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FUTURES INDUSTRY ASSOCIATION

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April 19, 1999

1999 APR 19 P 11:11

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

COMMENT

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RECORDS SECTION

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CFTC

Re: Proposed Rules Governing Access to Automated Boards of Trade

Dear Ms. Webb:

The Futures Industry Association ("FIA") respectfully submits this comment letter and FIA's proposal for an interim order in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") request for comment on its Proposed Rules Governing Access to Automated Boards of Trade ("Proposed Rules").¹ This Comment Letter highlights FIA's concerns with the Proposed Rules and proposes in their place an interim order ("Interim Order") that FIA recommends the Commission implement thirty-days after its publication in the Federal Register.

The FIA is a not-for-profit corporation, which acts as a principal spokesman for the futures and options industry. Its members include approximately 70 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all segments of the futures industry, both national and international. Reflecting the scope and diversity of our members, FIA estimates that its members effect more than 80 percent of all transactions on US contract markets.

Overview and General Comments

CFTC Proposed Rule 30.11 would establish an exemptive procedure under which foreign exchanges could petition the Commission under Commodity Exchange Act ("CEA") section 4(c)² for orders that would permit electronic access to those exchanges from United States locations without requiring them to be designated as US contract markets. US customers could use automated order routing systems ("AORSS") meeting the standards of Proposed Rule 1.71 to enter orders on the exempt electronic exchanges and on US futures exchanges.

¹ 64 FR 14159 (March 24, 1999). On March 31, 1999, the FIA filed a letter requesting that the CFTC withdraw the Proposed Rules or grant an additional sixty-day extension of the comment period.

² 7 USC § 6(c).

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A. Objections

FIA finds the Proposed Rules objectionable in two principal respects:

- a. Every electronic foreign exchange that is accessed via an AORS from a US location is deemed to be located in the US and must be exempted irrespective of whether the foreign exchange permits direct non-intermediated access to the exchange's trade matching/execution facility from a US location.³
- b. They impose a comparability standard in determining whether the foreign exchange should be exempted under section 4(c), in effect requiring that every foreign electronic exchange be regulated in a manner comparable to a US exchange before a person located in the US may access that exchange using electronic means. The Commission's approach is essentially a proxy for contract market designation.

The FIA seriously questions the Commission's jurisdictional authority in proceeding under section 4(c) of the CEA. More fundamentally, FIA believes that if adopted as proposed with their underlying principles and concepts, the Proposed Rules will have a serious negative impact on the ability of US users of global futures and US regulated intermediaries to use the technologically most advanced, efficient and cost-effective means of accessing global markets. This will have serious consequences for the trading and risk management activities of US registrants and US customers alike and will impair their ability to compete effectively in a global marketplace.

The FIA is very troubled that the current controversy surrounding the Proposed Rules has raised questions concerning the current use of AORSs to access foreign markets with no terminals in the US and could mean an indefinite continuation of the moratorium imposed by the CFTC on the placement of foreign terminals in the US. FIA therefore supports the objectives of the March 30, 1999 proposal, as modified, of CFTC Commissioner Barbara Holum to "Lift the Moratorium on Placement of Foreign Terminals in the US Immediately and to Continue Deliberations on Guidelines for Foreign Terminals Independently." At the same time, FIA believes it is imperative that the Commission clarify the circumstances under which firms may use, or permit the use by their customers of, AORSs from US locations to access automated foreign markets that do not permit access to DESs in the US.

Procedurally, while the FIA prefers action by the Commission to "no-actions" by CFTC staff, for the reasons noted herein we believe it may be premature in the current circumstances for the Commission to proceed to final rules based on the Proposed Rules. The issues involved in

³ These systems are referred to herein as direct execution systems ("DESs") or Foreign Terminals and are distinguished from AORS that permit the entry of orders intermediated by third parties. This distinction is discussed in more detail below.

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developing rules are complex and will require additional time for thorough consideration of the many perspectives. Indeed, rather than proceeding unilaterally, FIA recommends that the CFTC work with other international regulators through forums such as the International Organization of Securities Commissions ("IOSCO") to develop common standards in this area that each member jurisdiction could endorse. In the interim, in order not to disrupt ongoing business relationships and to ensure that US customers and US firms are not unfairly disadvantaged in their ability to access foreign markets, we strongly urge the Commission to implement the Interim Order as set forth below.

