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February 24, 2000

COMMENT

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OFFICE OF THE SECRETARIAT

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

COMMENT

Received CFTC
Records Section

Re: Proposed Amendment to Rule 1.41, 64 *Fed.Reg.* 66428 (November 26, 1999)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments on the proposed amendment to Commodity Futures Trading Commission ("Commission") rule 1.41, relating to the Commission's procedures for reviewing contract market rules. 64 *Fed.Reg.* 66428 (November 26, 1999). FIA, a not-for-profit corporation, is a principal spokesman for the futures industry. Its members include approximately sixty 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.

In the exercise of its authority under section 4(c) of the Commodity Exchange Act ("Act"), the Commission has proposed to adopt a new paragraph (z) to rule 1.41. Subject to certain conditions set forth in the rule and discussed below, proposed rule 1.41(z) would exempt an exchange from the rule review and approval procedures set forth in section 5a(a)(12) of the Act and other paragraphs of Commission rule 1.41.¹ The Commission would neither review nor approve a rule submitted pursuant to proposed rule 1.41(z), and a US futures exchange would be authorized to place a new rule or rule amendment into effect the business day following the Commission's receipt of the exchange rule.

Proposed rule 1.41(z) is designed to complement the Commission's recently adopted rule 5.3, which authorizes exchanges to list new contracts for trading without first seeking Commission approval.² The proposed rule, therefore, continues the Commission's announced efforts to refocus its regulatory program and to assume a less direct role in regulating the activities of the US futures markets and other futures industry participants.

¹ We ask the Commission to confirm that the proposed rule would also apply to rules adopted by exchange clearing organizations.

² See 64 *Fed.Reg.* 66373 (November 26, 1999.)

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In this connection, FIA understands that the Commission is currently developing a proposal that, if implemented, could result in a significant restructuring of the Commission's regulatory program. FIA supports the Commission's goals in this regard. The relationship between proposed rule 1.41(z) and the Commission's more comprehensive regulatory reform efforts is unclear, however. Therefore, when the Commission publishes its new proposal for comment, we request that the Commission explain in the accompanying *Federal Register* release how proposed rule 1.41(z) fits in the new proposal. The Commission may also wish to consider accepting additional comments on proposed rule 1.41(z) at that time. Although FIA generally supports proposed rule 1.41(z), its comments below are based on the Commission's existing regulatory scheme and could change in light of the Commission's new proposal.

The Proposed Rule Strikes an Appropriate Balance

In order to take advantage of the provisions of proposed rule 1.41(z), an exchange must be designated as a contract market in at least one contract that is not dormant. In addition, the rule submission must include the text and a brief description of the rule, along with a summary of any substantive opposing views expressed by members of the exchange or others with respect to the rule. Most important, the exchange must certify "that the rule neither violates nor is inconsistent with any provision of the Act or the regulations thereunder." Proposed rule 1.41(z)(1)(iii)(D).

FIA interprets this latter requirement to include a certification that the exchange rule is consistent with the public interest and the provisions of section 15 of the Act, which requires the Commission, in connection with its review of any exchange rule, to consider the public interest to be protected by the antitrust laws.³ FIA believes it is appropriate to require such a certification. We also support the proposed requirement that an exchange include in its submission a summary of any substantive opposing views expressed by members or others with respect to the proposed rule.⁴ In this regard, an exchange should also continue to have the obligation to include in its

³ See *Standards to be Applied in Disapproving Contract Market Rules*, 45 *Fed.Reg.* 34873 (May 23, 1980), in which the Commission stated:

It is the view of the Commission that these provisions of the Act [*i.e.*, section 5(7), which provides that a board of trade must demonstrate that futures trading will not be contrary to the public interest, and section 15] demonstrate that Congress did not intend to limit the Commission's authority to disapprove a contract market rule under section 5a(12) merely to those rules which are directly contrary to a specific substantive or procedural requirement of the Act or the Commission's regulations. Rather, the Commission understands its statutory responsibility to disapprove as well those contract market rules which conflict or are inconsistent with any of the policies, purposes and public interest considerations embodied in the Act.

