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BEFORE THE

COMMODITY FUTURES TRADING COMMISSION

PUBLIC HEARING ON

A NEW REGULATORY FRAMEWORK

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A G E N D A

OPENING REMARKS	PAGE
Chairman Rainer	4
Commissioner Holum	8
Commissioner Spears	9
Commissioner Newsome	11
Commissioner Erickson	14
Panel 1 - Noted Observers of the Industry	
Leo Melamed, Chairman Emeritus and Senior Policy Advisor, Chicago Mercantile Exchange	20
Philip McBride Johnson, Partner, Skadden, Arps, Slate, Meagher and Flom, LLP	27
Thomas A. Russo, Vice Chairman and Chief Legal Officer, Lehman Brothers	33
Richard L. Sandor, Chairman and CEO Environmental Financial Products, LLC	43
Robert K. Wilmouth, President, National Futures Association	54
Panel 2 - Futures Exchanges	
Mark G. Bagan, Vice President of Market Regulation, Minneapolis Grain Exchange	77
Dennis A. Dutterer, Interim President and CEO, Chicago Board of Trade	81
Mark D. Fichtel, President, Board of Trade	85
James J. McNulty, President and CEO, Chicago Mercantile Exchange	91
D. Patrick Thompson, President, New York Mercantile Exchange	99
Panel 3 - Over-the-Counter Markets	
Ruth W. Ainslie, Senior Director for Policy, International Swaps and Derivatives Association, Inc.	130
Mark C. Brickell, Managing Director, J.P. Morgan Securities, Inc.	136
R. Martin Chavez, CEO and Founder, Kiodex	142

Kenneth M. Raisler, Partner, Sullivan & Cromwell 146

Edward J. Rosen, Partner, Cleary, Gottlieb, Steen & Hamilton 154

CLOSING REMARKS:

Chairman Rainer 185

P R O C E E D I N G S

CHAIRMAN RAINER: Okay. Maybe we'll get started. I want to thank everyone for being here this morning and particularly thank you panelists, a distinguished group of experts who have agreed to provide testimony and respond to questions that we might have.

These next two days represent a continuation of our process, which we hope will lead to reform of our regulatory structure. You may recall this started late last year when we formed the staff taskforce, charged with the task of looking into these matters.

We've also had a number of public meetings, including a roundtable comprised of more than 30 professionals in the business, a technology roundtable shortly thereafter. We had an agricultural advisory committee during that same week.

We subsequently have had a technology advisory committee meeting on this subject and literally dozens of meetings with practitioners, legal representatives and other close observers of the scene, including former Chairs.

And so where we are now is that we have published a rulemaking in *The Federal Register*. I think that it was effective June 22 and as we commented a number of times over the preceding months, that during this 45-day comment period, we would be holding at least one public meeting, it

turns out we're going to have two or one long one over two days, which will be in conjunction with this comment period and will be very helpful to the Commission to get your comments today, but also I will strongly recommend to put your comments in writing, those of you who are not part of these panels, for us to consider later on in the comment period, which I think runs out August 7, if I'm not mistaken, after which time we'll take a look at all of these comments, digest them, and see where we can make improvements to this package.

And then if everything goes well, we would be in a position to go final after that and then we have a period for Congress to take a look at it.

So we're on schedule, in parallel, of course, with Congress. Both Houses of Congress are working diligently on passing legislation for the reauthorization of the Commodity Exchange Act, and we are very mindful of that. It's a parallel process, we're working very closely with our committees on this legislation, it's very important legislation and so we're doing two things at once.

I would note that while this is difficult, it's probably fitting that our first hearing or public meeting comes on

the day that -- the day after scientists announced the break through in the cracking of the genetic code, which has over three billion letters of it apparently, and has been described by one observer as an important as the invention of the wheel.

It gives me great hope that our task can be accomplished also, finding the right code or regulation for these markets in the future.

The process today, we are going to have three panels. The first panel are distinguished people in the industry who have been around a number of years and have had direct and deep experience with these matters and whose opinions I think we all respect.

After this panel we will have a panel that will cover the multi-lateral transaction execution facility portion, in other words, the exchanges.

And then we'll break for 90 minutes and have a third panel and that panel will be discussing by experts the topic of over-the-counter legal certainty and the piece of our proposal that impacts that part of the marketplace.

We are doing two things at once. One, it's sort of like a coin with two sides, on one side of the coin we're looking at restructuring the framework for regulation for the futures industry and the other side of the coin is that we're trying to come up with language that at the same time

enhances legal certainty for the over-the-counter markets and it is a tricky proposition because we have certain limitations that end up necessarily with making some decisions close calls and quite difficult, so your comments will be very helpful to us.

This morning, first I'll ask if the other Commissioners have an opening statement and then we'll move on to the panelists, each of whom will be afforded time to provide oral testimony, your written testimony may be submitted to the record.

After each of you provides your testimony, we'll have a question and answer session where each of us will have about five minutes to ask questions.

With that, I will ask the Commissioners if they have any comments, but before that, let me again thank each of you on this panel very much for being here this morning. It is a very important contribution to this process and we're very appreciative of your taking time out of your busy schedule to help us in this next step toward what we hope is a successful resolution of cracking this code.

Commissioner Holum?

COMMISSIONER HOLUM: Thank you, Mr. Chairman. I also wish to welcome everyone here this morning for discussion of the Commission's newly proposed regulatory framework. I look forward to hearing the comments of the distinguished individuals participating in these meetings.

The issues before us today involving initiatives to provide regulatory relief for the U.S. Futures Industry are of paramount importance. Because of advances in technology and global competition, the time has come for a reexamination of the existing regulatory model.

This is a very important day for many of us, but here at the Commission and in the industry who have worked so long and so hard to bring about much needed reform, but as long and as tirelessly as many of us have worked, an obstacle always seemed to appear to thwart our efforts.

Then one day in August, Chairman Rainer arrived. Not only did he immediately recognize the need to update our regulatory structure, but before the ink was even dry on his certificate of appointment, he jumped right in.

He began building coalitions with other Commissioners, with Commission staff, with the President's Working Group, with the Congress and industry representatives and here we are, less than a year later, with a significant, far-reaching and comprehensive regulatory reform package before us.

I would like to thank you, Mr. Chairman. I would like to thank my fellow Commissioners, I'd like to thank the Commission staff, thank industry representatives and thank members of Congress and the President's Working Group and everyone else who has worked so hard and creatively to make this day possible.

Under Chairman Rainer's continuing leadership, I am confident that the Commission can succeed in reforming the existing regulatory landscape to meet the needs and demands of an evolving and geographically expanding marketplace. Thank you, Mr. Chairman.

CHAIRMAN RAINER: Thank you. Commissioner Spears?

COMMISSIONER SPEARS: Thank you, Mr. Chairman. At the outset, I'd like to commend Chairman Rainer both for his leadership in bringing forward the most ambitious and far-reaching regulatory reform proposal in the 25-year history of the CFTC and for his diplomatic skills in doing so while maintaining coordination and cooperation with the other members of the President's Working Group on Financial Markets.

New markets, new trading systems and new technologies are bringing profound changes to the financial and

commodity markets around the world. If the U.S. markets are to maintain leadership in the fast changing global financial marketplace, they must be able to respond quickly and decisively to competitive challenges.

That will take not only innovation and imagination on their part, but also a regulatory system that is flexible enough to allow new ideas to blossom and grow without unnecessary regulatory burdens.

The goal of the proposed new regulatory framework that is before us today is to provide that flexibility. I fully support that goal, but as we reach for it, we must remember two things.

First, along with new opportunities for exchanges in structuring their businesses come added responsibilities for meeting the regulatory core principles.

Second, we must never lose sight of the Commodity Exchange Act's statutory mandate to assure customer protection and market integrity.

I hope today's witnesses, as well as other participants in the public comment process, will help us to determine how well we met that mark.

Also, as Chairman of the Commission's Agriculture Advisory Committee, I'm very interested in the comments of the agricultural community on these proposals. We would

welcome comment at today's hearing from any agricultural representatives wishing to speak.

However, to allow the agricultural community to digest the document more fully, we will be discussing the proposed new regulatory framework at our next Agriculture Advisory Committee meeting, tentatively scheduled for July 18. That date is within the comment period and the transcript of that meeting, like that of today's meeting, will be included in the public comment process and carefully considered by the Commission in its deliberations.

In closing, I'd like to express my sincere appreciation to Paul Architzel, who headed up the staff task force that put this package together and to all the other staff members who devoted countless hours to this project.

Let me also thank the witnesses who have come here today to share their comments and views with the Commission. I look forward to hearing your views. Thank you.

CHAIRMAN RAINER: Thank you. Commissioner Newsome?

COMMISSIONER NEWSOME: Thank you, Mr. Chairman. I too want to offer my hugs and kisses to the Chairman.

(Laughter.)

COMMISSIONER NEWSOME: Seriously, I want to thank you, Mr. Chairman, for the outstanding leadership and the direction that you have provided the Commission as we go forward.