B. FIA's Proposal: Interim Order

The FIA strongly urges the Commission to stay its consideration of the Proposed Rules and to adopt after a thirty-day notice period in the Federal Register FIA's proposal for an Interim Order Governing Automated Access to Foreign Exchanges, which consists of two parts: (a) Guidelines Governing the Use of Automated Order Routing Systems, Attachment A, hereto, and (b) Guidelines for Approval of Foreign Exchanges that Seek to Permit Direct Non-Intermediated Access to Their Trade Matching/Execution Facility from the US, Attachment B, hereto.

FIA's Interim Order:

- a. De-links regulatory treatment of AORSs from any approval required for Foreign Terminals.
- b. Articulates clear regulatory objectives rather than prescriptive rules that will permit firms that use AORSs to have the latitude necessary to make commercial and operational judgments about how they will meet regulatory requirements.
- c. Respects home country regulation of those foreign exchanges that seek to permit direct non-intermediated access from the US and is not a proxy for contract market designation by imposing a comparability standard.

This Comment Letter does not address the specifics of the CFTC's Proposed Rules. Rather, it explains the principles underlying FIA's strong concerns with the Proposed Rules and why we believe our proposal that the CFTC adopt an Interim Order more appropriately addresses the Commission's current legitimate regulatory concerns in respect of new technology without creating a new permanent regulatory construct based solely on the means of access to international markets.

Procedurally and substantively, the Interim Order strikes an appropriate balance between two compelling and time-sensitive objectives: (a) fostering innovation and the use of technology that makes trading more efficient, effective and cost-effective, and (b) safeguarding regulated firms and their customers from being harmed or disadvantaged in their use of new technology.

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Moreover, by adopting the Interim Order, the Commission could demonstrate its willingness to embrace new technology without sacrificing important customer protections. Specifically, the Commission could send a strong signal that if during this "pilot program" it has reasons to believe that the Interim Order or parts thereof are inadequate, it will take swift remedial action to remedy its regulatory concerns.⁴

I. De-Link Issue of AORSs From Approval Process for Foreign Terminals

A. Effect of AORSs Distinguished from Effect of Foreign Terminals

The FIA has strong concerns that a process commenced to formalize the Deutsche Terminbourse ("DTB" or "EUREX") no-action process⁵ has resulted in the Commission asserting regulatory jurisdiction over all foreign exchanges that may be accessed by AORSs located in the US.

The Proposed Rules state that automated markets are distinguishable from floor-based systems because the establishment of automated trading systems in the US that provide "rapid and proximate" access to foreign exchanges will cause a fundamental change in the nature of global trading and raise substantial issues regarding the regulation of increasingly international or multinational exchanges.⁶

Like the CFTC, FIA distinguishes between a DES that provides direct non-intermediated access to an automated foreign exchange's trade matching/execution facility from US locations and an AORS that allows entry of orders through another party to the foreign exchange's trade matching/execution facility. Consequently, in the FIA's view, the software provided by GL should be treated as a DES, if used by a member of the London International Financial Futures and Options Exchange ("LIFFE") to access LIFFE Connect, or an AORS, if used by a member or customer to access EUREX and that access is intermediated by a third party, e.g., a clearing member firm.

⁴ FIA believes that our proposal that the Commission implement an Interim Order after a thirty-day comment period is consistent with the CFTC's practice of implementing pilot programs, and is not otherwise inconsistent with the requirements of the Administrative Procedure Act, 5 USC § 553. Moreover, FIA notes that the CFTC previously issued an Interim Order in which it adopted interim measures in connection with the effectiveness of certain rules and regulations to avoid the unnecessary disruption of ongoing business relationships. See 53 FR 3338 (Feb. 5, 1988).

⁵ See CFTC Staff Interpretative Letter No. 96-28, Comm. Fut. L. Rep. (CCH) ¶ 26,669 (Feb. 29, 1996) (hereinafter "DTB No-Action Letter"). In June 1998, DTB changed its name to EUREX Deutschland.

⁶ 64 FR 14159, 14165.

