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October 9, 1999

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

Re: Petition for Exemption Pursuant to Section 4(c) of the Commodity Exchange Act, 64 Fed.Reg. 46356 (August 25, 1999)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments on the petition for exemption pursuant to section 4(c) of the Commodity Exchange Act ("Act") that the Chicago Board of Trade, the Chicago Mercantile Exchange and the New York Mercantile Exchange (collectively, the "Exchanges") submitted to the Commodity Futures Trading Commission ("Commission") by letter dated June 25, 1999 ("Exchange Petition").[1] 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.

For the reasons described in detail in this letter, FIA supports, in part, and opposes, in part, the Exchange Petition. Nonetheless, if, following its consideration of the comments received, the Commission elects to proceed and to grant the Exchange Petition in its entirety, FIA respectfully submits that the Commission should complete the task the Exchanges have implicitly requested it to undertake. The Commission should not limit the relief granted only to exchanges. Rather, as discussed below, the Commission should adopt an even broader exemption and take other steps that would truly open the futures markets to competition.

The Exchange Petition

The Exchange Petition requests the Commission to exercise its authority under section 4(c) of the Act to exempt each exchange that has been designated as a contract market in at least one contract from the rule approval process in three broadly-defined circumstances. First, the Exchange

[1] Letter from Carl A. Royal, Senior Vice President, Chicago Mercantile Exchange, to Jean A. Webb, Secretary to the Commission, dated June 25, 1999, with enclosure.

Petition requests that exchanges that have been designated contract markets be exempted from complying with the contract market designation process for new contracts under sections 5 and 6 of the Act, as well as any related regulations and provisions of the Act, including section 2(a)(8)(B)(ii).[2] Consequently, new contracts would be able to be listed for trading immediately and would not be subject to Commission approval, either prior to or after trading commences.

Second, the Exchange Petition requests that each exchange be exempted from the rule approval provisions of section 5a(a)(12) of the Act and related regulations, except the provisions relating to emergency actions, if the exchange provides notice of new rules or rule changes to the Commission 10 days in advance of the effective date. Rules that an exchange submits pursuant to this exemption could not be stayed or delayed, "unless the Commission finds that the rule is likely to cause fraud, render trading readily susceptible to manipulation or threaten the financial integrity of the market."

Finally, the Exchange Petition requests that an exchange be authorized to implement trading rules and procedures comparable to those of a competing foreign exchange that the Commission has authorized to locate trading terminals in the US, *provided,* that such rules and procedures may apply only to contracts listed by the US exchange that are subject to direct competition from a contract listed on the foreign exchange. The US exchange would be permitted to implement these rules immediately upon submission to the Commission of (1) the text of the rules and procedures being adopted, and (2) its certification that the foreign exchange employs comparable rules and procedures for trading a contract that competes directly with the contract listed by the exchange.

As explained in the Exchange Petition, the primary purpose of the proposed exemptions is to promote fair competition by permitting the Exchanges "to respond, without delay, to any new contract, contract amendment, advantageous trading practice, or less costly regulatory device offered or likely to be offered by foreign exchanges on US based trading terminals. . . . The Exchanges must be free to operate and modify their trading systems with no more governmental interference than is imposed on the foreign exchanges." 64 *Fed.Reg.* at 46539.

Section 4(c) of the Act

The Commission's exemptive authority under section 4(c) of the Act is extremely broad. Section 4(c) authorizes the Commission, "[i]n order to promote responsible economic or financial innovation and fair competition." to

> exempt any agreement, contract or transaction (or class thereof) that is otherwise subject to subsection (a)[3] (including any person or class of persons offering, entering

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[2] Section 2(a)(8)(B)(ii) of the Act requires the Commission to consult with the Department of the Treasury and the Board of Governors of the Federal Reserve System prior to designating any exchange as a contract market in any security issued or guaranteed by the United States or any agency thereof. The Department of the Treasury and the Board of Governors have 45 days to comment on any such contract.

[3] Section 4(a) of the Act essentially provides that any futures contract must be executed on or subject to the rules of a futures exchange.

> into, rendering advice or rendering other services with respect to, the agreement, contract or transaction), either unconditionally or on stated terms and conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsections (a), or from any other provisions of this Act (except section 2(a)(1)(B)), *if the Commission determines that the exemption would be consistent with the public interest.* [Emphasis supplied.]

