</u>

The Commission specifically asks for comment on "the point at which an FBOT that makes its products available for trading in the U.S. by permitting direct access to its electronic trading system from the U.S. (direct access) is no longer 'located outside the U.S.' for purposes of Section 4(a) of the Commodity Exchange Act." 71 *Fed. Reg.* 34070. The Commission has further explained: "Direct access to an FBOT's trading platform enables market participants to directly interact with a market, including observing prices, bids, offers, and the depth of market in real-time, making trading decisions and executing orders in a non-intermediated, non-filtered manner." 71 *Fed. Reg.* 34073.

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(2) the development of internationally accepted regulatory standards of best practice;

(3) the enhancement of international supervisory cooperation and emergency procedures;

(4) the strengthening of international cooperation for customer and market protection; and

(5) improvements in the quality and timeliness of international information sharing.

14 The CFTC was created with a mandate to avoid duplicative, overlapping regulation. It would be ironic, at best, if the CFTC's FBOT policy achieves the very thing Congress sought to avoid when it created the agency. 120 Cong. Rec. 34,997 (remarks of Sen. Talmadge, CFTC jurisdiction designed "to avoid unnecessary overlapping and duplicative regulation.")

While FIA understands the Commission's emphasis on non-intermediated trading in one sense, FIA does not believe the "located outside" language in CEA § 4(a) turns on whether an exchange affords direct access or not. How someone accesses an exchange would not seem to be relevant to whether that exchange is "located outside" the U.S. Exchanges place servers and trading terminals in the U.S. to make trading faster and more efficient for U.S. market participants. But that placement decision has nothing to do with whether the exchange is "located outside" the U.S. Under CEA § 4(a), that question must be resolved independent of any consideration of the contacts an FBOT might have with the U.S. Due to the legal risk FCMs and other regulated intermediaries may face over proper resolution of the FBOT question, FIA urges the Commission to adopt the view that the "direct access" issue has no legal bearing on whether a board of trade, exchange or market is "located outside the U.S." under CEA § 4(a).

Even if the Commission disagrees and determines that whether an exchange affords "direct access" could be relevant to whether that exchange is "located outside" the U.S., FIA requests that the Commission reconfirm what has been understood to be its AORS policy since at least 1999. Under that Commission policy, it would not constitute "direct access" for U.S. customers to obtain access to an exchange through an AORS or other form of order entry and execution intermediation performed by a U.S. registered FCM or a foreign firm operating under a CFTC-Rule 30.10 exemption. There should be no legal uncertainty if a foreign exchange allows U.S. customers to access its markets through such regulated intermediaries that the foreign exchange could lose its status as an FBOT under CEA § 4(a).[15]

On the other hand, if a foreign-based exchange is offering its electronic trading systems directly to U.S. customers without any involvement by a regulated intermediary -- whether or not in addition to allowing U.S. customer access through an AORS -- FIA understands that exchange would be offering "direct access" to U.S. customers and may be of regulatory interest to the Commission. The Commission already has taken enforcement action under CFTC Rule 32.11 against a foreign trading facility operating an Internet-based trading platform that allowed U.S. residents directly to buy and sell commodity options. *In the Matter of Trading Exchange Network*, CFTC No. 05-14 (2005). Although CFTC Rule 32.11 contains a "foreign board of trade" exemption which parallels the FBOT exemption in CEA § 4(a)(see CFTC Rule 1.3(ss)), the Commission found the respondent to violate CFTC Rule 32.11 for soliciting and accepting orders from U.S. residents for commodity options.