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The critical distinction between an AORS and a DES, therefore, is that with respect to an AORS a party other than the exchange can stop the execution of the trade entered into the AORS, whereas only the exchange can stop the execution of trades entered into a DES. Consequently, if there is no direct non-intermediated execution facility for the exchange in the US, an automated foreign exchange is no more "located in the US" than is a floor-based foreign exchange.

FIA strongly objects to the Commission's conclusion that the effect of both systems is the same, that is, that the foreign exchange accessed via either an AORS or DES is no longer "located outside the US" for purposes of section 4(a) of the CEA.⁷ FIA believes instead that the proper test for determining whether a foreign exchange should seek Commission approval is whether or not that foreign exchange permits direct non-intermediated access to its trade matching/execution facility from a US location, and urges the Commission to adopt this view.

B. Jurisdictional Approach

FIA has serious reservations concerning the Commission's interpretation of sections 4(a)⁸ and 4(c) of the CEA, i.e., that if contracts of a foreign exchange are accessible from within the US via either a DES or AORS, the foreign exchange is no longer "located outside the US" for purposes of section 4(a). To be consistent, this "access" approach to assertion of regulatory jurisdiction would require the Commission to apply the same standard to any foreign exchange that can be accessed by a US person from a US location. This proposed approach of the Commission that makes no distinctions between intermediated and non-intermediated access to the trade matching/execution facility of the foreign exchange suggests that one purpose of the Commission's approach is to regulate technology rather than to address any new issues of core regulatory concern raised by technology.

More fundamentally, the Proposed Rules ignore the mandate of section 4(b)⁹ that in regulating access by US persons to foreign exchanges, the Commission not assert jurisdiction over the terms and conditions of foreign exchange contracts, the rules governing the trading of such contracts or any action of, or the organization of, foreign exchanges. To that end, the CFTC previously in approving the link between the Chicago Mercantile Exchange and the Marché à Terme International de France, and CFTC staff in issuing the DTB No-Action Letter, took the view that pursuant to section 4(b) of the CEA the mere presence of foreign terminals in the US

⁷ 64 FR 14159, 14164.

⁸ 7 USC § 6(a).

⁹ 7 USC § 6(b).

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would not cause the Commission to deem any bona fide foreign exchange to be a domestic exchange requiring designation.¹⁰

The evolution of technology should not cause the Commission to abandon its long-standing approach to regulating access by US persons to foreign markets (via registration requirements for persons providing the access, e.g., FCMs) and to become, instead, a "border patrol" who on a case by case basis will determine which foreign markets may be accessed by US persons. The Commission's remedy against a foreign board of trade that it determines has established offshore to evade US regulation is to bring an action based on section 4(a). It is bad policy and bad law for the Commission to, in effect, shift the burden on every automated foreign exchange that otherwise operates no DES in the US to demonstrate to the Commission that it should not be designated as a contract market.

II. Adopt Interim Guidelines for Use of AORSs Rather Than Prescriptive Rules

In addition to our general objection to an approach that limits the use of AORSs from US locations to foreign markets approved under Proposed Rule 30.11, FIA also questions the underlying need for Proposed Rule 1.71. Indeed, the Commission itself notes that CFTC Rule 1.16¹¹ already requires that an FCM have in place appropriate internal accounting controls and procedures for safeguarding customer and firm assets.¹² The Commission states that it proposes Rule 1.71 because Rule 1.16 does not prescribe specific controls that must be in place.¹³ Again, FIA has serious reservations concerning the Commission's desire to "prescribe" minimum standards that it believes should be adopted by any "responsible" FCM or Part 30 firm.¹⁴

In addressing regulatory concerns related to technological innovations in the marketplace, FIA believes the Commission should aim to articulate regulatory objectives and the risks that regulations are intended to address, and should permit firms flexibility in the manner in which they achieve the objectives and address the risks. The Commission should refrain from micro managing or controlling the manner in which firms elect to use new technology and should also refrain from formalizing what it deems "common sense" requirements. In summary, the Commission should accept that it will not be able to develop one framework appropriate to all circumstances.

¹⁰ See, e.g., CFTC approval on September 25, 1992 of CME rule 575 permitting the CME to implement a cross-exchange access program with MATIF, and CFTC Staff Interpretative Letter No. 96-28, Id.

¹¹ 7 CFR § 1.16.

¹² 64 FR 14159, 14173.