Provided the Commission is able to find that the proposed exemptions are "consistent with the public interest," it would appear that the Commission has the authority to grant the Exchanges' request. For the reasons stated below, FIA believes that the Commission has the authority to grant the proposed exemption relating to listing of new contracts without prior Commission approval. However, FIA has concluded the two latter proposed exemptions that would permit the exchanges to adopt other rules without regard to the provisions of the Act or Commission regulations and with little or no prior review by the Commission would not be consistent with the public interest.

Legislative History of Section 4(c) of the Act

Section 4(c) provides the most convenient and, perhaps, the most efficient means by which the Commission could act to implement the regulatory reform that FIA has espoused. Nonetheless, FIA is mindful of Congress' admonition in enacting this section of the Act in 1992. Specifically, in the Conference Report submitted in connection with the enactment of the Futures Trading Practices Act of 1992, the Conference Committee stated:

> *The goal of providing the Commission with broad exemptive powers is not to prompt a wide-scale deregulation of the markets falling within the ambit of the Act.* Rather, it is to give the Commission the means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner. Except as discussed below [with respect to hybrids, swaps, forwards and bank deposits and accounts], the Conferees do not intend for the Commission to use this authority to grant broad exemptions from the Act for instruments and markets before these studies [being conducted by the General Accounting Office and others] are completed and Congress has ultimately decided the issues raised by them. [Emphasis supplied.][4]

The first exemption the Exchanges have proposed, authorizing an exchange to list a new contract for trading without the Commission's prior approval, appears to be within the type of targeted relief that Congress had in mind in extending the benefits of section 4(c) to designated exchanges. The exemption is consistent with the public interest, since no one is required to trade a new contract and the rules establishing the terms and conditions of the contract would not affect any person's existing rights. Therefore, provided the scope of the exemption is limited to the economic terms and conditions of a contract and would not extend, for example, to trade practices with respect to that contract, FIA would support a Commission decision to grant the first proposed exemption.

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[4] H. R. Rep. No. 978, 102d Congress, 2d Session, US House of Representatives (1992).

The other two exemptions the Exchanges have proposed, however, go far beyond simply authorizing the Exchanges to adopt rules and procedures for the stated purpose of responding to perceived threats from international exchange markets. To the contrary, the proposed exemptions—in particular, the second exemption—appear to authorize the Exchanges to revise their respective rules and procedures in their entirety, without regard to the provisions of the Act and Commission regulations that currently govern their conduct. As such, they effectively vest the exchanges with virtually unfettered authority to amend specific provisions of the Act and the Commission's regulations. For example, in addition to the proposed exemptions from sections 5 and 6 of the Act (relating to the approval of new contracts), the exchanges would appear to be authorized to adopt rules without regard to, and in direct contravention of, the following provisions of the Act: (1) section 4a (speculative position limits); (2) section 4e (registration of floor traders and floor brokers); (3) section 4f (capital requirements for futures commission merchants and introducing brokers); (4) section 4g (maintenance of books and records); (5) section 4j (dual trading and broker associations); (6) section 5a(b)(1) (audit trails); (7) sections 5a(b)(14)-(17) (exchange governance); and (8) section 15 (consideration of the public purpose to be protected by the antitrust laws, as well as the policies and purposes of the Act).

As the Commission is well aware, exchange governance is an issue that has been of considerable concern to FIA over the years. Although existing exchange governance structures may comply with the literal provisions of the Act, FIA nonetheless believes that they currently do not assure appropriate representation of all market participants. Consequently, FIA could not support a proposal that would remove the Commission's authority over exchange rules in this regard until such representation is secured. Moreover, an exchange's ability to adopt rules without regard to the antitrust laws and the public interest to be protected under the Act would be particularly troublesome.[5] For example, exchange rules (a) limiting access to the exchange or to particular contracts, (b) shifting regulatory obligations from the exchange to members or from one class of members to another,[6] or (c) affecting the ability of exchange members to effect transactions on other markets would not necessarily be found to cause fraud or render trading readily susceptible to manipulation.[7]

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[5] In this connection, FIA also assumes that the exchanges would not receive protection from the antitrust laws afforded by Commission review and approval of exchange rules.