⁴ We note, however, that no provision of the Act or the Commission's rules requires an exchange to solicit the views of its members or others before adopting the rule and submitting it to the Commission. Therefore, as is true today, the value of this requirement depends solely on the rulemaking procedures of the relevant exchange. As exchanges "demutualize" and as new for-profit exchanges are approved, the extent to which an exchange governing board solicits the views of persons potentially affected by a particular rule may be limited.

submission an explanation of the purpose and effect of the proposed rule, including a description of any potential anti-competitive effects on market participants. Commission rule 1.41(c)(1)(i)(D). Such information would be useful to the Commission and others that may have concerns or questions about the purpose and scope of particular rule.⁵ At the same time, it would not increase the regulatory burden on exchanges, which would have to consider the potential anti-competitive effects of a rule in order to make the required certification under the proposed rule in any event.

The proposed rule addresses a principal concern that we raised in response to the Commission's request for comment on the exchange *Petition for Exemption Pursuant to Section 4(c) of the Act* ("Petition"). 64 *Fed.Reg.* 46356 (August 25, 1999). As the Commission is aware, with limited exceptions, the exemption proposed in the Petition would permit exchanges to adopt and implement rules without regard to the provisions of the Act or the Commission's regulations that currently govern their conduct. The Commission could not initiate a proceeding to alter or supplement any such rule, unless it found that the rule was likely to cause fraud or render trading readily susceptible to manipulation. In its comment letter, FIA expressed the fear that the full exercise of the authority requested in the Petition could result in regulatory chaos and place FCMs and other Commission registrants that are members of one or more self-regulatory organizations in an untenable position.⁶

Proposed rule 1.41(z) alleviates this concern by requiring an exchange to certify that a particular rule does not violate and is not inconsistent with the Act and Commission regulations. Further, the proposed rule thereby assures the Commission and other affected parties an appropriate opportunity to review and participate in the development of a coherent regulatory reform effort across markets.

More Substantial Regulatory Reform is Required

As the existing exchanges continue to adapt to a changing market environment and as new exchanges with different trading systems develop, it will become increasingly more difficult for

⁵ The requirement that the exchange explain the purpose of the rule will also assist the Commission in identifying those emergency rules that the Commission must review in accordance with the provisions of section 5a(a)(12)(B).

⁶ As FIA explained:

Under the existing regulatory structure, exchanges have the authority to regulate only their members with respect to conduct or activities on their respective exchanges. Yet, an FCM may be a member of more than one exchange (or may not be a member of any exchange). Moreover, FCMs and other Commission registrants would still be subject to the Act and the Commission's regulations, as well as National Futures Association ("NFA") regulations. To the extent that an exchange rule would conflict with the provisions of the Act or Commission or NFA regulations, FCMs and other registrants would be placed in an untenable position.

exchange governing boards to certify that a certain rule is consistent with the Act and the Commission's regulations. For example, it is apparent that no exchange believes it would be able to make the required certification with respect to the various initiatives that the exchanges suggested in their Petition.⁷ Moreover, whether a rule is in the public interest or is consistent with the purposes of the antitrust laws is not always evident on its face. This determination depends on an analysis of all of the facts and circumstances surrounding the rule. Consequently, an exchange may well be unable or unwilling to make the required certification with respect to those rules that it will want to implement promptly.⁸

FIA, therefore, urges the Commission to redirect its focus. As all market participants now generally agree, neither the Act nor the Commission's regulations accurately reflect the needs of today's markets or of the institutional participants that dominate them. Therefore, the far more pressing need is to revise those provisions of the Commission's own regulations that govern the conduct of US exchanges.⁹ The potential benefits of proposed rule 1.41(z) will not be realized fully until the Commission undertakes to revise its own rules.¹⁰

Regulatory reform, of course, must not be limited to the exchanges. In other forums, including most recently the Commission Roundtable discussion held on December 2, 1999, representatives of FIA and certain of its member firms, identified those reforms that are of particular importance to market intermediaries. These issues include: (1) facilitating the review and approval of new exchange applicants; (2) developing procedures for the review and approval of new clearing

⁷ See Letter from Thomas R. Donovan, President, Chicago Board of Trade, M. Scott Gordon, Chairman, Chicago Mercantile Exchange, and R. Patrick Thompson, President, New York Mercantile Exchange, to David D. Spears, Acting Chairman, Commodity Futures Trading Commission, dated June 25, 1999. These initiatives included: (1) payment for order flow; (2) inducements to make markets or trade; (3) guaranteed pricing or execution; (4) price reporting; and (5) account identification.