¹³ Id.

¹⁴ Id.

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Although the FIA has strong concerns regarding the need for the CFTC to prescribe specific controls, we submit Guidelines Governing the Use of Automated Order Routing Systems appended hereto as Attachment A that FIA proposes the Commission adopt as part of its Interim Order in lieu of Proposed Rule 1.71 in its entirety. FIA believes that the guidelines contained therein that would apply to FCMs and firms exempted under CFTC Rule 30.10 that use, or permit the use by their customers of, AORSs from US locations address the CFTC's core regulatory concerns in the use of such systems.

III. Respect Home Country Regulation of Foreign Exchanges that Seek to Provide Direct Non-intermediated Access from US Locations

Proposed Rule 30.11 describes the exemptive process that foreign exchanges would need to comply with in order to permit electronic access to their products from US locations. FIA reiterates its objection to an approach that fails to distinguish between intermediated and non-intermediated access in determining which automated foreign exchanges are subject to Proposed Rule 30.11. In addition, FIA believes that the complexity and specificity of the proposed comparability process set forth therein could be interpreted as a proxy for contract market designation.

More fundamentally, FIA objects to the Commission's assertion that a bona fide regulatory system is one that is generally comparable to the US in terms of customer protection and market integrity and is monitored for compliance.¹⁵ In fact, the Commission's approach to the term "bona fide" is contrary to the internationally accepted view that different regulatory approaches can nonetheless achieve the same regulatory goals.¹⁶ In addition, FIA believes that the Commission's approach could have the unintended consequence of encouraging foreign exchanges approved under this "comparability" approach to offer products fungible with those traded on US exchanges.

The DTB No-Action Letter reviewed issues related to the general regulatory system applicable to DTB under German law, surveillance of trading on the system, the order processing system, clearing, system integrity and information sharing. It did not analyze customer protection issues such as registration, sales practices, financial requirements, risk disclosure, customer funds protection because access to US customers under the no action letter was limited to FCMs regulated by the Commission for these purposes. It further did not reach any conclusion that the regulatory system in Germany was generally comparable to that in effect in the US.

¹⁵ 64 FR 14159, 14165.

¹⁶ Indeed, in issuing "comparability" orders under Rule 30.10, 17 CFR § 30.10, the Commission imposes a myriad of conditions in order to ensure that the scope and level of regulation of the foreign firm is generally similar to that applicable to FCMs. Therefore, FIA takes issue with the view that the term "bona fide" is synonymous with the term "comparable."

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Rather than the approach in the Proposed Rules, we would encourage the Commission in the Interim Order to confine its review to addressing the following core issues:¹⁷

- a. Is the foreign market a bona fide foreign futures exchange, i.e., does the exchange have rules governing fair and orderly markets that are monitored for compliance by the relevant foreign market authority?
- b. Is there a home regulator that acknowledges its role as lead regulator of that exchange?
- c. Does the market adhere to the IOSCO Principles for the Oversight of Screen-Based Trading Systems for Derivative Products?¹⁸
- d. Does the Commission have the ability to obtain data on general levels of trading volume originating from the US and on the number and identity of US members?
- e. Does the Commission have the ability to access necessary information?

FIA submits for the Commission's consideration Guidelines for Approval of Foreign Exchanges that Seek to Permit Direct Non-Intermediated Access to Their Trade

¹⁷ In this regard, we refer the Commission to the recent order issued by the US Securities and Exchange Commission, "TradePoint Financial Networks plc; Order Granting Limited Volume Exemption from Registration as an Exchange Under Section 5 of the Securities and Exchange Act," Securities and Exchange Act Release No. 4119910 (March 22, 1999).

¹⁸ These Principles address:

- Compliance with applicable legal standards, regulatory policies, and/or market custom or practice where relevant;
- The equitable availability of accurate and timely trade and quotation information;
- The order execution algorithm used by the system;
- Technical operation of the system that is equitable to all market participants;
- Periodic objective risk assessment of the system and system interfaces;
- Procedures to ensure the competence, integrity, and authority of system users and to ensure fair access to the system;
- Consideration of any additional risk management exposures pertinent to the system;
- Mechanisms to ensure that the information necessary to conduct adequate surveillance of the system for supervisory and enforcement purposes is available;
- Adequacy of risk disclosure, including system liability; and
- Procedures to ensure that the system sponsor, providers, and users are aware of, and will be responsive to, relevant regulatory authorities.

