

COMMODITY FUTURES TRADING COMMISSION

Futures Market Self-Regulation

AGENCY: Commodity Futures Trading Commission.

ACTION: Request for comment.

SUMMARY: The Commodity Exchange Act (the “Act”),¹ through Core Principles added by the Commodity Futures Modernization Act of 2000 (“CFMA”)² and otherwise, imposes upon trading facilities (designated contract markets or “DCMs” and derivatives transaction execution facilities or “DTEFs”), upon registered futures associations (“RFAs”),³ and upon clearinghouses (derivatives clearing organizations or “DCOs”) certain self-regulatory obligations with respect to futures commission merchants (“FCMs”) that are members of such DCMs, DTEFs, RFAs, and DCOs (together, “self-regulatory organizations” or “SROs”). In order to avoid duplicative supervisory burdens upon FCMs that are members of more than one SRO, the Commodity Futures Trading Commission (the “Commission” or “CFTC”) permits SROs to enter into voluntary, cooperative agreements to both allocate certain supervisory responsibilities among themselves so that each FCM has a single designated self-regulatory organization (“DSRO”) and to share relevant financial and risk information among themselves. Under such an agreement, each DSRO is primarily responsible for conducting periodic examinations of firms assigned to it, and the other SROs rely upon the findings of such examinations, yet under the Act and

¹ 7 U.S.C. § 1 *et seq.* (2000).

² See Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

³ CFTC Regulation 170.15 requires each FCM to be a member of at least one RFA that is registered with the Commission pursuant to § 17 of the Act. Commission regulations referred to herein may be found at 17 C.F.R. Ch. I (2003).

Commission regulations each SRO retains ultimate responsibility for ensuring proper performance of its self-regulatory duties.⁴

Any two or more SROs may propose to enter into an agreement to effectuate a DSRO plan but such a plan may not be implemented unless and until the Commission, following appropriate notice and opportunity for public comment, approves the plan (in whole or in part and as submitted or as modified according to the Commission's direction).⁵ The Commission also may, after appropriate notice and opportunity for hearing, withdraw its approval of a plan (in whole or in part) that it has previously approved if, in the Commission's determination, the plan (or part) no longer adequately effectuates the purposes of the Act or Commission regulations.⁶

In 1984, a number of SROs entered into a Joint Audit Agreement ("1984 Agreement") to effectuate a DSRO plan.⁷ Proposed amendments to the 1984 Agreement were recently submitted for approval ("Proposed Agreement"). In accordance with § 1.52(g) of its regulations and in conjunction with its ongoing review of the self-regulatory system for futures markets, the Commission is publishing this notice to request public comment on the Proposed Agreement.

⁴ DSROs also monitor compliance in the areas of sales practice, recordkeeping, and anti-money laundering protections.

⁵ Regulation 1.52(g) states:

After appropriate notice and opportunity for comment, the Commission may, by written notice, approve such a plan, or any part of the plan, if it finds that the plan, or any part of it: (1) Is necessary or appropriate to serve the public interest; (2) Is for the protection and in the interest of customers; (3) Reduces multiple monitoring and auditing for compliance with the minimum financial rules of the [SROs] submitting the plan for any [FCM or IB that] is a member of more than one [SRO]; (4) Reduces multiple reporting of the financial information necessitated by such minimum financial and related reporting requirements by any [FCM or IB that] is a member of more than one [SRO]; (5) Fosters cooperation and coordination among the contract markets; and (6) Does not hinder the development of [an RFA] under [S]ection 17 of the Act.

⁶ See Regulation 1.52(i).

⁷ See 49 FR 28906 (Jul. 17, 1984) (approved in large part on Oct. 10, 1984 ("1984 Commission Letter")).

DATE: Comments must be received on or before [INSERT DATE 45 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Interested persons should submit their views and comments to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. In addition, comments may be sent by facsimile transmission to (202) 418-5521, or by electronic mail to secretary@cftc.gov. Reference should be made to “Futures Market Self-Regulation”. This document also will be available for comment at <http://www.regulations.gov>.

FOR FURTHER INFORMATION CONTACT: Thomas J. Smith, Associate Deputy Director and Chief Accountant, or Natalie A. Markman, Senior Special Counsel, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Telephone (202) 418-5450.

SUPPLEMENTARY INFORMATION:

I. Background

A. The DSRO System

The Commission promulgated Regulation 1.52 in 1978 to permit cooperative self-regulatory arrangements such as the DSRO system that operates today.⁸ Under CFTC regulations, the term “designated self-regulatory organization” means an SRO of which an FCM is a member or, if the FCM is a member of more than one SRO, the SRO to whom certain self-regulatory responsibilities are delegated pursuant to a DSRO agreement.⁹ Notwithstanding the

⁸ 43 FR 39956, 39981-82 (Sep. 8, 1978). Although the regulation has been amended over the years, its fundamental requirements have remained substantially the same.