This action could be interpreted to indicate the Commission's belief that foreign electronic trading facilities used to solicit and accept orders directly from market participants may not be considered to be foreign boards of trade. While FIA would disagree if the foreign-located exchange met the three "located outside" the U.S. statutory FBOT factors stated earlier

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15 In this regard, FIA disagrees strongly with a prior Commission's statement in 1999, that "boards of trade that were accessible from within the U.S. via trading screens, the internet or other automated trading systems were not 'located outside the U.S. for purposes of section 4(a) of the Act'" 71 Fed. Reg. 34073. FIA requests that the CFTC disavow that statement. In our view, a board of trade's location is not affected, in any way, by how customers access that market. Indeed that prior Commission's misreading of the statute does not take into account the more recent technological developments whereby intermediaries provide software and other mechanisms to clients through which orders may be entered directly on exchange electronic trading systems.

(supra at 2),[16] FIA appreciates that the Commission's view of "direct access" would be consistent with its longstanding and analogous position that foreign-based entities that solicit U.S. customer business are of regulatory concern to the Commission and must be either registered as futures commission merchants or qualified for an appropriate exemption.[17]

Based on these precedents, when a foreign exchange allows direct access to its electronic market without any regulated intermediary involvement, that exchange could consider applying for a CFTC no-action letter or a CFTC exemption under CEA § 4(c).[18] In FIA's view, however, any foreign exchange "located outside" the U.S. under CEA § 4(a) would qualify legally as an FBOT even if it provides for "direct access."

The Value of the No-Action Letter Approach

By Order dated June 2, 2000, the Commission instructed its staff to begin issuing no-action letters to FBOTs subject to terms and conditions or other guidelines prescribed by the Commission. That Order was published by the Commission in the Federal Register on June 18, 2000. 64 Fed Reg. 32829. The Commission's recent Federal Register notice lists the multiple no-action letters the agency's staff has issued with the Commission's authorization and consent. 71 Fed. Reg. 34071, notes 10-12.

As many observers testified at the Commission's June 27 hearing, the no-action system has worked well. It has the virtues of flexibility, adaptability and accountability, all without the legal risk formal Commission action would present. Staff no-action letters are not agency action under the Administrative Procedure Act and should not be subject to challenge by disgruntled competitors. Board of Trade of the City of Chicago v. Securities and Exchange Commission, 883 F.2d 525, 530-32 (7th Cir. 1989) (staff no-action letter not subject to judicial review) is particularly instructive on this point. The Seventh Circuit refused to consider a no-action letter to be agency action that was subject to judicial review even though the no-action letter was both reviewed by the agency and integral to a statutory action the agency was taking.

At the same time, some have expressed concern that the FBOT no-action letters are formally issued by the staff, not the Commission. That concern is more form than substance. The no-action process is a Commission process in every meaningful respect.

In any event, FIA recommends that the Commission itself take action now to adopt a safe harbor interpretive statement setting forth the "located outside" the U.S. criteria under CEA § 4(a), as we have set forth earlier in this letter.[19] Foreign-located exchanges and regulated

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16 The Commission's Order of Settlement recites that the respondent was not subject to regulation in its home country, or anywhere else, so it would not have met at least one of the three "located outside" FBOT safe harbor factors set out in this letter. See *In the Matter of Trade Exchange Network*, CFTC No. 05-14, at 2 (Sept. 29, 2006).

17 See http://www.cftc.gov/opa/backgrounder/opap30bkoia.htm (the Commission's Backgrounder on Rule 30.10 Exemptions).

18 Another alternative would be to seek designation as a contract market or registration as a derivatives transaction execution facility subject to some form of lead regulator concept which the Commission would negotiate with its foreign counterparts.

19 In the past, the Commission has issued such safe harbor interpretations in the context of its 1990 forward contract interpretation and the 1989 swaps policy statement.

intermediaries serving customers on those exchanges should be able to do business with legal certainty knowing that the exchange qualifies as an FBOT and the contracts traded on that exchange are not potentially unenforceable under the CEA. There should be no doubt, for example, that an FBOT that permits access to its markets by U.S. customers under an AORS or other form of intermediation from an FCM or Rule 30.10 exempt firm may continue to operate without legal risk under CEA § 4(a). The Commission's safe harbor interpretation should reconfirm this position, especially for those exchanges that do not offer "direct access."