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Matching/Execution Facility from the US, appended hereto as Attachment B that FIA proposes the Commission adopt as part of the Interim Order in lieu of Proposed Rule 30.11 in its entirety. These requirements should be adequate to permit the CFTC to evaluate on an ongoing basis whether the foreign futures exchange is and remains a bona fide foreign exchange.

Conclusion

The advent of new technology that has the potential to make access more efficient and cost-effective and that enhances the trading and risk management capabilities of regulated intermediaries and market users should not lead to the perverse result that access is impeded rather than facilitated.

FIA is very concerned that the Commission could be setting a new standard for access to foreign exchanges that could have significant consequences for access to US exchanges if adopted by foreign jurisdictions. The Commission has not provided a convincing regulatory or jurisdictional predicate for the Proposed Rules. Indeed, one very real concern is that foreign regulators and foreign exchanges will interpret the purpose of the rules as an attempt by the Commission to protect its own regulatory franchise and to protect the competitiveness of US futures exchanges from innovations of their foreign competitors.

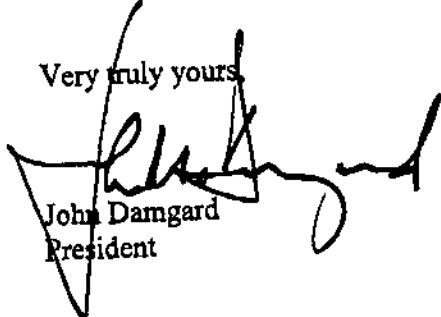
FIA believes that regulation is ineffective as a tool either to facilitate competition or to impede it. Regulation should be competition neutral. If every jurisdiction adopted the approach proposed by the Commission, the result would be regulatory gridlock. FIA strongly urges the Commission and regulators internationally to cooperate to establish common standards and procedures for approving cross-border automated trading systems.

In order to avoid regulatory gridlock and to provide US customers and US firms access to technology that makes trading more efficient, effective and cost-effective, while safeguarding regulated firms and their customers from being harmed or disadvantaged in their use of new technology, FIA urges the Commission to stay its consideration of the Proposed Rules and to adopt after a thirty-day notice period in the Federal Register FIA's proposal for the following Interim Order: (a) Guidelines Governing the Use of Automated Order Routing Systems, Attachment A, hereto, and (b) Guidelines for Approval of Foreign Exchanges that Seek to Permit Direct Non-Intermediated Access to Their Trade Matching/Execution Facility from the US, Attachment B, hereto.

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FIA appreciates the opportunity to submit these comments in response to the Commission's publication of the Proposed Rules and our proposal for an Interim Order. If the Commission or its staff has any questions regarding this letter, please contact the undersigned at (202) 466 - 5460.

Very truly yours,



John Damgard
President

cc: The Honorable Brooksley E. Born
The Honorable Barbara P. Holum
The Honorable David D. Spears
The Honorable James E. Newsome
I. Michael Greenberger
Daniel R. Waldman
Geoffrey Aronow

Attachment A**CFTC Proposed Rule 1.71: FIA Alternative Proposal****Interim Order: Guidelines Governing the Use of Automated Order Routing Systems**

The Commodity Futures Trading Commission issues the following guidelines that apply to registered futures commission merchants and firms exempted under Rule 30.10 (hereinafter "Firms") that use, or permit the use by their customers of, automated order routing systems ("AORSs") from locations in the United States:

1. The AORS used should have features that permit the implementation of internal controls and supervision, including reasonable safeguards that address unauthorized access and unauthorized trading.
2. Firms should have arrangements in place that provide them with the capability to block or otherwise restrict any customer's use of AORS when they deem it necessary to safeguard their financial or operational viability.
3. The use of AORSs should not impair Firms' ability to comply with any applicable regulatory requirement to which they are subject, including recordkeeping and reporting requirements.