⁹ Originally, Regulation 1.3(ff) defined a DSRO to be an SRO:

of which [an FCM] is a member or, if the [FCM] is a member of more than one [SRO] and such [FCM] is the subject of an approved plan under § 1.52, then [an SRO] delegated the responsibility

DSRO system, moreover, each SRO must establish and maintain appropriate procedures for monitoring the financial integrity of its member firms.¹⁰ This fundamental obligation is reflected in the Act.¹¹

The 1984 Agreement created a Joint Audit Committee (“JAC” or “Committee”) made up of one representative appointed by each of the parties to the agreement.¹² Currently, if an FCM is a member of a single DCM among a group of certain DCMs that are long-time JAC members, then that DCM serves as DSRO for such firm. If an FCM is a member of more than one DCM within that group, then the Committee designates one of those DCMs to act as the firm’s DSRO.

by such a plan for monitoring and auditing such [FCM] for compliance with the minimum financial and related reporting requirements of the [SROs] of which the [FCM] is a member, and for receiving the financial reports necessitated by such minimum financial and related reporting requirements from such [FCM].

43 FR at 39967. Regulation 1.3(ff) subsequently has been amended to include introducing brokers (“IBs”) and leverage transaction merchants.

¹⁰ Commission staff has provided detailed guidance on conducting an effective surveillance program. See Division of Trading and Markets Financial and Segregation Interpretation No. 4-1 – Advisory Interpretation for Self-Regulatory Organization Surveillance over Members’ Compliance with Minimum Financial, Segregation, Reporting, and Related Recordkeeping Requirements, 1 Comm. Fut. L. Rep. (CCH) ¶ 7114A at ¶ 43 (Jul. 29, 1985).

¹¹ Both trading facilities and clearing organizations have important self-regulatory obligations under the Act. Core Principle 2 requires each DCM to monitor and enforce compliance with its rules. Core Principle 11 further requires each DCM to establish and enforce rules to ensure the financial integrity of FCMs and IBs and the protection of customer funds. 7 U.S.C. § 7(d)(2) and (11). Core Principle H requires each DCO to monitor and enforce its rules, and the rules of a clearing organization focus extensively on issues of financial integrity. Moreover, Core Principle C requires each DCO to establish appropriate continuing eligibility standards (including appropriate minimum financial requirements) for its members and participants, and Core Principle M directs each DCO to enter into all appropriate and applicable information-sharing agreements and to use relevant information obtained thereby in carrying out its risk management program. 7 U.S.C. § 7a-1(c)(2)(C), (H), and (M); see also, DTEF Registration Criterion 4, 7 U.S.C. § 7a(c)(4); DTEF Core Principle 2, 7 U.S.C. § 7a(d)(2); and Section 17(b)(4) of the Act (financial responsibility standards for RFA members), 7 U.S.C. § 21(b)(4).

¹² The parties to the 1984 Agreement were: the Board of Trade of the City of Chicago (“CBOT”); Board of Trade of Kansas City (“KCBOT”); Chicago Mercantile Exchange (“CME”); Chicago Rice and Cotton Exchange; Coffee, Sugar & Cocoa Exchange, Inc. (“CSCE”); Commodity Exchange, Inc. (“COMEX”); MidAmerica Commodity Exchange; Minneapolis Grain Exchange (“MGE”); New York Cotton Exchange (“NYCE”); New York Futures Exchange, Inc.; New York Mercantile Exchange (“NYMEX”); and NFA.

Current JAC members are: the AMEX Commodities Corp.; BrokerTec Futures Exchange, LLC; CBOE Futures Exchange, LLC; CBOT; CME; CSCE; COMEX; Island Futures Exchange, LLC; KCBOT; Merchants’ Exchange, LLC; MGE; NQLX, LLC; NFA; NYCE; NYMEX; OneChicago, LLC; Philadelphia Board of Trade; and U.S. Futures Exchange, LLC. Not all members, however, have been assigned DSRO responsibilities.

If an FCM is not a member of one of the DCMs within that group, then NFA acts as the DSRO for such FCM.

In addition to allocating DSRO responsibilities among certain SROs, the Committee also oversees the design and implementation of the examination program utilized by those DSROs that maintain in-house examination staffs in their examinations of assigned firms. (The NFA has a comparable examination program that it utilizes in examining firms for which it has been assigned as DSRO and firms that it examines under contractual arrangements with other SROs.) The Committee also determines the minimum examination practices and procedures to be followed in the conduct of examinations. Committee members may share information with each other about the financial condition and risk exposures of FCMs but are under confidentiality restrictions with respect to sharing such information with other persons.¹³

B. Commission Review of the DSRO System

CFTC Chairman James Newsome announced in May 2003 that the Commission would review “the roles, responsibilities, and capabilities of SROs in the context of market changes,” such as demutualization and increasing competition.¹⁴ Chairman Newsome recognized that self-regulation “has been integral to the success of the futures markets” and stated that it is appropriate for the Commission “to ensure that the principles of objectivity, confidentiality, and consistency continue to be adhered to as well as they have always been in this business.”¹⁵

¹³ For example, Paragraph 8(b) of the 1984 Agreement does not permit a DSRO to share such information with any clearinghouse except the clearinghouse that clears transactions executed on the DSRO’s trading facility. The proposed amendments, however, would permit a DSRO to share information about an FCM with *any* DCO of which the FCM is a member.