⁸ For this same reason, FIA does not believe it would be appropriate to require an exchange to submit all eligible rules under proposed rule 1.41(z). The Commission should not constrain either its own flexibility or the flexibility of the various self-regulatory organizations in this regard.

⁹ In this regard, we understand that the Commission's congressional oversight committees have encouraged the Commission to use its exemptive authority to reduce the regulatory burdens on US futures exchanges. See, e.g., Letter to William J. Rainer, Chairman, Commodity Futures Trading Commission, from Richard G. Lugar, Chairman, Senate Agriculture Committee; Larry Combest, Chairman, House Committee on Agriculture; Charles W. Stenholm, Ranking Member, House Committee on Agriculture; Thomas W. Ewing, Chairman, Subcommittee on Risk Management, Research and Specialty Crops; and Peter G. Fitzgerald, Chairman, Research, Nutrition and General Legislation Subcommittee, dated November 30, 1999.

¹⁰ In the interim, FIA does not object to Commission review of exchange rules, provided such review is timely. In our comment letter on the exchange Petition, FIA noted that the Commission must revise its procedures to assure that it addresses particular issues, and makes decisions with respect to those issues, promptly. We noted as an example that it was not until August 1998 that the Commission took final action on the Chicago Mercantile Exchange petition for rulemaking relating to the post-execution allocation of certain bunched orders, which the exchange had filed in February 1992. Fn. 2, supra. In this regard, FIA recommends that the Commission propose revisions to rule 13.2 to establish a more formal procedure and timetable for considering petitions for rulemaking.

organizations that may be independent of an existing exchange or exchange applicant; (3) facilitating the ability of Commission-regulated clearing organizations to provide clearing services for over the counter products; (4) adopting procedures to permit firms to offer to all market participants the ability to engage in off-floor execution of futures transactions at competitive prices that would then be cleared by a clearing organization that also clears the same exchange-traded futures contract;¹¹ (5) facilitating the ability of Commission registrants to serve their clients in a global market environment;¹² (6) expediting the procedures by which foreign stock index contracts are approved for trading by US persons;¹³ and (7) recognizing the use of automated order routing systems by market intermediaries and their clients. None of these issues will be addressed through the implementation of proposed rule 1.41(z).

Procedural Questions

If the Commission elects to promulgate proposed rule 1.41(z) as a final rule, FIA requests the Commission to address certain procedural questions. In the *Federal Register* release accompanying the proposed rule, the Commission states that it intends to use its existing statutory authority "to conduct investigations, to gather information, and generally to oversee the contract market's adherence with the requirements and conditions of the Act." 64 *Fed.Reg.* at 66429. However, the Commission does not identify what action it would take in the event the Commission initially determined that a rule submitted under proposed rule 1.41(z) violates or is inconsistent with the Act or the Commission's regulations.

A rule submitted pursuant to proposed rule 1.41(z) is exempt from the provisions of section 5a(a)(12) of the Act, which sets forth the authority of the Commission to disapprove an exchange rule. FIA assumes that the Commission nonetheless intends to retain the authority to disapprove an exchange rule under section 5a(a)(12) in particular circumstances.¹⁴ (If the Commission determines that a rule violates or is inconsistent with the Act or the Commission's regulations, a

¹¹ In this connection, FIA is pleased that the Commission has approved the rules that the Cantor Financial Futures Exchange had proposed to implement block trading procedures. 64 *Fed.Reg.* 54620 (October 7, 1999).

¹² For example, in addition to procedures to facilitate the transmission of client orders for execution on a foreign market, which currently are the subject of a proposed rulemaking, 64 *Fed.Reg.* 46618 (August 26, 1999), the Commission must also address issues relating to the computation of the foreign secured amount and revisions to (or elimination of) the Division of Trading and Markets' Financial and Segregation Interpretation No. 12.

¹³ In this regard, certain FIA member firms have indicated that the delay in approving the S&P/TSE 60 stock index futures contract traded on the Montreal Exchange, in particular in face of the expiring Toronto Stock Exchange index contracts, effectively forced many institutional participants to enter into economically comparable OTC instruments in connection with the expiration of their futures positions.