[6] FIA's concerns in this regard are not unfounded. The Commission will recall that, when the Chicago Mercantile Exchange first submitted for approval its rules relating to Globex trading system, the exchange had sought to impose on its clearing members full responsibility for any losses a member or customer might incur as a result of a failure of the system.

[7] The Exchanges have asserted that over-the-counter markets and other exchanges provide alternatives to exchange transactions. Therefore, any person adversely affected by an exchange action could simply refuse to trade on the exchange going forward and could effect its transactions elsewhere. This assertion ignores the considerable financial investment that FCMs have in the organized exchanges as well as the substantial costs, in time as well as money, that are incurred either in forming a new exchange or in listing a competing contract (and developing sufficient liquidity) on an existing exchange.

Notwithstanding the broad authority that the exchanges would be permitted to exercise under the proposed exemptions, the exemptions would reserve to the Commission the right to stay or delay the effective date of an exchange rule only in particular circumstances and, then, only if the Commission were able to find that the rule "is likely to cause fraud, render trading readily susceptible to manipulation or threaten the financial integrity of the market." The standard of proof that the Commission would be required to meet in order to find that a particular rule is likely to cause[8] fraud or render trading readily susceptible to manipulation is extremely narrow. Therefore, it is only in the rarest of instances that the Commission could ever stay the effective date of a rule or subsequently disapprove a rule after it had taken effect.

The third proposed exemption goes even farther and denies the Commission the authority to review certain exchange rules in their entirety. Specifically, the Commission would have no authority to delay or stay the effective date or otherwise review trading rules and procedures that the exchange certifies are comparable to those of a competing foreign exchange that the Commission has authorized to locate trading terminals in the US and apply only to contracts listed by the US exchange that are subject to direct competition from a contract listed on the foreign exchange.[9] Regulatory parity should not be a driving force of regulatory reform. To the extent that certain international exchanges may be subject to a different or apparently less burdensome regulatory structure, these structures should be analyzed to determine whether they offer a better approach to regulation. In the end, however, the Commission, together with Congress, must determine the appropriate regulatory structure for US markets based on their analysis of the public interests to be protected. Neither the Commission nor Congress should defer to the judgment of other jurisdictions simply for the purpose of achieving regulatory parity.

The full exercise of their authority under either the second or third exemption threatens regulatory chaos. 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. If, on the other hand, the exchange rule were to apply only to floor brokers and floor traders, its value in meeting perceived competitive threats from foreign exchanges would be substantially reduced.

The ability of the Commission, in accordance with the provisions of section 8a(7) of the Act, to alter or supplement exchange rules adopted pursuant to the proposed exemptions is also in

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[8] FIA assumes that the use of the term "cause" in the Exchange Petition was intentional. In this regard, unless the rule required specific conduct that was inherently fraudulent, it is difficult to imagine how a particular rule could cause, rather than facilitate, fraudulent conduct.

[9] Whether a particular contract competes directly with another contract may be open to debate, and the Exchanges offer no guidance in this regard. Nonetheless, FIA is not aware that any major foreign exchange currently offers a contract that competes directly with a contract offered by a US exchange.

doubt.[10] Section 8a(7) of the Act 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. Although the Commission has exercised its authority under this section of the Act infrequently, the broad language of section 8a(7) is in stark contrast to the narrow standards of review set forth in the proposed exemptions. If the Commission were to retain this authority, the value of the proposed exemptions to the exchanges would be significantly reduced.[11]

Given their broad scope, the proposed exemptions could indirectly result in the "wide-scale deregulation of the markets falling within the ambit of the Act" that Congress cautioned the Commission to avoid. Such a seismic shift in the regulatory structure of the futures industry should be undertaken only at the direction of Congress. In this regard, as the Commission is aware, Senator Lugar, Chairman of the Committee on Agriculture, Nutrition and Forestry, and Congressman Ewing, Chairman of the Subcommittee on Risk Management, Research and Specialty Crops, have issued a joint statement in which they confirmed that one of the goals of the current reauthorization process will be to "revamp" the functions of the Commission to transform the agency from a "front-line" regulator to an "oversight" agency. The current reauthorization process, therefore, provides an appropriate and timely opportunity to obtain the necessary Congressional guidance.

