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AND RESEARCH

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COMMENT

Office of the Secretariat
Commodities Futures Trading Commission
Three Lafayette Centre
1125 21st Street, N.W.
Washington, D.C. 20581
E-MAIL: secretary@cftc.gov

August 25, 2000

**Re: New Regulatory Framework**

Dear Sirs and Madam:

The Derivatives Subcommittee[1] of the Association for Investment Management and Research's (AIMR)[2] Advocacy Advisory Committee[3] is pleased to comment on the Commodities Futures Trading Commission's (CFTC) proposed *New Regulatory Framework*. The Derivatives Subcommittee is charged with reviewing and responding to regulatory and legislative initiatives involving derivative instruments that affect AIMR's global membership and the efficiency and integrity of financial markets.

## GENERAL COMMENTS

The Derivatives Subcommittee would like to commend the CFTC for proposing a regulation that seeks to enhance the efficient functioning of domestic derivative markets and to improve the competitiveness of our markets vis-à-vis off-shore competition. More specifically, we support the CFTC's effort to (1) reduce the degree of regulatory oversight for market participants, (2) introduce flexible *Core Principles* that easily adapt to changing market needs, and (3) extend additional legal certainty to over-the-counter (OTC) market participants by expanding the current CFTC Part 35 exemption for swap transactions.

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[1] Members of the Derivative Subcommittee that commented on the CFTC;s *New Regulatory Framework* proposal included Gary L. Gastineau, Chair; James J. Winter, CFA; John D. Van Slooten, CFA; Donald J. Smith; Ira Kawaller; and J. Paula Pierce.

[2] The Association for Investment Management and Research is a global, non-profit organization of over 41,000 investment professionals from over 90 countries. Through its headquarters in the U.S. and 95 Member Societies and Member Chapters worldwide, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

[3] The Advocacy Advisory Committee is a standing committee of AIMR charged with reviewing and responding to major new regulatory, legislative, and other developments that may affect AIMR's global membership and the efficiency and integrity of financial markets.

Like the CFTC, we too believe that market efficiencies should not be achieved at the expense of investor protections. We regard the current proposal overall as an important step towards improved functioning of our domestic derivative markets. We believe that increased competition and improved market efficiency will lead to lower trading costs, which will in turn positively impact all market participants, including exchanges, broker/dealers, and investors (large and small).

Although we support the general premise of the proposal, we do believe it can be strengthened by incorporating the following initiatives:

1. allowing the use of single-stock futures;
2. eliminating mandatory position limits for all markets;
3. clarifying the definitions of "market" and "customer" that determine a firm's regulatory tier;
4. explaining how the CFTC will measure and enforce the proposed Core Principles;
5. incorporating the legal certainty provisions into the Commodities Exchange Act (CEA); and
6. adding ethics and proficiency training requirements to the body of *Core Principles*.

SPECIFIC COMMENTS

**Single-Stock Futures**

We strongly support amending the Shad-Johnson Accord to allow single-stock futures to trade on domestic exchanges. Although we recognize that the CFTC lacks the legal authority to make this modification, it does have the power to influence the outcome of the related bills currently in Congress (H.R. 4541 and S. 2697) by publicly advocating single-stock futures.

Single-stock futures are currently available in many developed markets. Not allowing U.S. markets to offer and trade similar contracts places U.S. markets, as well as U.S. participants in those markets, at considerable competitive disadvantage vis-à-vis their international counterparts. Permitting the development of actual single-stock futures contracts (which currently can be created synthetically using put-call parity relationships) would (1) increase the effectiveness and reduce the cost of hedging and (2) bring our regulations inline with international standards.

We believe that single-stock futures should be subject to the same regulatory requirements and afforded the same flexibility as other futures products. Differing treatments will discourage entry of new market participants.

**Position Limits**

We strongly support eliminating position limits and replacing this requirement with the concept of *position accountability* to deter market manipulation as has been done in other financial markets. Although position accountability does not cap a dealer's contract position, it does oblige a dealer to explain to the exchange or relevant SRO the rationale and logistics behind

material positions. The exchange may initiate position liquidation proceedings should it disagree with the rationale offered, or if the position threatens to negatively impact the market.