I also want to thank my fellow Commissioners. Even though we don't always agree, I think the level of cooperation is extremely high, the level of professionalism is very high and certainly it's an enjoyment to have the opportunity to work with this very fine group.

It was apparent to me soon after coming to the Commission that regulatory relief was certainly in order, given technological changes that have taken place in the industry and I certainly think it's appropriate for our regulatory changes to address the advancements that have been made in technology.

I think it's important that we've removed the regulatory obstacles for those who are innovative and creative, those of you who have thought outside the traditional box.

I think it's just as important that we do as good a job as possible in terms of leveling the playing field for all market participants so that the success of participants is determined by the market and not certainly by regulatory obstacles.

I've got two main thoughts that I'm going to be thinking about as we go throughout the next two days. First is that

as we decrease these regulatory obstacles and prescriptive rules, I think it is extremely important for market integrity that we maintain the authority to have swift, strong enforcement as a deterrent to those who want to get outside the regulatory rules.

And secondly, I think it's critically important that as we address these changes in the marketplaces and the technological advancements that have take place that we not only look at problems as they exist today, but that we try to become creative and we appreciate your help in doing so, but that we try to focus on where the market is headed, where we may be years from now so that in five years or even two years that we don't get locked into the same corner that we've been in recently.

So I very much appreciate the wisdom and advice that you panel members are going to provide to us. We thank you for taking time away from your businesses to come to Washington and testify before the Commission. Thank you.

CHAIRMAN RAINER: Thank you, Commissioner Newsome. Commissioner Erickson?

COMMISSIONER ERICKSON: Thank you, Mr. Chairman, and I think you mentioned three billion letters was the magic number for cracking the code?

CHAIRMAN RAINER: Something like that.

COMMISSIONER ERICKSON: Maybe Paul can start counting and we can find out when we get to three billion in the proposal.

These issues are complex and I hope these meetings today and tomorrow will help us further develop an understanding of how to best oversee a changing industry in a way that is responsible and at the same time encourages innovation and growth.

That being said, I cannot help but think that the proposal before us today raises as many questions as it attempts to answer.

One of the major questions it raises, for example, involves the much-discussed issue of legal certainty. The framework is advanced as a partial solution to questions of legal certainty. However, the solution it proposes seems to me to open the door to some expanded uncertainties.

I look forward to hearing a discussion about this issue and how the concerns of the industry can be met by this proposal.

More specifically, the Commission's jurisdiction generally extends to contracts for future delivery and

options. The proposed framework is grounded in the authority that allows the Commission to exempt certain transactions without making any determination of whether they are within the Commission's jurisdiction.

The framework would extend this relief to transactions in each of the three new marketplaces envisioned, exempt MTEFs, DTFs and RFEs, while retaining the Commission's anti-fraud and anti-manipulation authorities.

Under similar circumstances in the past, some members of the over-the-counter derivatives community have expressed concerns about the enforceability of these fraud and manipulation authorities that have been retained under the existing Part 35 exemption for swaps.

Given this history and the much broader exemptions at work in the proposed framework, I wonder if members of the industry have any similar legal certainty concerns with regard to these exempt markets that the Commission proposes regulating on a voluntary basis.

The proposed framework would also preserve the Commission's responsibility for detecting and deterring fraud and manipulation in each of the markets described in Parts 35, 36, 37 and 38 of the framework.

But the Commission would be expected to do so without some of the tools currently available to it. It thus appears the Commission would lose at least some ability to detect and to deter.

Personally, I think it's in the Commission's best interest to have more than those tools necessary to just pick up the pieces following a market event, and I look forward to some additional comments along those lines.

More generally, the proposed framework clearly follows a trend that we've seen reflected in the Report of the President's Working Group on Over-the-counter Derivatives, as well as in the legislation currently pending in both the Senate and the House.

The common theme throughout is the notion that this agency has a diminished, or in some cases even no, interest in regulating or overseeing certain types of markets, transactions, and/or market participants.

Given this general direction, I wonder if it isn't legitimate to begin speculating about whether we should retain any of these interests in certain of these markets as we move forward on the regulatory front. If we do retain an interest, I believe we should be taking a hard look at what tools we have in our toolbox to vindicate those interests.

These are a few of the issues I hope to see discussed today and tomorrow. I recognize the need to modernize and streamline our approach and would like nothing more than to have industry and Commission agreement over a system that provides the industry with the lighter regulatory touch and legal certainty that it craves.

Legal certainty, however, is a double-edged sword, and I look forward to a plan that also provides the Commission with adequate certainty about its own role in preserving the usefulness and integrity of these markets.

I do not think it serves anyone's interest to have a Commission that retains responsibility for oversight, but has a diminished ability to detect and deter fraud and other market abuses.

I'm hopeful that these public meetings provide us with a record that will both address and allay these concerns.

Finally, I'd be remiss if I didn't acknowledge the efforts of the Commission staff. Today's and tomorrow's public meetings are the culmination of a great deal of hard work on their part and creative thinking that resulted in the recent *Federal Register* releases outlining this new proposal.

I believe it is always in the agency's best interest to reexamine how it approaches regulation, to provide relief from burdensome regulation where possible and to ensure that regulation remains current with the demands of evolving markets.

I realize that change involves an element of risk, and I am prepared to take those necessary risks, so long as the public record is developed on the questions raised by members of the Commission, by representatives on the panel and others in the industry and also the public. Accordingly, I welcome today's and tomorrow's hearings.

I'd also like to take a moment to thank the Chairman for making available to us today and tomorrow so many talented industry participants. I know you all care deeply about these issues and the markets and that many of you have worked closely with the staff taskforce in helping to put forward these proposals.

I look forward to hearing from you, and I hope that our discussions will make me and everyone else take greater comfort in the proposal we have before us. Thank you.

CHAIRMAN RAINER: Thank you, Commissioner Erickson. Before I turn to our first panelist, let me make two additional comments, really under the rubric of thank yous.

I want to thank the other members of the Commission, my colleagues. As you can tell, they're very engaged in this

process, have been very helpful bringing different points of view as we've gotten to this point and I think that what we have is a full and robust Commission debating these issues in a very healthy manner.

I also want to thank our staff, our staff taskforce and the Chairman of the taskforce, Paul Architzel, for what I think is remarkable, absolutely extraordinary work done with this framework. They've taken us a long way to where we are today, with guidance and help from a number of you, but I would be remiss if I didn't underscore the importance of the work by our talented people on the taskforce, led by its Chair, Paul Architzel.

And with that, let me introduce our first panelist, Leo Melamed. He needs no introduction for most of you, we all know Leo. He's currently Chairman and CEO of Secure Adelsure, he's Chairman Emeritus of the Chicago Mercantile Exchange. He is known as a visionary in this industry, well known and liked by everybody and we are very pleased to have him lead us off.

The order of the panel, you may be interested to know, is essentially alphabetical as we move from your right to your left, with the exception of Leo, who gets to go first

because he needed his computer plugged into that wall socket right there.

Leo, the floor is yours and thank you.

MR. MELAMED: Well, thank you, Mr. Chairman and Commissioners. I am pleased and honored to be here and participate in this important process.

I was asked by you to sort of set the stage. There will be two days of hearings where many will speak in specifics, but rather than to lead off with specifics, I think you suggested that I offer an historic overview, where we were, how we got here and perhaps where we are going. I've tried to do that in a very brief, hopefully succinct fashion and I will read my remarks.

In the words of the late Merton Miller, the 1990 Nobel Laureate in Economics who recently passed away, the launch of financial futures represented "the most significant financial innovation of the last 20 years."

These instruments of finance and currencies, treasury bills, gold, eurodollars, US bonds, federal funds, oil and gas, stock indexes, changed the nature of risk management in business, ushered in the modern era of finance and served as the cradle for today's global financial derivatives market.

Alan Greenspan agrees, and I quote, "By far the most significant event in finance during the past decade," he

said a few years ago, "has been the extraordinary development and expansion of financial derivatives...the reason that growth has continued despite adversity, or perhaps because of it, is that these new financial instruments are an increasingly important vehicle for unbundling risks. These instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it...a process that has undoubtedly improved national productivity, growth and standards of living." He said a mouthful.

Of course, Mr. Greenspan for the most part was probably talking about the giant derivatives market in the over-the-counter world. Still, he was no doubt aware that to a great extent our cousins in the OTC marketplace still look over their shoulder to exchange-traded derivatives and consider them as their trustworthy security blanket on which they greatly depend, certainly in moments of upheaval.

Besides, Mr. Greenspan was fully aware that the derivatives invention occurred and was nurtured mostly by floor traders on the floors of the futures exchanges. Without this formative history, the transformation of

derivatives, a consequence of modern computer technology, into the present global derivatives marketplace might never have occurred.

Thus, the futures industry can be justly proud it's middle name was innovation and that its exchanges were a critical component in our nation's march to the top of the global financial service ladder.

The benefits which, as Mr. Greenspan pointed to, not only served to improve national productivity, growth and standards of living, but without question were instrumental in making our nation the financial center of the world.