¹⁴ In these circumstances, the Commission should also retain the authority to suspend the effectiveness of a rule when appropriate. At the same time, however, the Commission should confirm that the Commission's decision to disapprove, or alter or supplement, a rule would not affect the validity of any action previously taken in compliance with that rule.

condition of the exemption from section 5a(a)(12) would not be met.) However, the Commission should clearly state its position in this regard.¹⁵

In the absence of such authority, the Commission presumably would act pursuant to its authority under section 8a(7) of the Act, which authorizes the Commission to alter or supplement the rules of an exchange, if the Commission determines that such changes are "necessary and appropriate . . . for the protection of traders or to ensure fair dealing in commodities traded for future delivery" on that exchange. It is not clear, however, whether the scope of the Commission's authority under section 8a(7) is as broad as it is under section 5a(a)(12).

Similarly, the Commission has not indicated what procedures are available to an exchange member or other person that believes an exchange rule violates or is otherwise inconsistent with the Act or Commission regulations. Such persons must have an opportunity to request the Commission to consider, at least informally, whether an exchange rule was properly submitted under rule 1.41(z).

The ability to initiate a private action under section 22 of the Act would not appear to be an acceptable alternative. In order to be successful under this section of the Act, a plaintiff must establish that an exchange acted in bad faith in taking an action or failing to take an action that caused the plaintiff's loss. Moreover, the only relief apparently available under section 22 is monetary damages for actual losses. Consequently, the plaintiff in any such proceeding would face a high burden. A separate claim under the antitrust laws would also face substantial obstacles.

Other Comments

The Commission asks whether the proposed rules implementing a new electronic trading system at an existing exchange should be processed under proposed rule 1.41(z). Provided such rules do not violate and are not inconsistent with the Act and the Commission's regulations, there would appear to be no reason why an exchange should not be able to submit such rules under the proposed rule. The far more important issue, however, is the extent to which the Commission reviews the trading system itself.¹⁶ In this regard, FIA encourages the Commissions to undertake to develop procedures to streamline its review of exchange electronic trading systems, consistent with IOSCO's "Principles for the Oversight of Screen-Based Trading Systems." In particular, the Commission should consider the extent to which it can and should reasonably defer to the findings of qualified independent auditors in this regard.

¹⁵ In this connection, FIA also requests the Commission to confirm that it may initiate a proceeding to disapprove a rule if the Commission determines that the rule may be inconsistent with the purposes of the antitrust laws. Further, we request the Commission to confirm that the exchanges would not receive protection from the antitrust laws afforded by Commission review and approval of exchange rules.

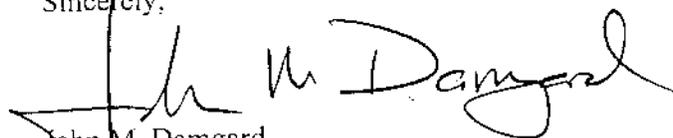
¹⁶ The Commission should also clarify when an exchange electronic trading system would be considered "new." This term would certainly include the first electronic trading system an exchange adopts. It is not clear, however, if this term would include an existing trading system that undergoes significant modification.

Finally, an exchange is required under the provisions of Commission rule 5.3 to note in its rulebook whether any contract listed for trading has been listed for trading pursuant to the provisions of rule 5.3 and, therefore, not approved by the Commission. FIA suggests that the provisions of proposed rule 1.41(z) similarly be revised to require an exchange to identify in its rulebook those rules that have been submitted pursuant to that rule. In this regard, in order to assure that market participants have notice of any such rule changes, FIA further recommends that the Commission require the exchanges post such rules (and all exchange rules for that matter) are available on the applicable exchange web site.¹⁷

Conclusion

FIA appreciates the opportunity to submit these comments on proposed rule 1.41(z). If you have any questions regarding this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,



John M. Damgard
President

cc: Honorable William J. Rainer
Honorable Barbara Pederson Holum
Honorable David D. Spears
Honorable James E. Newsome
Honorable Thomas J. Erickson
C. Robert Paul, General Counsel
John C. Lawton, Acting Director, Division of Trading and Markets
John Mielke, Acting Director, Division of Economic Analysis
Phyllis J. Cela, Acting Director, Division of Enforcement

¹⁷ We also suggest two technical revisions to the proposed rule. First, we believe that the clause in paragraph (z)(1)(ii) that reads "under Sections 4c, 5, 5a(a) and 6 of the Act" should read "under Sections 4c, 5, 5a(a) *or* 6 of the Act." Second, paragraph (z)(2)(ii) should be revised to read as follows (addition in italics): "The initiation, conduct or disposition of any Commission proceeding to disapprove, *alter or supplement* the rule or require the contract market revise the rule."