The Need for Regulatory Reform

The Commission should not interpret FIA's comments as a call for delay, pending the completion of the reauthorization process. FIA, no less than the Exchanges, believes the time has come for the Commission to act more boldly in reforming the regulatory structure governing the conduct of business on exchange markets. As FIA has noted in other forums, these markets are an integral part of the US financial market structure, on which transactions are effected primarily on behalf of institutional market participants, including commercial end users. On several occasions, therefore, FIA has strongly endorsed initiatives that recognize the needs of such market

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[10] Section 8a(7) of the Act 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. Although the Commission has exercised its authority under this section of the Act infrequently, the broad language of section 8a(7) is in stark contrast to the narrow standards of review set forth in the proposed exemptions.

[11] Similarly, the proposed exemptions may affect a person's ability to institute a private right of action against an exchange. Section 22(b)(1) of the Act provides that an exchange may be liable for actual damages a person sustains, if the exchange fails to enforce any bylaw, rule, regulation, or resolution that it is required to enforce by the Commission or, in enforcing any such bylaw, rule, regulation, or resolution, the exchange violates the Act or any Commission rule, regulation, or order. Moreover, in order to be successful under section 22, a person is required to establish that an exchange acted in bad faith in taking an action or failing to take an action that caused the person's loss. Consequently, the plaintiff in any such proceeding already faces a high burden of proof. If an exchange is authorized to adopt rules that directly conflict with the Act or the Commission's regulations, the resulting confusion arising from this conflict would limit even more a person's ability to institute an action against an exchange.

participants and enhance the efficiency of the exchange markets.[12] These initiatives have included various measures intended to alleviate regulatory obstacles that FIA believes are not necessary for the protection of institutional market participants, including procedures to authorize the post-execution allocation of bunched orders as well as certain off-floor transactions with respect to large orders. In this regard, therefore, the additional trade practice requirements specifically mentioned in the Exchange Petition—the ability to delay reporting certain transactions for a period of time, requirements relating to the allocation of bunched orders, and the ability to enter electronic orders without account identification information—directly affect the ability of FCMs to provide services on behalf of their clients. Consequently, FIA would support appropriate amendments to the Commission's regulations authorizing such practices.

In this latter regard, FIA is encouraged that the Commission has published for comment the rules that the New York Board of Trade recently submitted on behalf of the Cantor Financial Futures Exchange. As described in the *Federal Register* release, these rules establish procedures pursuant to which qualified market participants will be allowed to negotiate transactions away from the exchange. Within ten minutes following execution, the parties would be required to report the relevant details of the transaction to the exchange for clearing and settlement, *i.e.*, contract, contract month, price, quantity, time of execution and counterparty clearing member. 64 *Fed.Reg.* 54620 (October 7, 1999).

The Commission's decision to request comment on these proposed rules indicates that the Commission has concluded that such procedures are not prohibited under the Act or the Commission's regulations. FIA endorses the Commission's conclusion in this regard. FIA believes strongly that market participants must have the ability to negotiate and execute futures transactions off-floor.

Although progress has been made on some issues, the Commission's cautious approach has placed the industry in general at a competitive disadvantage. Moreover, the effect of a change in one rule on others is not always appreciated. For example, as a result in substantial part of this piecemeal approach to regulatory reform, the Commission's rules do not even contain a uniform definition of the term "institutional customer." Instead, the class of customer that falls within the definition of that term differs depending on the Commission's view of the ability of particular customers to appreciate the supposed additional risks that accompany the specific relief granted.[13]

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[12] FIA has also supported the exchanges' objectives of promoting product innovation and enhancing their ability to respond expeditiously to the needs of institutional market participants and the competitive demands of the international marketplace. One such enhancement currently under consideration at several exchanges is a change in the governing structure of the exchange. For example, both the Chicago Board of Trade and the Chicago Mercantile Exchange, which, like other exchanges, are owned and governed by their members, are analyzing the costs and benefits of converting to a corporate form.

[13] In this connection, the Commission's recently proposed rule 30.12, which is designed to codify and amend procedures by which certain institutional customers of an FCM may place orders directly with a foreign affiliate that carries the FCM's customer omnibus account, creates yet another definition of institutional customer. Proposed rule 30.12(a), 64 *Fed.Reg.* 46618 (August 26, 1999).