Not too shabby a heritage for an invention that is hardly three decades old. Alas, the story may have a very sad ending. Our innovation patent may have run out.

Our full potential may never be reached. Alas, the home of the invention which gave birth to this magnificent, even breathtaking story, has been added to the list that includes the California Condor and the Chinese Panda. In other words, an endangered species.

The cause for this sad state of affairs is well documented. The information revolution and computer technology gave the world the ability to duplicate what we had inspired and often do it better, quicker and cheaper.

For a time, our industry was thrown into a state of shock and immobility. Sadly, American futures markets

refused to face the changing technological reality, losing precious time in a fierce internal tug-of-war between the certainty of an open outcry past and the insecurity of a technological future.

But much worse. All the while American traditional exchanges were shackled with antiquated crippling rules and product restrictions that made it nearly impossible for them to compete in the altered financial landscape.

They were doomed to an uncompetitive fate. Not only were they required to meet a revolutionary transformation, they were in a battle for their lives in Washington, D.C., where regulatory inertia ruled the day.

The foregoing realities drove nearly every traditional exchange to consider a transformation of its structure. For centuries financial exchanges have been member-owned organizations, but nearly all of them are in transformation from a non-profit, member-owned structure to a for-profit entity with publicly traded stock.

The shift towards electronic trading of stocks, futures and options changes not only the manner of how these instruments are traded, but also the organization,

governance and finances of the exchanges on which they are traded.

At the Chicago Mercantile Exchange and at the NYMEX, this transformation is nearly completed. We have taken the bold measures dictated by modern day challenges and have prepared to reshape our existence. We intend to be lean, efficient and competitive. Other exchanges are following suite.

We are prepared to defend our franchise and our innovative heritage, but the hour is late. It is now within the grasp of most financial institutions to acquire and operate trade execution systems that duplicate the trading function of exchanges.

As a result, every dealer is poised to create an exchange or join and expand operation of an existing exchange. There is a major story almost every day announcing a new alliance to operate an exchange or a quasi exchange.

There is no technological barrier to cross border operations and foreign exchanges want their share of the U.S. transaction business. Indeed, the new entrants are aghast that they may be subject to CFTC jurisdiction and regulation if they create their own electronic exchanges.

Thus, we have been treated to a bizarre spectacle as every segment of the derivatives industry tries to explain

why its proposed or projected exchange is not really an exchange and should not be treated like the CME, CBT or NYMEX.

The efforts of next exchange entrants to avoid a consistent, logical definition of exchanges that would subject them to CFTC jurisdiction have been matched only by the efforts of the SEC regulated securities exchanges to keep futures markets from competing in turf they have reserved for themselves.

Seventeen years ago the Shad-Johnson Accord resolved a jurisdictional conflict between the SEC and the CFTC. It was not intended as a permanent barrier to innovation and growth.

Today, Shad-Johnson is being used as a weapon against competition. Stock index futures, invented on the futures exchanges, have matured into vital financial management tools that enable pension funds, investment companies and others to manage their risk of adverse stock price movements. Futures exchanges have been frozen out.

The hour is late. Nothing we do internally will save our industry from extinction unless we also achieve

regulatory reform. The issues are before you and Congress as we speak.

While we support relief for the OTC market and the opening of our markets to foreign competitors, we cannot support a package that gives relief to one segment of the derivatives market at the expense of domestic exchanges.

Congress must lift the single stock futures ban and repeal Shad-Johnson. If the clock strikes midnight before the futures markets, the very entities that created the primordial soup from which evolved today's modern derivatives market with its $80 trillion derivatives contracts, do not complete their modernization agenda or are not allowed to compete equally with every other derivatives counterpart, whether foreign or domestic, then the recent *Chicago Tribune* editorial announcing the demise of our Chicago markets may indeed be proven right. I pray not.

And there is some hope that our prayers will be answered. In the last moments of this sordid tale, in a style reminiscent of a well-known western story line, there seems to have appeared a lone stranger, accompanied by a posse of four.

Low and behold, he may even be riding a white horse whose thundering hoof beats may come to our rescue and if

one listens carefully, one may even hear the strains of the William Rainer Overture in the background.

But the ending of this tale is still in grave doubt. Will this masked rider be in time? Will the federal marshals join his historic call for reform? Will he awaken the settlers on the Hill or will they instead wrangle among themselves and give way to the powerful land grabbers? As they say, stay tuned.

While all of this may sound exciting and even amusing, make no mistake about the nature of this battle. It is deadly serious business. For if the futures industry loses, so does this great nation. Thank you.

CHAIRMAN RAINER: Thank you, Leo. Our next panelist also needs no introduction, Phil Johnson is a partner of Skadden, Arps. He's been involved directly and deeply in this industry for many, many years, was a former Chairman of the CFTC and of course, is the Johnson piece of what we call the Johnson-Shad Accord, back in 1982.

With that, Phil, thank you for being here and I'll turn the floor over to you.

MR. JOHNSON: Thank you very much Mr. Chairman and members of the Commission. Leo made a very well organized

and impressive statement. I, on the other hand, am going to talk extemporaneously, if you don't mind.

I have a number of clients that will be commenting on the specifics of these proposals and so as not to cross wires with any one of them, I'll try to stay away from the details of the plan as such.

Mr. Chairman, you suggested that there might be a little historical input that might be useful here and so I think I'll focus principally on that.

If you go back to the year 1900, the principal concerns of the futures markets -- oh, by the way, I appreciate that there are people who think that I learned the regulations by looking at pictures on the cave wall and it is true that I've been around the industry since I got my papyrus diploma from Yale, but I can't claim to have any personal recollection of the year 1900.

CHAIRMAN RAINER: Not a bad year.

MR. JOHNSON: Not a bad year, I suppose, for those who were there. At that time I think there were probably two principal concerns that the industry had, particularly the markets had.

The first was that the agriculture community was clamoring for some kind of government regulation of the markets and the other was that there were all these private entrepreneurs operating out of store fronts and upstairs in

various offices, selling futures contract look-alikes that were referred to derisively by the industry as bucket shops.

By 1921 and '22, the farm community had persuaded Congress that it was time to have regulation and the exchanges exacted as consideration for coming under federal regulation, that all futures trading henceforth would have to occur on and through their facilities. As a consequence, the bucket shops rapidly disappeared.

Over the years after that, until the early 1980s, the level of federal regulation of course ratcheted up on a fairly consistent, deliberate basis to the point where when I started practicing law and the Commodity Exchange Authority and the Department of Agriculture was still running the show, we had a little pamphlet, it's thinner than most of the pamphlets you can get in the reception room down on the fourth floor these days, and those were the rules and regulations of the Commodity Exchange Authority.

Well, we know how far we have come since then, but so long as the exchange has had what amounted to a collective monopoly over the business, the added costs and stresses

and burdens of piling on of additional layers of regulation was sort of a no harm/no foul phenomenon in that there was not any chance of them becoming vulnerable to outsiders.

By the early '80s, two things happened that changed that scene dramatically. The first was that many of the foreign countries began to develop their own futures markets under a radically different, in many cases, regulatory regimes. So international competition began to emerge at that time.

Here at home, as we know, the over-the-counter derivatives business began to boom in the mid '80s and was perceived of as being in many ways in competition with the futures markets and it is a huge, huge business today, as we all know.

All of a sudden, the level of regulation was no longer no harm/no foul. A lot of harm was happening, a lot of disability was resulting from it all and all of that was sort of prelude to the chemistry that you are now undertaking and I congratulate you for it because it is not -- as Leo says, not a moment too soon.

But I don't want to discuss the structures that you have in mind because there will be plenty of opportunity to take input from that, both here and through the comment period.

But I want to come back to a point that Commissioner Erickson made in his opening remarks. Regulation and law enforcement are two very different things.

Regulation creates an expectation in the public's mind that bad things just aren't going to happen. Law enforcement is he robs a 7-11, you chase him down, you handcuff him, you try him, you convict him, you put him in jail, hurray, the system is working.

With regulation, there's not supposed to be a robber in the 7-11, you were supposed to have prevented that from happening in the first place and in a regulatory environment, the most common criticisms in my experience have been in times of peace and quiet, why are you picking on these people.

Something goes wrong, that very same voice is heard out of the wilderness, how in the world could you have let that happen.

So regulators are caught in this vice of having to always tighten around every conceivable external risk. What I think is the most significant step that you're considering taking now is moving away from that risk averse posture that everyone encourages regulators to take and moving more into the area of saying in order for this business to be done, in order for the nation to remain a strong economy, in order for these markets to survive, we

simply have to step back and accept a little bit of the risk ourselves, because if we do not, if we do not shut down these markets, we will have some level of risk and the more we open them up, a little more risk we're taking.

So in my view, I want to congratulate you, irrespective of the structures you're talking about. I want to congratulate you, Mr. Chairman, and I want to congratulate the members of the Commission, that this is a very courageous and a very unprecedented thing you're thinking of doing and I think it's correct and I hope you proceed with it and I hope you carry it through. Thank you.