Attachment B**CFTC Proposed Rule 30.11: FIA Alternative Proposal****Interim Order: Guidelines for Approval of Foreign Exchanges that Seek to Permit Direct Non-Intermediated Access to Their Trade Matching/Execution Facility from the US**

1. A board of trade ("Petitioner") that is located outside the United States and that wishes to allow from the United States direct non-intermediated access to the exchange's trade matching/execution facility ("DES") may apply for an order from the Commodity Futures Trading Commission ("CFTC") that it is not required to be designated as a US contract market.
2. The CFTC may issue such an Order if it finds that the following conditions for relief have been satisfied and the issuance of the Order would not otherwise be contrary to the public interest:
 - a. The Petitioner is an established board of trade that has been licensed pursuant to applicable laws, rules and regulations of, and whose activities are primarily located in the jurisdiction of, a licensing Foreign Authority.
 - b. The Foreign Authority represents to the CFTC that it will assume responsibility as lead regulator for the Petitioner and will monitor the Petitioner for compliance with its laws, rules and regulations on which the CFTC has based its Order.
 - c. The laws, rules, systems and compliance mechanisms applicable to Petitioner require the Petitioner to maintain fair and orderly markets, prohibit fraud, abuse and market manipulation and provide that requirements in this regard are monitored for compliance by the relevant Foreign Authority
 - d. The Petitioner represents that in the operation of its DES it adheres to the IOSCO Principles for the Oversight of Screen-Based Trading Systems for Derivative Products (June 1990).¹

¹ These Principles address:

- Compliance with applicable legal standards, regulatory policies, and/or market custom or practice where relevant;
- The equitable availability of accurate and timely trade and quotation information;
- The order execution algorithm used by the system;
- Technical operation of the system that is equitable to all market participants;
- Periodic objective risk assessment of the system and system interfaces;

- e. Petitioner maintains and consents to provide to the CFTC on a quarterly basis or upon request:
- For each contract available to be traded through Petitioner's DES accessed from the United States, the total trade volume originating from such systems compared with total worldwide volume for its products; and
 - Information that identifies, and provides the main business addresses in the United States for, those of its members and affiliates thereof that have access to DES from the United States.
- f. Petitioner consents to provide the CFTC with written notice within 30 calendar days of any material change to any information provided in its Petition to the CFTC or disciplinary action taken by the Petitioner against any person based in the US material to that person's access to the Petitioner's DES: Provided, however, that the board of trade will notify the CFTC promptly of any matter which in its judgement affects the financial or operational viability of the market.
- g. The Petitioner represents that it will file a valid and binding appointment of an agent for service of process in the United States.
- h. Satisfactory information sharing arrangements are in effect between the CFTC and the Petitioner or the Foreign Authority.
3. Unless expressly noted, the information/representations set forth above may be provided by the Petitioner or the Foreign Authority, consistent with applicable local laws, rules and regulations. The CFTC may require other information of the Petitioner to evaluate its continued eligibility for or compliance with the conditions of the order.
4. The CFTC shall publish in the Federal Register a notice of availability of each Petition received for the purpose of providing notice to the public.
5. The CFTC may, as it deems appropriate, condition, modify, suspend, terminate, or otherwise restrict the terms of any Order if the CFTC determines that a Petitioner is in material violation of any term or condition of the Order, that the continued effectiveness of the Order, in

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- Procedures to ensure the competence, integrity, and authority of system users and to ensure fair access to the system;
 - Consideration of any additional risk management exposures pertinent to the system;
 - Mechanisms to ensure that the information necessary to conduct adequate surveillance of the system for supervisory and enforcement purposes is available;
 - Adequacy of risk disclosure, including system liability; and
 - Procedures to ensure that the system sponsor, providers, and users are aware of, and will be responsive to, relevant regulatory authorities.

whole or in part, would be contrary to public policy or the public interest, or that circumstances otherwise do not warrant continuation of the Order as issued.

6. The CFTC shall act upon Petitions filed under this Provision within sixty-days of their receipt, either by issuing the Order requested, or notifying the Petitioner of the reasons for the denial.

7. If the products of multiple boards of trade are traded on the same DES, each board of trade whose products will be made available from DESs accessed from United States locations must, either individually or jointly, submit a Petition in accordance with this Provision: Provided, however, that a board of trade whose products may be offered through such DESs need not submit a petition to the CFTC under this Provision if its products are accessible on DESs pursuant to a particular linkage arrangement under the rules of a designated contract market that are in effect under section 5a of the Commodity Exchange Act.