FIA, therefore, encourages the Commission to undertake a thorough review of all its rules. FIA strongly believes that the Commission's regulatory program should be designed in the first instance to reflect the needs of the institutional customers (including exchange members) that account for 94 percent of the volume on those markets. The Commission should not assume that the existing regulations, which were promulgated primarily to protect retail customers and smaller commercial hedgers, are appropriate and that it should seek only to identify and amend those rules that are of particular concern to institutions. The Commission should start anew and develop a comprehensive regulatory program that more accurately reflects both the nature of the institutional customers that trade in those markets and the manner in which these trades are executed.

In this latter regard, FIA believes the Commission must also move quickly to implement a flexible, forward-looking regulatory framework that will better accommodate new technology and increase market access for FCMs and customers alike. Regulation of electronic access to trading in the futures markets, which includes both order routing and trade matching systems, requires enormous flexibility so as not to limit innovation. Technological change will not be discouraged or slowed by inflexible regulation, it will merely find, and flow to, the jurisdiction in which the change can be implemented most efficiently and expeditiously.

Moreover, as FIA has stated previously, any rules governing exchange execution systems should be based only on risks that the Commission reasonably identifies rather than anticipates will result from activity employing new technology. The Commission should be able to articulate the specific risk arising from the use of technology that any proposed rule is intended to address. A general discomfort with or suspicion of the unknown, in the absence of any demonstrable increase in risk to customers, FCMs or the markets in general, is an insufficient predicate for Commission action. Nor is it appropriate to require the industry to demonstrate to the Commission on an on-going basis that any new technology proposed to be introduced is not susceptible to any risk.

To this end, the Commission's proposed rules relating to direct access to automated boards of trade were obviously a false start, in particular to the extent that they failed to distinguish between direct execution systems and automated order routing systems, as those terms were defined in the proposed rules. 64 *Fed.Reg.* 14159 (March 24, 1999). FIA, therefore, was pleased that the Commission had the wisdom to withdraw the rules, while acknowledging that "further consensus among the various parties must be sought before rules or guidelines may be finalized in this area." 64 *Fed.Reg.* 32829, 32830 (June 18, 1999). FIA is concerned, however, that certain Commission actions since the rules were withdrawn appear to reflect the Commission's determination that FCMs may not make automated order routing systems available to their customers for the transmission of orders for execution on foreign exchanges, except in connection with transactions executed on electronic exchanges that have received permission to place their terminals in the US.[14]

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[14] See, for example, proposed rule 30.12, relating to foreign order transmittal, 64 *Fed.Reg.* 46618 (August 26, 1999), and the no-action letters that the Division of trading and Markets has issued to the London International Financial Futures and Options Exchange, Eurex Deutschland, the Sydney Futures Exchange, the New Zealand Futures and Options Exchange and Parisbourse.

In addition, the Commission must revise its procedures to facilitate the process by which it designates a new exchange as a contract market. Regulation, by its very nature, poses a barrier to entry for new exchanges. Granting the Exchange Petition without concurrently streamlining significantly the initial contract market designation process will effectively raise that barrier even more and place the existing exchanges in a favored position. However, such streamlining does not require the Commission to reject the principles for screen-based trading that the International Organization of Securities Commissions has adopted. Rather, the Commission must rationalize the process by which a new exchange demonstrates that its system complies with those principles. The type of detailed demonstration and subsequent Commission staff analysis now undertaken is simply unnecessary.

More generally, the Commission must also revise its procedures to assure that it will address particular issues and make decisions promptly. Neither the industry nor the Commission itself can afford to wait while the Commission anguishes over particular rule proposals that may challenge the existing regulatory structure. Although it is certainly the most egregious example of rulemaking run amok, the long and painful six and one-half year history of the Commission's consideration and adoption of rule 1.35(a-1)(5), authorizing the post-execution allocation of certain bunched orders is instructive. The Chicago Mercantile Exchange submitted a petition for rulemaking in this regard in February 1992; a proposed rule was published for comment in May 1993; a revised rule was re-proposed in January 1998; and a final rule was promulgated in August 1998. FIA would be pleased to assist the Commission in any way the Commission deems appropriate in developing these revised procedures.

Conclusion

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

Sincerely,

John M. Damgard

cc: Honorable William J. Rainer
Honorable Barbara Pederson Holum
Honorable David D. Spears
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