CHAIRMAN RAINER: Thank you, Phil. Our next panelist is Tom Russo. Tom is Vice Chairman of Lehman Brothers and the firm's Chief Legal Officer. He's also counsel to Lehman Brothers' executive committee, is a member of its operating committee.

Some of you may be aware that before that he was a partner at the law firm of Cadwalader, Wickersham & Taft and he has also served as Advisor to the Brady Commission in 1987.

What we're very interested in and proud of is that he was the first Director of the Division of Trading and Markets for this agency back in the '70s. He's been a personal help to me, I'm very appreciative of his being here.

Tom, why don't you take the floor. Thank you.

MR. RUSSO: Thank you very much, Mr. Chairman. It's really an honor to be here and it's particularly an honor to be here with these panelists, who I've known for decades and had the privilege of working with each of them over those many years and I feel really very, very privileged to be here, sitting with them, particularly you, Leo, who as I understand, was voted or was acclaimed one of the ten most important businessmen in the last century from Chicago, which is really incredible.

I once did that from Staten Island, a little neighborhood in Staten Island, and it was actually in the last 20 months or so, I think it was, but the same idea.

I wanted to address some of the specifics of the proposal, but again I'll try to do it as generically as possible and I make my comments not only as a lawyer, but also in my capacity at Lehman Brothers I chair a variety of committees, one is the Operating and Exposures Committee, which deals generically with all the risks, and one is a New Products Committee, which is all of the new products of the firm, which is particularly relevant to some of the proposals that the Commission has asked for comment.

I'm also co-chair of a committee called the Global Documentation Steering Committee, which is hosted by the New York Fed, which deals with documentation in the over-the-counter market and every aspect of the ISDA documents to (inaudible) documents to bond market association documents, and the whole thought there is to get them all in one way of looking at life, which goes to some of the proposals in Part 35. So with that background, I'll make my comments.

I have prepared written comments I would ask to be part of the record. These are comments that are extemporaneously now.

I ask myself what should a regulatory structure look like in the modern world, what would I do in the perfect world if I were setting the regulatory structure. First of all, and this goes to one of the things that Commissioner Erickson I think was dealing with, I would never label things.

I think in the course of my experience, labeling things is just a mistake. When I look at risk at Lehman Brothers and I think when most other people look at risk, you have just to look at things that trade.

In one speech I've once given, I said I'd just call the stuff "stuff," because when something trades, it's got a lot of numbers associated with it, it has volatility issues

with it, it's got liquidity issues, it's got lots of things associated with it.

But the thing I don't look at, I would never ask someone in risk well, is it a security, is it a commodity, is it a futures. It's irrelevant to me what the hell the thing is. I've just got to know what the counterpart is, what the issues are, what the documentation is, what the legal risks are and what have you.

And the reason why I think that is particularly important is that while in this specific proposal it may give a little more certitude and in the enforcement area by calling something a futures, you have no assurances what the next Commission is going to do, the Commission after that and what have you, and carrying the baggage of a label is a mistake.

I just want to go back one step, since we all have a lot of history with us. One of the reasons why we have the exclusive jurisdiction section in Section 2(a)(1), when the Federal Home Loan Mortgage Corporate in the early '70s wanted to have a futures contract on mortgages, it did a proposal to the SEC.

At that time I was an associate at Cadwalader, representing the Federal Home Loan Mortgage Corporation and I remember very clearly doing a memorandum, I remember exactly when it was, I remember the day we submitted it and it was submitted actually May 20, 1972 and I was very proud of that memo explaining why there should be a futures market in mortgages.

The SEC responded because it was in their view a security that it would have to have a registration statement, a registration statement for each of the individuals involved. It would be something that was so onerous, of course, this could never happen and as a result -- in part as a result of that and because of commodity option problems, you've got Section 2(a)(1) and then Rich Sandor wound up writing the first contract on the Ginnie Mae.

Had the SEC not been ham strung with this concept of labels and what have you and looked and said whatever the hell it is, it's a good idea, we'll figure out a way to do it, I don't think -- I think we would have gotten things moving much quicker and the evolution of the futures market would be a lot different. So I think labels is not a good thing, I would not put that in there.

Also, I think a regulatory structure should deal with the global nature of the customers and firms. In firms

like ours, we're again oblivious to whether someone is United States or not, we look at the customer, we look at the credit quality of the customer, we look at the ability of them to pay, we look at the suitability for the products, we look at all these things.

We have criteria for people that we don't really look at where they're from. We try to do a business that is blind to where someone is from. We select jurisdictions to do things in that are efficient, not to avoid regulations, but to do it in an efficient way.

In an efficient way, even if there's no regulation, doesn't mean we don't have capital criteria, it doesn't mean we don't have all those other risk things, because when all is said and done, we want to make money, we don't want to use money and we do that just out of our own self-interest.

I would also have a regulation structure that deals with different kinds of customers because one size, as the Chairman has said, doesn't fit all. That's exactly what you're doing in this structure.

And I would have a structure that is totally, totally flexible. In my role as Chairman of the New Products

Committee, I see dozens and dozens and dozens of new products. I am always amazed at the ability of people to go and change things around to something new. I would say the vast majority fail, but that's part of life.

You want to encourage, particularly today you want to encourage as many things as is possible within a realm and pigeon holing things or giving lack of flexibility is not a good idea and so the thoughts that Leo made, in terms of using regulation as a shield, you should never -- that's just a mistake because the great thing that this country has more than any other country is its ability, its imagination to move things forward and you have to have a structure that permits creativity, within certain bounds and I think that's exactly what this proposal does.

I want to make one other comment, because I know this is important in Commissioner Erickson's mind and it's a point that Phil made and I think it's a good point.

You take a risk when you do some of these things. When you don't label something, someone will say well, it's really not a futures contract or you can't go out after us. If you don't have the enforcement ability, it does raise questions about the integrity of the whole program, because you're taking on a big responsibility and you may not be able to afford to, there's no doubt about it.

But all of life is cost/benefit in many ways. You give up that, yes. My own experience is most -- where there is fraud, you're going to win a case. It just happens, whether it be in common law, to win any case, you need sex appeal and legal handle. Fraud is the sex appeal, any judge anywhere will find a way if there's fraud.

Most cases settle and to the extent you're before your own agency, I think you have a great deal of flexibility there, in terms of administrative proceedings.

So I think that the reality of the marketplace is that where there is fraud, the person who committed the fraud is behind the eight ball anyway, any judge, any person will find a way to go against them and there will be some that get through in the process, that's true, but the benefit is that you're not going to stereotype the program.

I just want to make -- I had other comments, but I just want to make one about the Part 35, which is dealing with the over-the-counter market and again, this is -- essentially what the Commission is proposing here is to get rid of a lot of the labeling again.

It got rid of labeling something as a swap. I think that's terribly important because it doesn't make any

difference, it's a bilateral transaction. Calling it a swap, you pigeon hole it, some people are not exactly sure what something is and they could mislabel it and that could be a problem.

Permitting clearing, and I recognize clearing as again, the silliness of old Part 35 and indeed of the policy statement itself is the very things you want to encourage, clearing, margining, things that are important in the financial integrity of the contract itself, because one is trying to not pigeon hole it as a futures, so therefore this were characteristics of a future, you take away the very things that you would want to have.

This to me shows a problem if you try to pigeon hole things. I think what the Commission is proposing there is very important.

And finally, what the Commission is doing with the permissibility of fungible and standardized contracts again is very important. I mentioned earlier this Documentation Steering Committee that is hosted by the New York Fed. We're trying essentially to get all documents in sync, whether it be bond market or what have you, because in the global world, it's irrelevant, you do transactions, some of which one side of the transaction is under a bond market association, the other side may be under an ISDA agreement, but the important parts of those agreements, such as the

blow out provisions and (inaudible), if they're not in sync with one another, you could have a calamity and the documents have what I consider a documentation basis risk.

They don't match, so when the numbers are done by risk managers, they're looking at the basis risk involved just in the underlying products, but really, if blow out provisions are different, the real risk involved is the documents don't mesh.

So you want again standardization in it. So the fact that the Commission is proposing that this would be okay in the over-the-counter market is very much in sync with the work of this committee, which was a follow up to the Kendell Party Risk Management Policy Group Report.

And I guess I must mention the non-repudiation proposals that are found throughout this in Parts 35, 36, 37 and 38. I think they're terribly important. Unfortunately, legal risk is, generally speaking, not one of the risks that you find in the computer risk analysis of most firms.

The legal risk, though, is an all or nothing risk, it's terribly important and everything that is being done in this connection and the clarity that is being done in particularly -- I'll address Part 35.3, I think is very,

very important because these markets, if permitted to grow on their own, with the exception of fraud, which is carved out, and manipulation, these markets are really going to be markets which we're not going to -- which are going to add to the strength of this country and the financial markets.

It's where creativity is now and the fact that you are able to get specious cases out and the only way you can get in is on fraud I think is probably where it should be, particularly given right now the institutional nature of these markets.