Speculative position limits are merely one tool for preserving market integrity and are not an adequate substitute for effective market surveillance. Many academics, and the CFTC's own studies over the years, have indicated that speculative position limits are not an efficient regulatory tool and that their damage to market liquidity may be significant.[4] Limits reduce market liquidity and interrupt the market's price discovery function. Though we share the CFTC's market manipulation concerns, we firmly believe that prophylactic remedies should not be in the form of rigid position limits.

Consistent with the CFTC's proposed rules, which envision a more flexible regulatory approach and shift responsibility to the exchanges to adopt rules consistent with the CFTC's Core Principles with CFTC oversight, it is inappropriate to continue to require a specified compliance remedy, which we believe has no demonstrated efficacy. Rather, we believe the exchanges should be the ones to decide whether position accountability rules or some other compliance procedure, instead of speculative position limits, are less restrictive, less anticompetitive, and a more effective means of monitoring and discouraging market disruptions and manipulation. Exchanges should have the flexibility to customize market manipulation and disruption deterrents to each of their separate markets as needed.

**Legal Certainty**
We strongly recommend clarifying and codifying the legal certainty wording proposed in the *New Regulatory Framework* within the CEA. Given their origin as well as their proposal and implementation process, CFTC rules are easier to modify than legislation mandated by Congress. Codifying such wording within the CEA will significantly reduce the legal uncertainty and periodic panic dealers experience when regulatory changes affecting bilateral contracts are proposed.

**Proposed Regulatory Tiers**
The more tailored regulatory approach recognizes the different operational profiles and risks inherent to individual participants. However, we are most troubled by the effect of the tiers on market liquidity if the CFTC were to require bifurcation of the Registered Futures Exchanges (RFE) and Derivatives Transaction Facility (DTF) regulatory structures into different markets. Specifically we believe, as contemplated by the CFTC proposal, that it is appropriate to structure regulation according to the participants in the market and that a different tier of regulation may

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[4] The empirical evidence and academic studies conclude that current limits add no benefit to the liquidity and efficiency of the markets and, in fact, impair the price discovery mechanism by discouraging liquidity. The CFTC's Advisory Committee on the Economic Role of Contract Markets as early as 1976 concluded that speculative position limits may actually reduce competition, lead to congestion in the delivery month and have no utility for markets with a broad supply or which may be easily arbitraged in foreign markets. See Advisory Committee Report, p. 28 (July 17, 1976). See also Report of the Commission's Working Group on Speculative Position Limits of the Regulatory Coordination Advisory Committee, p.4 (May 20, 1991). Those non-U.S. jurisdictions that do not impose limits and the U.S. markets that have adopted position accountability rules have not resulted in price aberrations or manipulative activity.

be applicable to less sophisticated investors than sophisticated investors. Nevertheless, this can be accomplished by requiring intermediaries (through which less sophisticated investors trade) to provide additional customer protections and disclosures, rather than segregating the markets, so that liquidity is not reduced. Derivative markets are traditionally "thinner" than the more popular equity and bond markets. Fragmenting available trades between three separate marketplaces may further hinder liquidity in a market that, in its current state, often has a need for improved fluidity.

We also believe that agricultural markets should not be excluded from any of the proposed tiers. While we are aware discussions addressing regulation of these markets engender strong sentiments, these markets, like all other markets, have (1) a diverse set of market participants including institutional participants and (2) a need for liquidity. In addition, we are concerned that institutional customers may hesitate (at least initially) to trade within the DTF tier as it offers fewer investor protections when compared to the current structure than the RFE tier. It is worth noting that the primary reason why many customers choose established exchanges over the OTC markets is due to the market transparency of the former.

While we support the concept of a more flexible regulatory structure, which entails changing the CFTC's role to one of "overseeing" regulated entities and markets, we believe the CFTC should be very clear in defining the criteria distinguishing the regulatory tiers. We believe there is significant subjectivity in the quantification of the tiers. This subjectivity, coupled with each participant's ability to identify its market, may lead to inconsistencies between similar participants. This problem is further compounded by the fact that market makers will seek to minimize the amount of regulatory oversight they are subject to and that markets continue to be in a constant state of flux. Contracts that qualify to trade within the DTF tier (e.g., U.S. Treasuries) may not have the market depth to justify that classification going forward.