Even for those foreign exchanges that do offer "direct access," it is important for the Commission to confirm that an FBOT offering "direct access" maintains its legal status as an FBOT "located outside the U.S." under CEA § 4(a). The systemic risk implications of this issue could be profound. If an FBOT loses its FBOT status once it offers "direct access," regulated intermediaries and their customers doing business on that FBOT could face substantial risk of contracts becoming unenforceable under CEA § 4(a), with potentially far-reaching consequences. That is a major reason why FIA insists that an FBOT "located outside the U.S." under CEA § 4(a) must remain an FBOT even if that exchange offers direct access to U.S. customers.

At the Commission's June 27 hearing, some participants raised the efficacy of using the Commission's exemption authority in Section 4(c), rather than the current no-action approach. Under Section 4(c), the CFTC could exempt an FBOT or any other party from the DCM requirements in Section 4(a) and virtually any other requirement under the CEA. Section 4(c) exemptions, like a no-action letter, do not mean that the Commission has decided it has, or is asserting, jurisdiction over the transaction or parties being exempted. Congress and the Commission have made that clear long ago. See 58 Fed. Reg. 5587, 5588 and note 13 (Jan. 22, 1993) (CFTC Adoption of Swaps Exemption in Part 35). For example, the Commission could grant an exemption under a Section 4(c) public interest finding that would be available to both boards of trade located outside the U.S. under the safe harbor criteria stated earlier (see <u>supra</u> at 2) and to boards of trade that do not meet those criteria, but want to avoid DCM regulation. Exemptions under CEA § 4(c) do offer some level of reasonable legal certainty, as we have seen in the past.

That increased legal certainty comes at a cost, however. Section 4(c) exemptions are Commission actions and would be subject to judicial review. Any competitor of a foreign exchange could file suit to challenge a Commission-granted CEA § 4(c) exemption. That legal tactic, even if not ultimately successful, could impose undue delay in having a new foreign exchange enter the U.S. market and surely would increase the cost for a new exchange of starting up its business. Even the threat of a law suit after an exempt FBOT begins operations could cloud the legal certainty over an ongoing market.

Section 4(c) exemptions also might disenfranchise retail, non-institutional customers from trading on an FBOT. Section 4(c)(2)(A) limits the Commission's ability to exempt transactions from the DCM requirement in CEA § 4(a) to those transactions entered into solely with "appropriate persons." The statutory "appropriate person" definition lists a number of "institutional" or "otherwise-regulated" market participants, but not unregulated individuals. (See CEA § 4(c)(3)). Congress left it to the CFTC to include as appropriate persons "such other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections." CEA § 4(c)(3)(K). Some or all retail customers could be foreclosed from participating directly in an exempt FBOT market under CEA § 4(c), a result that could hurt U.S. retail customers and the FBOT itself.

Practical Considerations Relating to the Suggested U.S. Contact Triggers

The Commission has proposed three general categories that could cause an FBOT to lose its "located outside" the U.S. status: a) a high level of U.S. customer trading on the FBOT; b) the existence of FBOT facilities, like servers, in the U.S. and c) the design of an FBOT's trading products to replicate those traded on U.S. DCMS, including deliveries in the U.S. These categories were the subject of considerable, informed discussion at the June 27 hearing.

FIA has two over-riding concerns about these criteria. First, none of these criteria should affect the legal analysis whether an FBOT is located outside the U.S. under CEA § 4(a). As explained earlier, any FBOT that meets the three "located outside" factors should be found to be an FBOT for purposes for CEA § 4(a) no matter how much trading volume it receives from the U.S., whether its servers or terminals are placed in the U.S., or its contracts involve "commodities" with a U.S. nexus. Second, FIA endorses the over-arching theme adopted by the New York Board of Trade in its comment letter filed with the Commission on June 26, 2006. NYBOT warned that imposing additional U.S. regulation for FBOTs based upon any of these general categories is not "possible" "without being arbitrary and inviting reciprocity from" foreign regulatory bodies. NYBOT June 26, 2006, letter at 2. FIA agrees with this general concern and offers some additional points and perspectives for the Commission's consideration.