I just want to thank this Commission again for letting me appear here and I also want to commend this Commission. I've been -- as Chairman Rainer said, I was the first Director of Trading and Markets, something I'm very, very proud of, but when I look at what this Commission has done under Chairman Rainer in this last not even one year, I have never seen at any agency, at any time, at any place, such dynamism, such focus and such change that I think is in the public good and I want to thank you.

CHAIRMAN RAINER: Thank you very much, Tom. Our next speaker is Richard Sandor, every well-known in the industry. He currently is the Chairman and CEO of Environmental Financial Products. We generally associate Rich with his expertise in new products and as was referred to by Tom Russo, he wrote the Ginnie Mae contract, he did

the bond contract, the note contract and the options on those contracts, is very deep in this business and well-known and we're very appreciative that he could make it here this morning.

He was in London yesterday, so we appreciate the effort to get here and I'll turn it over to you, Rich.

MR. SANDOR: Thank you, Mr. Chairman, fellow Commissioners and fellow panelists. It really is a privilege to be up here. It's not such a privilege to have a name that starts with "s," because when you have panelists like this who precede you, you kind of feel like Elizabeth Taylor's seventh husband. You kind of know what you have to do, but you don't know how to make it interesting, so I think I'm going to try to make it short, Mr. Chairman, in view of that.

And I'd like to specialize along something that I have some small degree of experience and to draw on the history that you have asked us to draw into and Tom took half of the issues with regard to Ginnie Mae's, but I do want to mention that we should remember that the formation of this agency came after the '73 Arab oil crisis and the rise up

in agricultural prices in the '70s. This was a legal response to a market problem, the birth of this agency.

But it did carry a very positive role for business, no matter what its response was. It permitted ultimately the trading of interest rate and equity derivatives, partly the way Phil designed and Leo had worked on engineering the definition of a contract, which we spent a lot of time on, a service, a right general enough so that it could be all-inclusive and exclusive so that we wouldn't have internecine and warfare with regard to other regulatory agencies and I think it's very important as you have your considerations to remember those aspects of it and to keep them alive, because they will be the creativity of the index markets of other new products.

I also want to talk a little bit about those early products and the process of what things were like then. We did in fact lace -- Phil did and a number of us at the exchange laced the history of the legislation with little footnotes to mortgages and with guys like Pres Martin, who was then head of Freddie Mac and ultimately became Vice Chairman of the Federal Reserve Board.

We were looking to establish a secondary market in mortgages and I think everybody would agree that futures was important, but we put in the legislation mortgages in subtext.

Notwithstanding that, we got a knock on the door from the SEC on October 20, 1975 from the first contract approved by this agency, which sought an injunction to stop trading. What's the take away on that, no matter how clear and how resolute you are, you've got to even be more clear in defining that exclusivity and what it means. This is a very important message.

That was a contract, by the way, and I was Chief Economist at the time, and to share with you an idea, an idea that took six months to get approval of and three people were assigned from the old CEA and we actually got questions -- this is where the knowledge curve was, we got questions asking if there was enough storage space in Chicago for Ginnie Maes.

(Laughter)

MR. SANDOR: We've come a long way from that, but we got the process done in six months. We started trading U.S. treasury bonds, and this is particularly relevant in this, when a wonderful event in 1977, from our point of view, the U.S. went back into the long bond business.

They issued the 7-5/8ths of 07, affectionately known as the James Bond. The James Bond, among market participants,

became a bellwether. The Chicago Board of Trade, which knew absolutely nothing about bonds, created a fictional 15-year bond when the standard was 30, created an 8 percent coupon for which there was none and never did and instead of trading the current issue that the Treasury would have liked, created this God-awful cheapest to deliver contract, which has been extraordinarily successful and flew in the face of everything that the commercial world had thought and the U.S. Treasury had thought. I think that's another message.

I want to remind myself also when we started that contract there was lots of talk about manipulation. When we started that contract there were $18 billion of long term government bonds as opposed to $400 billion of issuance in the decade of the '90s. You don't need as much supply as one thinks when you're talking about anti-manipulation provisions.

You need the mechanics and all of the infrastructure to look at it and I would urge all of you to do that.

Having said all of that, I think that the structure that you've come up with is nothing less than outstanding. I would score everything that everybody said. You have been brilliant, you've been bold, you've been creative and Chairman Rainer I think has found the bid on the regulatory

front, where does that market go and I think to be congratulated.

I have one criticism, RFEs, DTFs, MTFs, there are too many letters and I'm going to refer to them as RFEs, RFED and RFEE for the three things, so there's just the regular one, a diversion and an eversion, the exempt and the derivative. In those schemes I think you pretty much cover the waterfront.

I would go along the lines of, in the other two points I'd like to make, the lines of what are the opportunities in the industry and what does this new regulatory framework allow for and what the potholes might be.

I think the same opportunities exist today in things that we all believe in, like equity indices and I want to just share a simple thought process in this, why is this important for this industry.

The government bond contract, $400 billion of issuance, $400 billion considered either the most liquid market in the world or one of the most liquid, depending what's happening, its issuance is going down, it is shrinking, but at its height it rode the fastest and highest plane ever.

A company that got started, went public ten years ago, called CISCO, has a market capitalization after the crash of $550 billion. What are the opportunities in equity derivatives? Enormous. With $550 billion, a single company, what are the manipulation potential and those kinds of things? Please look at some of these products in that way.

If we take a look at Microsoft, CISCO and Intel, the market capitalization of those three companies alone is greater than the sum of all of the gold held in every central bank in the world, those three stocks, and people don't talk about gold manipulation. Silver maybe, but not gold.

(Laughter)

MR. SANDOR: There are going to be big challenges that are going to have to do with harmonization, I think you have to get that right, but I believe you can, but I do think the opportunities are changing.

We grew up in an industry in which, unfortunately, the growth, romance and sex appeal was debt and it's no longer there. The trend is the opposite way, it's an old industry, fortunately the deficits are going down, here, around the world. They may have pockets of increase.

Aside from the Civil War, the anomalies of the inflation of the '70s and '80s are really rare in economic history.

I think a lot of us in the industry are making the bet it's going to come back and I think that's a high risk bet, so I think you want to look at new frontiers.

What are the other frontiers? These other frontiers are very important, again, for the enabling part of the legislation, et cetera.

They are in things like we never hear about generally within the futures exchanges themselves. We do hear of them at the exchanges, but the exchanges have not taken advantage of them and they have been taken advantage by the investment banking communities, new companies like Enron (phonetic) that are inventing whole new classes of commodities.

We are seeing a sulfur dioxide environmental derivative created by the Act of Congress here, tradable emissions right which this year will equal the wheat crop in trading, $4 billion. It's very important that you look at the macro trends.

In the concluding two minutes, I really want to say that in the 17th or 18th century we were driven by commodity-based wealth. In the 19th century we were driven by

manufacturing-based wealth. In the 20th century we were driven by financial-based wealth and engineering.

In the 21st century, my humble opinion is it's going to be knowledge-based commodities and that's what it is, it's telecoms, it's band width, it's environmental derivatives, it's human capital and to the extent you're thinking about what and how to include in these regulatory structures, it's less important to me about interest rate swaps because it's well-defined, we know about it, we know how to manage it, I think it's easy to understand manipulation, it has a liquid market. The challenges I think that you'll face is in this new space.

Let me in conclusion say that I think that the world that is creating these new products is unfortunately not part of the futures business and the futures business is one link in a vertically integrated space.

I work with about ten dot com companies and I'll tell you two of them, just to give them an experience to think about.

One of them is a energy-based trading company in Houston, Texas and that company basically runs the largest liquid market -- it does liquid natural gas, it does energy, it does everything and let me tell you what it does and what the model of the future is.

You make a trade with that company, it sells you the back office software. It sells you the front office software. It clears the trade for you. You do the confirmations. It also sells you the software to get the gas from a place in Texas where it's produced and schedules it, which is not a trivial mathematical problem, to get it to Indiana, where it's needed and when it's needed.

Why do I tell you that? Because the trading component is one part of it. If that component is a bottleneck, it's not good for anything.

The other level is that some of these commodities may in effect go by Wall Street. They are things like -- and I'll conclude with this example -- e.credit, another company that's work and they have a very simple thing, they have a credit scoring model and they have 95 things, they've turned credit granting into a commodity, they have serious clients like Gateway and Fleet Bank.

You plug it in, you go in and you buy 20 Gateway computers from one of Tom's offices someplace, they hit a button, it scores everything. If Tom doesn't like it, he puts in the 46 Russo factors, it readjusts those 46, reintegrates the model on your own desk, double checks it

with D&B, immediately gets it on line and it's implementable.

So those people go in, you get credit right away, then it goes to the syndicated bank. The bank looks at it and there are seven financing partners and here's the reason for the other example. That's a credit derivative that doesn't even hit Wall Street and the capital markets, it never will.

It goes from the guy in the store to the credit bank, to the credit bank partner and never even gets securitized like an asset-backed piece of paper and you're going to be dealing with commodities like that. How do you handle that, what's the manipulation?