To better quantify the criteria that differentiates between tiers, we strongly recommend that the proposed framework clearly define the following concepts or terms:

- the criteria and process the CFTC will follow to categorize investors as institutional (sophisticated) or retail customers;
- the criteria and process the CFTC will follow to determine an acceptable "minimum deliverable supply of futures contracts;"
- the definition of an intermediary and its market role; and
- how the CFTC will regulate a firm's choice of tier.

### Core Principles

- *RFE Core Principles*
  We view the *RFE Core Principles* as being similar to existing regulatory requirements for exchanges. We do, however, recommend the following changes:

  - *Core Principle No. 3* – reword simply to require exchanges to adopt the necessary process and rules to deter market manipulation.

- *Core Principle No. 4* – reword to require exchanges to hold their members accountable for their positions rather than impose position limits. Position accountability deters manipulation without imposing unnecessary and arbitrary size restrictions, which adversely affect the market's liquidity availability and price discovery function. Position limits are not necessary if participants comply with *Core Principles 3 and 8.*

- *Core Principle No. 8* – reword as follows: "Provide a competitive, open, and efficient market and facilitate the appearance thereof."

- *Core Principle No. 10* – the term intermediary needs to be further defined.

➢ *DTF Core Principles*

An overriding concern regarding *DTF Core Principles* is that they may hinder the transparency of market information in terms of both (1) the quality and (2) the quantity of data made available to the general public. Since we believe that most exchanges will categorize themselves as DTFs, we fear that the quality of future market research will suffer as a result. As the structure exists today, there is a need for better availability and transparency of market data in both the futures and swap markets. This is especially true for swap trades as trade-related information is considered proprietary. Although the quote data is available, actual trade data is unknown. In addition, there is no volume information on swap contracts. Academic and industry-led research adds significant value to the efficiency and effectiveness of our markets today. Research spurs innovation and is a source of continuing education for all participants. Accordingly, market information should be required at all of the regulatory tiers.

**Core Requirements for Intermediaries**

Although we collectively view the proposed requirements for intermediaries as an improvement over the status quo, they are much less complete and less flexible than the *Core Principles* extended to futures and OTC exchanges. As written, the term "intermediaries" is defined too ambiguously and, by omission, excludes commodity pool operators (CPOs) and commodity trading advisors (CTAs). CPOs and CTAs serve a crucial linkage role between the exchanges and the public. They are professionals that (1) invest significant time and effort to establish proficiency in their fields, (2) complete various regulatory exams, and (3) often pursue further studies. Having these professionals stand between the exchanges and the public provides a desirable level of regulatory protection.

We believe the proposed Core Principles for intermediaries, therefore, are incomplete. These principles should include CPOs and CTAs and convey the regulatory flexible extended to the exchanges without compromising investor protection needs. In this regard, we note the National Futures Association's (NFA) draft of Core Principles applicable to CTA and CPO intermediaries. It is imperative that Core Principles for Intermediaries be developed and implemented simultaneously with the other principles proposed in this New Regulatory Framework. We encourage the CFTC to work closely with the NFA in achieving this task.

Finally, we would like to highlight the fact that CPOs' and CTAs' actions have not spurred significant regulatory issues or concerns. In general, CPOs and CTAs are professionals who have designated specific market approaches to manage the high leverage and risk of trading in futures and OTC markets. Preventing or restricting these professionals from trading in futures and OTC markets would not only damage market liquidity but also the clients who have no other access to these markets. Investors who retain CPOs and CTAs to invest on their behalf are retail investors who have no other alternative for investing in derivative markets and, hence, would be unable to diversify their portfolios using derivative contracts. The CFTC should encourage participation of these investors through registered professionals.