¹⁴ Address by Chairman James E. Newsome at the Futures Industry Association Law and Compliance Luncheon (May 28, 2003), available at <<http://www.cftc.gov/opa/speeches03/opanewsm-40.htm>>.

¹⁵ In congressional testimony, Chairman Newsome explained that he initiated a review of the SRO system “not because there are any particular issues that have arisen; but given the number of changes that have taken place in the industry over the last 2 or 3 years of both the exchanges and the firms, we think it is prudent and responsible for the CFTC to take a look at SROs and to make sure that the same principles that applied when

In February 2004, the Commission issued a press release announcing several initiatives in connection with its ongoing review of self-regulation.¹⁶ One such initiative is the examination of the DSRO system, including its cooperative agreements and programs.¹⁷ The CFTC's Division of Clearing and Intermediary Oversight has been assessing the impact of changes in the futures industry, such as new entrants being designated as DCMs¹⁸ and the CFMA's creation of a new registration category for DCOs,¹⁹ upon the DSRO system and its examination programs. A timely review of the DSRO system will ensure that DSROs continue to meet the needs of the markets and their participants. Accordingly, staff is conducting a formal review of the DSRO system as administered by the JAC through its examination program, including assessment of: (1) the governance and operation of the JAC; and (2) the effectiveness of the JAC and NFA examination programs, and related programs ("Programs").

The Commission invites comment on the Proposed Agreement, particularly with respect to the ability of the DSRO system to serve the public interest, reduce duplicative reporting and examination burdens on FCMs, strengthen customer protections, and foster cooperation and

SROs were put into place[] apply now." Commodity Futures Modernization Act: Hearings Before the Subcomm. on General Farm Commodities and Risk Management of the House Comm. on Agriculture, 108th Cong., 1st Sess. 6 (2003) (statement of James E. Newsome, Chairman, CFTC).

¹⁶ CFTC Press Release 4890-04 (Feb. 6, 2004), available at <<http://www.cftc.gov/opa/press04/opa4890-04.htm>>.

¹⁷ In a related initiative, the Commission encouraged each SRO to reexamine its policies and procedures, training efforts, and day-to-day practices to confirm that there are adequate safeguards to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-regulatory activities. The Commission also encouraged SROs to publicize any safeguards so market participants would continue to have faith in the integrity of the self-regulatory process and to participate enthusiastically in it.

¹⁸ The Commission has designated seven new DCMs since passage of the CFMA.

¹⁹ The CFMA changed the manner in which clearing organizations are recognized and regulated under the Act, and granted the Commission explicit authority to regulate DCOs. *See* 7 U.S.C. § 7a-1. Each DCO must comply with certain core principles to maintain its registration. In particular, Section 5b(c)(2)(H) – Core Principle H on rule enforcement – requires a DCO to “maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance” with its rules and for resolving disputes and to “have the authority and ability to discipline, limit, suspend, or terminate a member’s or participant’s activities for violations” of its rules.

coordination among the markets. Some, but certainly not all, of the issues that the Commission may consider in its assessment of the Proposed Agreement include:

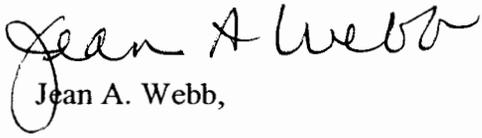
1. Membership criteria;
2. Decision-making processes and the limitation of voting eligibility on the bases of longevity and self-performance of examination services;
3. The process by which an FCM is assigned to a particular DSRO;
4. Delegation versus outsourcing of examination services;
5. Distinctions between RFAs and non-RFAs with respect to delegation and outsourcing issues;
6. Distinctions between DSRO responsibilities and SRO responsibilities;
7. The extent to which the Commission should review the JAC's governance and operation on a more routine, periodic basis; and
8. The general transparency of the DSRO system and its operation.²⁰

In addition to the issues mentioned above, the Commission welcomes comment on any aspect of the DSRO system.

The 1984 Agreement, 1984 Commission Letter, and the Proposed Agreement are available on the Commission's website at <http://www.cftc.gov> upon the issuance of this notice by the Commission. Copies also may be obtained from the Office of the Secretariat, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C., 20581.

²⁰ Commission staff receives and reviews the Programs on an annual basis, but has not in the past reviewed the Joint Audit Agreement except in response to the submission of a new agreement.

Issued in Washington, D.C. on April 7, 2004, by the Commission.

Handwritten signature of Jean A. Webb in cursive script.

Jean A. Webb,

Secretary of the Commission.