In conclusion, this industry is I think up for grabs. I think we haven't done a good job at capturing any of that space and it was our space. I think that we're going to see something similar to what happened in the '70s and '80s happen to the futures business. We're going to follow the savings and loans and bank model.

You're going to have a lot of people consolidating, going out of business, joining force with others and a lot of new entrants. I see 20 people alone that have come to our particularly small firm to start new exchanges in a variety of commodities that eventually want to get before you to have an organized derivative and I think it will be

-- you'll have, as you have great names now like Wachovia that you didn't have 10 years ago in banking or 15 and you won't have names like Continental Illinois that you did have.

The good news is, I think, and I'll conclude on this, I think the industry is filled with dynamic people, incredibly inventive, excluding myself, these people at this table, and very importantly, I think the model that we're going to have is the chip industry that was basically written off and came back to re-dominate the world, and banking, which was written off and came back.

But it can only be with a private/public sector partnership where you provide a facilitating nature for the capital markets to invent. Thank you.

CHAIRMAN RAINER: Thank you very much, Rich. The final panelist on this panel is Robert Wilmouth. Bob is President and CEO of the National Futures Association and has been so since inception in 1982.

I think most people are aware that for five years prior to that he was the President and CEO of the Chicago Board of Trade and before that, many years as a distinguished banker in the banking industry.

With that, Bob, why don't I turn the floor over to you. Thank you.

MR. WILMOUTH: Thank you, Mr. Chairman. That was a nice way of saying that I'm pretty old and have been around a long period of time. And by the way, thinking of these distinguished venerable gentlemen to my right, I am by far the oldest of them, I think I have them all by at least a dozen years.

Be that as it may, Mr. Chairman and your fellow Commissioners, I have some good news for you and I have some bad news for you.

The bad news is that when I walked into my hotel room last night, the message light was blinking. I pushed the message light, "You have no verbal messages. You have one 507,000 bit message." Oh, my God, what the hell is this? That's the bad news.

I found out that it was a fax from my distinguished colleagues behind me, Misters Driscoll and Roth and Ms. Baffus (phonetic) telling me what they think I should tell you today.

The good news is that's about 1/60th, Commissioner Erickson and Chairman Rainer, of your three billion bits that you need, so if you pay close attention, you may solve 1/60th of your problem today.

Over the course of these 50 years that I have been active in the financial services industry, I've seen tremendous change in the futures industry, but little or no change in its basic regulatory structure.

The Commission's current proposal presents an historic opportunity to change that. The new regulatory framework is needed, it's long overdue and like my colleagues, I enthusiastically support it.

The gentlemen on the right wing of this panel are long time leaders in the futures industry and they presented you with some historical information and some valuable insights on how the futures industry should be regulated.

However, my perspective is a little bit different from theirs. In fact, out of all the witnesses that you will hear today, I am the only one that is in the same business that you're in. I am a regulator.

These days, that's not always something you like to admit in public, but the fact is that regulation is all we do at NFA and as a regulator, we share the same basic goals that you in the Commission have.

We also share some of the same basic problems. Just because the CFTC and the NFA are regulators, it doesn't

mean that we are immune from the competitive pressures that affect the rest of the industry.

All of the revolutionary changes occurring in this industry stem from the simple fact that both exchanges and intermediaries have to find more efficient ways to deliver their services to their customers. If they do, they will thrive. If they don't, I believe they will perish. What's true for exchanges and intermediaries is true for regulators as well.

At their core, regulators are service providers. Our customers include the customers and end users who trade on the exchanges, Congress, which represents those consumers, customers and end users, and the businesses which are subject to the regulations.

Like any other service provider, regulators must provide services that their customers actually need. That's another way of saying that regulations have to advance important public policy objectives.

We also have to provide those services, you and I, at a competitive cost. That's another way of saying that regulations can't impose undue burdens. If we as regulators fail to provide the right services at the right price now, the regulated industry will not be able to compete, business will flow overseas or to OTC markets and we will have little or nothing left to regulate.

It seems to me that providing the right services at the right cost is at the heart of the Commission's proposal and that's why I strongly support it. The proposal promotes competition and provides the right regulatory services by recognizing that different types of markets have different types of needs.

Markets trading commodities with an inexhaustible supply have different regulatory needs than markets trading commodities susceptible to manipulation. Sophisticated institutional customers have different regulatory needs than retail customers.

By noting these critical distinctions, the Commission could get rid of and would get rid of the one-size-fits-all approach and deliver the regulatory services that its customers really need. But that's just half of the equation.

The proposal will also make it possible to deliver regulatory services at the best possible price. It does that by making the Commission an oversight manager rather than a micro manager of the industry.

In my view, it is entirely appropriate for the Commission to set the standards that registrants are

required to meet, but regulation becomes micro management when the Commission tells the registrants not just what to do but how to do it. That's the trap that we fall into with detailed, prescriptive rules which become outmoded as technology changes the way that the industry does its business.

Using core principles supplemented with interpretive guidance on acceptable business practices is a far better approach. It's much more likely to adapt to a changing business environment and much less likely to cause undue burdens.

In short, the core principles, properly implemented, should help reduce regulatory costs and ensure that our regulatory services are at the right price.

Having said that, I strongly support the Commission's initiatives, I think a number of improvements should be made. Although the proposal makes extensive use of core principles for exchanges, it is far more limited with respect to intermediaries.

There are some areas, ethics training for example, where the Commission is true to its general approach by eliminating existing regulations and replacing them with core principles supplemented by interpretive guidance.

There are other areas, however, record keeping, risk disclosure and trading standards on RFEs, for example,

where the proposal backs away from the core principle approach and merely amends existing regulations.

We firmly believe that the Commission's overall approach is the correct one and should be applied to FCMs, IBs, CPOs and CTAs as well as trading facilities.

The proposal also fails to make full use of self-regulation in developing interpretive guidance on some of the core principles. Whenever we talk about best practices or acceptable practices, as I believe the current proposal calls them, we have to consider the basic question of best practices from whose perspective.

To be effective, these practices have to be considered from the perspective of the customer, both the users of the markets and the people we regulate. The best way to ensure that involvement is through the self-regulatory process.

Although the Commission's proposal recognizes a place for NFA in issuing interpretive guidance, it does not make full use of NFA's resources and, therefore, does not provide regulatory reform at the most efficient price.

For example, the Commission notes that NFA will develop the acceptable practices guidance for disclosure to retain customers trading on DTFs, but reserves to itself the role

of developing guidance on other issues relating to intermediaries. We would be only too happy to develop the guidance relating to intermediaries, as always, subject to Commission approval, and we encourage the Commission to supply that role to us.

We have the knowledge, we have the ability and we have the desire through our proven method of developing rules through our committee efforts.

I would also like to briefly address one other aspect of the Commission's release. The proposal provides for streamlined registration of banks and broker/dealers dealing only with sophisticated customers, but limits that relief to situations in which the sophisticated customers are trading on DTFs.

I don't see why the process, we way we process registration forms, should depend on what type of market the sophisticated customers are trading on.

And finally, I would hope that the Commission recognizes that regulatory change is an attitude, not just an action.

Chairman Rainer, you and your colleagues have done great things for the industry, particular you in your short term as Chairman. But you're not going to be here forever. It's imperative that the staff as a whole shares your vision for this new regulatory scheme.

While it is one thing to change the rules, the real test comes when those rules are implemented. We have worked closely with the CFTC staff for over 18 years now and we have always been impressed with their dedication and their professionalism.

But they face the same challenge that we face every day at NFA. We cannot become so entangled with the letter of the rules that we lose sight of the spirit of the rules.

If either NFA or the CFTC falls into that trap, no structure you develop will provide the sort of flexibility that we need in today's world. I know that both of our organizations can and will continue to meet that test.

And finally, I'm sure that we all recognize that it would be helpful for Congress to codify the basic structure outlined in your proposal and we will continue to work to achieve that legislation as quickly as possible. Thank you very much.

CHAIRMAN RAINER: Thank you very much, Bob, and thanks to all of you.

We're moving into the Q&A portion. Because we're running a little late, I do have a question or two myself, but they may be covered by one of my colleagues here, so

I'll just see if that happens, so I will just move directly to Commissioner Holum and ask if she has questions.

COMMISSIONER HOLUM: I have no questions, thank you.

CHAIRMAN RAINER: Okay. Commissioner Spears?

COMMISSIONER SPEARS: Thank you, Mr. Chairman. I have a couple of very general questions to start with. I know this panel spent a lot of time talking about history and where we've come from, where we've been and where we're going. I'd ask you also to think a little bit about the future here in regard to this question.

With the ever changing business landscape, new technology, increased foreign competition, my question centers on what would be the biggest challenge, our biggest competitive challenge or concern for the exchanges today under this new proposed regulatory framework?

If any one of you would like to try to tackle that question, I'd appreciate it. What do you see as the biggest competitive challenge under this new proposed framework for the U.S. domestic exchanges today? Richard?