U.S. Customers

The Commission attempted to find an objective measure of U.S. involvement in an FBOT's business through an accounting of U.S. customer trading. In FIA's view, however, using U.S. customer volume as a trigger mechanism would be problematic, impractical and costly, even if it was consistent with the statute, which it is not.

At the Commission's June 27 hearing, many witnesses testified that ascertaining when trading is done for a true U.S. customer is difficult and cumbersome. FIA Chairman Richard Berliand testified there are at least eight different ways to account for a customer's location in the context of a fund or other form of collective investment: the location of 1) the individual investors; 2) the fund vehicle itself; 3) where the advisor to the fund is domiciled; 4) where the advisor is organized; 5) the intermediary placing the order for the fund; 6) the office of the intermediary where the order is placed; 7) the software used for routing the order; and 8) the exchange gateway to which it is being routed. June 27 Hearing Transcript at 117. In short, the complexity of modern trading makes it unworkable, and potentially inaccurate, to characterize many traders as being from the U.S.

Even if that was not true, customers that are located in the U.S. could be hurt by this proposal. No FBOT would want to risk triggering non-FBOT status with its attendant legal certainty issues. FBOTs could be expected therefore to adopt ceilings on U.S. customer positions to avoid that legal risk. As a result, U.S. customers could find their trading on an FBOT to be severely restricted to the point that appropriate hedging and portfolio management strategies would need to be abandoned or curtailed. Sophisticated U.S. customers might find a way to side-step those restrictions (even at a cost), using OTC transactions or off-shore affiliates to place trades. A policy that encourages those forms of trading outside the CEA's reach can hardly be championed as promoting regulatory or national economic objectives. Moreover, retail U.S. customers could not readily and realistically avail themselves of these techniques.

U.S. FCMs would also be harmed by this policy. Firms would be required by FBOTs to count U.S. customers' trading volume, a process that would impose special costs and seemingly unmanageable obligations on U.S. FCMs, potentially discouraging them from sending business to FBOTs, thereby reducing competition.[20] Some of the administrative expense of capturing U.S. customer volume would involve substantial and costly changes to the infrastructure of firms' trading platforms which today may route foreign and U.S. customer business through the same operations center in the U.S. before transmission to an FBOT. Treating that foreign customer business as U.S. customer business shows that the so-called certainty of an objective U.S. customer volume number is neither certain nor objective.

Some of those increased FCM costs could be both substantial and incalculable. For example, suppose an FBOT decided to try to stay under the U.S. customer limit by restricting the number and size of orders a U.S. FCM could send to the FBOT. If U.S. FCMs adopted that sensible approach, they could face serious risks in deciding which of its customer orders to fill when filling all U.S. customer orders would exceed its limit. In that circumstance, would and could the CFTC grant immunity to U.S. FCMs for giving one U.S. customer a partial fill while another received a complete fill? Would that immunity flow from a Commission exemption or staff no-action? How else could an FCM avoid the litigation risk it would face from the customer whose orders did not get filled? How could U.S. FCMs compete with their overseas counterparts who would have no limit on the amount or size of orders they could enter on the FBOT? Is this something the CFTC could take into account in granting foreign firms exemptions under Rule 30.10 in order to level the playing field?

Establishing a U.S. customer limit also could create legal certainty anomalies. For example, if a German Bank copies the Bund futures contract on EUREX and enters into an OTC trade with a U.S. hedge fund, the transaction is completely excluded from the CEA. If the same trade occurred on EUREX, after (and if) EUREX exceeded whatever U.S. customer limit the CFTC might impose, the EUREX trade would become an illegal futures contract since EUREX could no longer claim to be an FBOT. As a result, the trade on the regulated exchange would be illegal under the CEA, while the identical OTC trade would be perfectly legal.