**Proposed Ethics and Proficiency Training Changes**
We strongly believe that sound ethics and proficiency standards are important to the industry overall and its participants. Further, we believe that regulators (such as the CFTC) should emphasize and support consistent, high-quality ethical and proficiency training for all registrants. We oppose allowing the individual firms (or employers) to determine the amount, quality, and frequency of training for market participants trading solely with a sophisticated clientele. We fear that firms may assign a low and inadequate priority to this training. In addition, we are concerned this proposed change will send the wrong message to the market regarding the importance the CFTC assigns to integrity and sophistication of market participants. Stated more positively, we favor applying ethics and proficiency requirements to all OTC participants that agree to CFTC oversight.

We do, however, recognize that there are legitimate concerns as to how ethical and proficiency training is implemented today. To improve its effectiveness, we recommend that this training be part of the *Core Principles for RFEs and DTFs*. If training is part of these principles, an exchange would be responsible for (1) requiring that its members have an adequate ethics and proficiency training process tailored to best fit their needs while still protecting the investing public, and (2) enforcing this principle and ensuring the adequacy of their members' training standards. We believe that brokers should be also be subject to the current registration process. Though recognizably not experts, those that pass the necessary test(s) do receive a basic understanding of the market, an emerging rapport with the industry jargon, and a familiarity with regulatory requirements. By incorporating the training into the Core Principles, the CFTC reinforces the importance of ethical and knowledgeable behavior, while still affording flexibility to individual participants and not micromanaging individual firms.

Lastly, we were unsure as to the meaning of the second paragraph on page 19 of the *New Regulatory Framework* – more specifically, "[Associated person (APs)] [...] handling only institutional clients would be subject to proficiency requirements of the employer." We ask that the CFTC specify if this sentence conveys that APs are subject to the requirements of their employers and the CFTC or solely subject to the requirements of their employer. As stated above, we do not believe employers should be allowed to set minimum competency training standards for their employees.

**CFTC's Proposed Regulatory Role**
We applaud the CFTC's proposed new regulatory role, which approaches market regulations by oversight rather than micromanagement of those it regulates. By utilizing industry ingenuity to adapt to market changes and by reshaping compliance procedures to meet the needs of the market and all of its participants, the CFTC can focus its resources on (1) its market oversight function, (2) "fine-tuning" the existing *Core Principles* or developing new ones if needed, and (3) analyzing the effect of these principles on applicable markets.

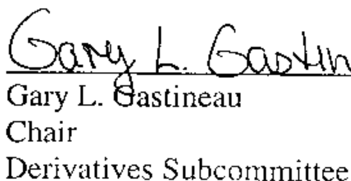
We favor the proposal to formalize the 45-day review time limit for new contracts. We do, however, encourage the CFTC to further reduce the review period. We have some concerns regarding the proposal to streamline the regulatory approval process of rule changes at the exchanges. As written, exchanges must notify the CFTC of any rule change. The CFTC is then responsible for making open issues or concerns known to the exchange. While this proposal facilitates the implementation process of routine rule changes, exchanges may be subject to unforeseen legal and other unknown risks from the manner in which it operated during the interim period should the CFTC take issue with a change that has already taken place. We, therefore, recommend that exchanges follow a 15-day notification period before implementing any rule change. This period gives the CFTC ample time to raise concerns, if any exist. Routine and emergency rule changes should be excluded from the 15-day window.

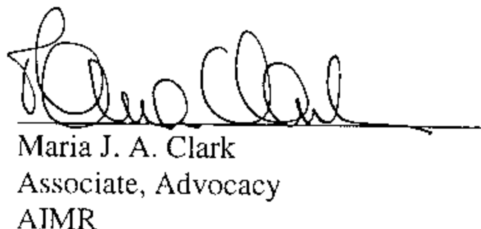
We are also concerned with the possible confusion created by allowing participants to choose their regulatory overseer. Permitting participants to choose their regulator may lead to (1) confusion among participants, (2) unequal disclosures to participants, and (3) enforcement problems. We recommend that the framework clarify who has enforcement responsibility when multiple regulators are involved.

## CONCLUSION

The Derivatives Subcommittee of AIMR's Advocacy Advisory Committee appreciates the opportunity to comment on the proposed *New Regulatory Framework*. Should you have questions or need additional information, please do not hesitate to contact Maria J. A. Clark by phone at 804.951.5314; by fax at 804.951.5320; or by e-mail at jac@aimr.org.

Sincerely,





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