MR. SANDOR: I think the biggest competitive challenge is the industry's own problem. It's got to change its business model and it's heretic to say so, but the level of infantilism in the industry is hard to regard in certain instances.

It sings the praises of a system which may have some application in the future, I think the bid side of the market for an organizational structure like mutualization and electronic is probably July 1 of this year and I put the offer side of the market December 2001. I think Stanley Kubrick is going to get it right with the film metaphor.

In industry has not to -- and the Merc has taken great steps in it, you know, well ahead of everybody else recognizing that you can't have a mutual, look at the S&Ls and the other kinds of industries that have lived under it, they've got to change the business model.

They've got to go back to what is something very, very basic and recognize that all of their glory and growth has been in the creative area, what the Merc has done, what the Board has been, what the NYMEX has done with products that didn't exist 20 years from now and you can't make decisions with committees, boards of directors that are 37 people wide and have no value proposition and what might even be heretical, where your clients are now your competitors and basically, those people who bring you order flow would like to take away all your order flow.

And so I think it's an industry problem. If you give us the framework, we'll overcome that. We'll learn the way to it, at some exchanges better than others, but I think it's the business model and the lack of rapid introduction of electronics.

COMMISSIONER SPEARS: Bob, did you have a comment?

MR. WILMOUTH: Just very briefly. I would support what Richard says, but in addition to that, I think the biggest challenge the exchanges face, and some of this is based on my experience at the Board of Trade almost two decades ago, is the same challenge that I threw out to NFA and to the Commission staff and it's an attitude change.

I think they have made tremendous strives, particularly the Merc, the New York Merc, the Chicago Merc and I know the Board of Trade is moving in that direction. But the attitudes of their members have to change to accept the new attitude that's going to have to occur if they're going to be run as businesses, like they should be.

COMMISSIONER SPEARS: Thank you. Leo?

MR. MELAMED: Well, only to add a little bit to what both Rich and Bob have said. I certainly agree with them, but I think that given the changes that we've already accomplished and given that we understand the framework will change to allow us to compete, now our challenge is to

find that business that we can serve the best way we know how to the industries that want it.

In other words, we have to find within our institutions those resources, those ideas and those products that will in fact serve the industries. They may not yet exist in our world, but such things like clearing are certainly in our capacity to serve to the rest of the community and we will do that.

But there are many things that we have to invent in order to be able to serve the new world and that's our challenge. Find those inventions. And I'm not speaking about traditional products like new instruments only, but various ideas that serve the communities, whether they be in the b(2)(B) arena or whether they be in the b(2)(C) arena, but clearly to serve those needs. That's our challenge.

MR. SANDOR: I'd like to, if I can, make just one point and it's really underscoring Leo, because I think the Merc has made a good step and I'm hopeful tomorrow the Board will do it, it's the executions and they're providing a leadership role in this, but when Leo mentioned new instruments, I thought of a little anecdote which I just

wanted to share with you because I got a call from a young man in Silicone Valley and he said I hear you're in the new instrument business and we need some help on some markets and I said yeah, what are you doing.

He said well, we've got two million old violins and cellos, these instruments, they're old instruments, but we've got to find a new way for these instruments to be traded and he said I gather you know a little bit about trading and how do we trade these instruments and I said well, I can share with you a little bit about ascending price auctions, descending price, distributed algorithms, lifo systems and maybe invest some things, but I don't know what you're asking.

He said no, no, we've got all of this. I said what do you mean, you have all of that; he said well, we did that last week and I said what did you do last week, I'm giving you an idea for the competitive framework. He said somebody came in and wanted to start a used instrument exchange and I said what did you do for them.

He said we gave them the technology. I said how long did it take you to give them the technology; he said this one was pretty tough, it took us about 64 hours and I said what; he said yeah and he said look, some of them take two weeks.

Now, out there are nerds and geeks who eat Ho-Hos and sleep under tables and create billion dollar enterprise value and we've got to be able to compete with those people that are now even making some parts of the technology a commodity.

CHAIRMAN RAINER: Thank you.

COMMISSIONER SPEARS: Thank you, Mr. Chairman.

CHAIRMAN RAINER: Commissioner Newsome?

COMMISSIONER NEWSOME: Thank you, Mr. Chairman. I know that most of you kept your comments relatively general and I'll try to keep questions to this panel general as well.

I've really got one question with two parts. In your opinion, is there any aspect of the framework in its current form that would discourage innovation?

And secondly, given today's and/or tomorrow's marketplace, is it still of benefit or value to have oversight of CFTC on your risk management products?

MR. JOHNSON: Commissioner Newsome, I can't find fault with the proposals in the broad strokes basis. One point that probably is worth making and I think Bob Wilmouth has hit on it a bit is core principles are a wonderful,

flexible tool, but it is an intense resource commitment that has to be made to make it work.

Everyone at this table has come into the Commission or gone to other agencies and said what if we were to come at this issue from a different perspective and we found here at the Commission that they're always very receptive to consider it, but in each instance it's virgin territory, it takes some chewing over and some checking out and things of that nature.

In the time frames that Rich Sandor has referred to, you're going to need to have staff who can turn around those "what if" questions very, very quickly or else it will become the norm to go back to the tried and the true and the creative juices will dry up.

MR. SANDOR: I think that one addendum to Phil's point is I think also you have to really look at the boundaries of manipulation and what it means because under certain guises, you would have not approved the bond contract in its early days or even the Ginnie Mae contract, which had registered bank users, and you would have heard that the market could be manipulated early on, particularly by those people who were operating in inefficient markets with wide bid ask spreads in the three of them and it's a $2 billion business, but it's the great Chicago Blackhawk players you

really have to regulate, like in hockey, you've got to go where the puck is going, not where it's been.

And I think it's very important that you look at the manipulation issue in light of by the time you get through with your procedure, what's on the horizon. You can't just go backdate in a business where you're getting multi-billion dollar industries springing up in a year or two. By the time you've completed your analysis or looked at manipulation, there may be five new entrants into the business.

So look at the history of how you've approved in the past and while I'm unambiguously in favor of anti-manipulation, none of us want it, it doesn't bred volume, but be cautious in protecting too much because in a world with its new economy, it will lead you down a danger slope.

COMMISSIONER NEWSOME: Bob?

MR. WILMOUTH: As a follow up to what Phil and Rich have said, but you know, much simpler put, if I understood your question correctly, it's do we consider Commission oversight valuable. I think the answer is it's not only valuable, but essential.

I have never understood, in the almost 25 years I've been in this business, why the Commission hasn't moved to this step a lot earlier. For example, just take NFA as an example as a self-regulator.

You have the exchanges and their self-regulatory responsibilities. You have total control over everything we do. You go up or you go down on what we want to do. We sit down and we discuss things and we reach conclusions and we perform and I think we have performed more than adequately over the past 18 years and we can only perform, however, with the valuable oversight from the Commission in oversighting, not micro managing us, and that's the key to this, and having the right attitude when you oversight us and we'll perform the functions that are necessary for us, whether it's the intermediaries, NFA as the sole regulator of the exchanges in their capacity as self-regulators or whatever way.

But I consider it essential. Not valuable, essential.

COMMISSIONER NEWSOME: Mr. Melamed?

MR. MELAMED: I have a task here first to respond on behalf of Merton Miller, whose last words were to me "Tell them no."

Having said that on his behalf, I will say that I do find a most important role for the CFTC is to continue its

existence, but along its modern, presently proscribed fashion.

And the reason I say that is because with all due respect to everyone at this table, including myself, we cannot predict the future. None of us can. And we don't know what tomorrow, what the next year or ten years from now may demand upon this industry, if there is still this industry, for the role of the CFTC in those days. It may happen.

I give you this example. It was this industry and this CFTC that caused cash settlement to occur. The gentleman on my left was Chairman of the CFTC at that time and we had this discussion and his words were but that's unheard of, won't that be gambling, and it isn't gambling.

And of course, he had the vision, the strength, the boldness, the guts to lead the CFTC and do the unthinkable, allow cash settlement.

Well, I can't tell you what that next giant step will be of a similar nature which will require a CFTC Chairman and Commissioners to say yes, we can do this for you because it's a great thing and without it, maybe you won't have a role or a history.

So yes, I think the CFTC has a role and should remain, but under its framework as presently suggested.

COMMISSIONER NEWSOME: That's all, Mr. Chairman.

CHAIRMAN RAINER: Thank you very much. Commissioner Erickson.

COMMISSIONER ERICKSON: Thank you. First of all, I would like to thank the panel very much for your insight. It's been very helpful to me and I especially appreciate some of the attention paid to the issues that I've laid out on the table in the past.

One of the things that Tom talked about was this notion of labels. I completely agree that labeling gets us into trouble more often than it helps us out. Along those lines, you talked about potential problems with enforcement of fraud. Certainly we can point to that anomaly in our current regime as well, with the 9th Circuit and our inability really to chase fraud in the foreign currency markets in that part of the country.