U.S. Technology Contacts: Network Servers

FIA understands that FBOTs have placed, or may want to place, servers in the U.S. in order to enhance the ability of U.S. market participants to receive the quickest order fills and service from the FBOT's electronic trading system. The practical benefits of U.S. server placement for U.S. market participants are substantial: from faster fills to more real-time market

20 It is unclear how this policy would affect firms operating under Rule 30.10 exemptions and doing business with U.S. customers. Would orders from U.S. customers that are routed to a foreign brokerage firm's operations center be considered U.S. customer business for this purpose? How would the Commission handle the cross-border implications of a U.S. customer limit?

data. Market participants throughout the world are looking for quicker, more efficient ways to trade everyday in global markets where every millisecond counts. FBOTs that place servers in the U.S. are performing a vital service by allowing U.S. market participants to compete for speed of execution with their counterparts overseas. The Commission typically administers the CEA to promote trading opportunities for U.S. market participants. Discouraging FBOTs from providing the best service to U.S. customers can not be consistent with the CEA's purposes

This aspect of the FBOT issue illustrates well the problems inherent in trying to tie legal and regulatory policy decisions to particular kinds of technology. Innovations in technology and market structure will always move faster, than rigid legal concepts. As long as technology is being used to make markets fairer, faster, and more efficient, it would not be in the public interest for the Commission to penalize FBOTs by disqualifying them from being "located outside" the U.S. In CEA § 3(b), Congress itself recognizes that responsible innovations are to be promoted, not penalized. Commission policy should be consistent with that statutory objective.

Nature of the Trading Product

Nationalizing a particular form of futures contract, and asserting that it must be traded only under full U.S. regulation, would promote a dangerous precedent out of step with our global economy. In response, other countries could develop a similarly protectionist jurisdictional approach that could increase regulation and costs for products traded on U.S. DCMs. How would the Chicago Mercantile Exchange's Eurodollar futures be treated under that test? What impact would this policy have on other U.S. traded futures on international commodities with delivery points overseas? What about the New York Mercantile Exchange's announced new contract offering for Singapore-bunker fuel futures, which calls for physical delivery in Singapore?[21] What about other NYMEX offerings that it has indicated may be proposed for European delivery points?

The Commission does have a regulatory interest in making sure that market surveillance and integrity of any futures contract traded on a U.S. DCM is not compromised. If an FBOT decides to list such a contract and compete directly with a U.S. exchange, any CFTC surveillance concerns should be addressed to the FBOT's foreign regulator, as was done recently with ICE Futures and FSA. "Nationalizing" futures contracts would be an unwarranted, over-reaction.

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21 See http://www.singaporeoffshore.com; or http://www.nymex.com/SE_term.aspx.

Conclusion

The Commission's request for comment has stimulated a healthy dialogue about an important issue. FIA urges the Commission to avoid both allowing any legal uncertainty to fester and imposing artificial regulatory constraints on competition by confirming that an exchange that is 1) subject to substantive government regulation overseas; 2) legally-organized overseas; and 3) managed for self-regulatory purposes overseas, qualifies as an FBOT under CEA § 4(a), especially where U.S. market participants access the FBOTs only through regulated intermediaries offering AORs or other systems for purposes of order execution. While FIA believes this same legal conclusion should apply even if the electronic trading conducted on an FBOT allows U.S. market participants "direct access" to the FBOT without any regulated intermediary, FIA appreciates that markets offering such "direct access" may seek appropriate no-action or exemption relief under CEA § 4(c). FIA has every confidence in the Commission's administration of this policy consistent with the statute in order to promote fair competition and address any substantive regulatory issues or gaps that may arise. When called for, the Commission's collaborative efforts with its colleagues around the world can be counted on to safeguard the public interest.

Very truly yours,

John Damgard
President