So there are things we just might have to bite the bullet and live with. Would you put manipulation in that category? Because one of the things that I wonder about is this notion of a manipulation in an exempt MTEF marketplace. It seems to me that the first thing that the Commission needs to do in proving up that matter is to go

in and investigate to make sure that the transactions fall within the jurisdiction. Is that an okay result?

MR. RUSSO: Let me just say with respect to manipulation, there aren't that many cases of manipulation. There are a lot of cases of fraud.

COMMISSIONER ERICKSON: Thankfully.

MR. RUSSO: Fraud is a much more universal thing, manipulation is a very small part and I don't see that -- I see that as a potential problem, what you pointed out, but in my earlier testimony I think that's just one of the things that one lives with for all the benefits you get without the labeling.

I want to make one point because it ties into Commissioner Newsome's question earlier, which I didn't respond to. This Commission, in my view and I think the view of this panel, certainly is doing the right thing. It's very creative, it's really a model for others in what it's doing. It's very broad-based, giving enormous flexibility to people to grow and to make their own mistakes. I think that's what it's doing.

I'm not sure that that's going to be what it's going to be years down the road. I don't know that. Labeling is going to cause that problem.

The other point and the point I think that Bob made and that is a real concern of mine is that we just -- we went through an earlier Commission and what have you, a different environment. We now have a totally -- see change in the environment, we don't know what's going to happen next.

We have the staff that's going to carry it on. I think it's a difficult thing for a staff to do because first of all, a large part of the staff are lawyers and that's -- I just finished a book by Henry Kauffman which is very interesting and he was talking about another agency, I won't say who it is, but their initials are S-E-C, but he was pointing out in the book that because lawyers by their very nature, they look at words and they interpret words and what have you, you can easily get stuck in the words and not in the spirit.

It's very easy to do and it's just by its very nature because that's their charter, that's what they're supposed to do and I don't know how you solve that problem, but that's going to be a problem because if we get down away from core principles into ways of doing things and into very little readings and not following, as Rich Sandor

said, where the puck is, I think that's going to be a problem and I think that's worthwhile considering how you solve it.

Unfortunately, just like with our Chairman, you get a person, it's going to depend I think in large part on how you select the staff and who the future staff members are going to be. I think that is going to be a problem because then that's where my real fear of labeling is, because once they begin to label, everything follows from that and it gets us nowhere and so I think that's a cost that you have to do.

I don't think manipulation is where the real issue is, I think it's fraud and I think there are other ways, as I mentioned earlier, that one could deal with that and have all the benefits of what you're doing without the cost of stereotyping.

MR. JOHNSON: Commissioner Erickson?

COMMISSIONER ERICKSON: Yes.

MR. JOHNSON: Following up on Tom's point, the federal law has prohibited manipulation for about 80 years now, that's been tens of thousands of contract expirations and hundreds of different contracts and I suspect that at least

at the enforcement level, there probably hasn't been more than a dozen manipulation cases throughout that entire period.

So it's a rare thing, but the reason why it's important is because it does market-wide damage. Fraud tends to be targeted at you or me, market manipulations are targeted at everyone out there, so it's like an atomic bomb assessment as contrasted with a bullet.

So it's important that you continue to be on that beat and I notice that in these proposals you're proposing to do exactly that.

COMMISSIONER ERICKSON: Thank you. I have no further questions.

CHAIRMAN RAINER: Okay. Thank you very much. Commissioner Erickson covered the essence of the question I had, that related to legal certainty. I may ask individually if you will comment on that for the record afterwards, but we're running behind.

Let me take a moment once again to thank you panelists, distinguished experts. You've been very helpful to me and I think we can tell to all of us and we will dismiss this panel and move on to the next panel. Thank you very much.

(Pause.)

CHAIRMAN RAINER: The panelists are in place and the Commissioners are in place, so why don't we start with our

second panel. Let me thank each of you for being willing to come today and provide testimony and discuss these important issues.

The second panel is focusing on the futures exchanges and the elements that are interesting or important to you or issues that have been raised in your mind about our proposal and I think we'll do as we did with the first panel, which is to go from your right to left, we're in alphabetical order I see again.

Why don't we start with Mark Bagan, who is the Vice President of Market Regulation of the Minneapolis Grain Exchange. Mark?

MR. BAGAN: Thank you. The Minneapolis Grain Exchange is pleased to have the opportunity to appear before the Commission today.

The board of directors of the Minneapolis Grain Exchange announced the hiring of a new president about a week and a half ago. The board of directors named Ken Horsagger as the Exchange's president. Unfortunately, Mr. Horsagger had previous commitments which precluded him from being here today and representing the Minneapolis Grain Exchange.

Mr. Horsagger is eager to meet with those of you he does not know and furthering relations with those of you he's become acquainted with while serving as the former Chairman of Exchange's board of directors. He was the Chairman of our board in the mid 1990s.

Mr. Horsagger wanted me to point out that my remarks today may not be representative of the Exchange's membership or contract users, however the Exchange does intend to provide written comments on the Commission's proposed rules regarding the Commission's regulatory reinvention, after listening to what our market users have to say.

In general, the Minneapolis Grain Exchange is quite supportive of these proposed rules to modernize federal regulation. The Exchange applauds the effort to streamline the regulatory process. Further, the Exchange appreciates the ability to choose which degree of regulation we operate under based upon the commodities we trade.

However, given our current line of products, we will generally be a recognized futures exchange, the tier that receives the least benefits with respect to your flexibility. However, the Exchange is pleased with the proposed regulatory relief under the other two tiers.

Additionally, the Exchange is pleased to see recognized futures exchanges would continue to be able to launch new

contracts under exchange certification. This is a process which the Minneapolis Grain Exchange has successfully utilized within the past two months to launch our cottonseed contract.

A major concern of the Minneapolis Grain Exchange does have to do with one of the requirements, an RFE, in terms of changing the contract terms and conditions for agricultural commodities. The proposed rules, and as is currently the situation, require ag commodity rule changes to be submitted for review and approval.

The Minneapolis Grain Exchange respectfully requests that the Commission alter the proposed rules to permit rule changes to terms and conditions on ag contracts by exchange certification. Permitting exchange certification for rule changes on terms and conditions of ag commodities would aid the Minneapolis Grain Exchange in responding to market users and the conditions they may face.

The Exchange views the 45-day review and approval process for changing ag commodity terms and conditions as lengthy and unnecessary.

Given that the rule changes have undergone months of discussion at the committee, board and membership levels at

the Exchange, the Exchange has a vested interest in proposing rule changes on ag commodities that will suit the majority of our contract users.

Consequently, the Exchange asks again that Recognized Futures Exchanges or RFEs, be permitted to alter rules effecting terms and conditions on ag commodities by exchange certification.

Alternatively, the Commission could permit ag commodities to be traded on DTFs. The Exchange certainly would appreciate the flexibility afforded the DTFs, a major benefit there being the rule change notification process.

While the Exchange does not believe the majority of growth in our industry will come from ag products, we do believe there are many ag products out there that can be successful as niche type contracts.

In conclusion, the MGE supports the Commission's proposal, however we do find it puzzling that an exchange can launch a new contract overnight by utilizing the certification process, yet it can take 45 days or longer to approval a single change to a term or a condition on an existing contract.

Consequently, the Minneapolis Grain Exchange request that RFEs be permitted to certify rule changes, avoiding the 45-day review and approval or permit ag products to be traded on DTFs. Thank you.

CHAIRMAN RAINER: Thank you very much. The next panelist is Dennis Dutterer, he's interim President and CEO of the Chicago Board of Trade. Immediately prior to that, he was the leader of the Board of Trade Clearing Corp. and a number of us around here remember his being general counsel of the CFTC. Dennis?

MR. DUTTERER: Thank you. Good afternoon, Chairman Rainer. I appreciate the opportunity to be here today and to speak about the new regulatory framework you have proposed.

My written comments have been submitted and will be made part of the record. Accordingly, I will not present all of those here today, but will highlight what we believe are some of the important concepts.

First, let me commend you, Chairman Rainer, Commissioners and Commission staff, for the efforts that you've devoted to developing this new framework. We at the Board of Trade believe that this proposal creates an environment in which the U.S. futures industry can compete effectively in the global derivatives marketplace.

For years the Board of Trade has advocated that exchanges should be afforded the same type of flexible

treatment that is enjoyed in the over-the-counter derivatives markets and the overseas exchanges. Our argument was and has been that the same instruments traded among the same participants should have the same oversight.

By establishing the three new market categories, we believe this proposal goes a long way toward granting the flexibility that we have long sought. The detailed regulations that we experience and know today would be replaced with core principles. Importantly and significantly is that the exchanges would decide and design how to meet the core principles.

The hallmark, as we see it, of the Commission's proposal really is to switch from the statutory mandates to what the proposal calls broad and flexible core principles. We strongly support that change.

We believe that the Commission should supervise, not dictate, how the exchanges meet these broad performance standards. We recognize that there are those who may not see the proposed framework in the same light, that express some concern that flexible core principles, because they are flexible, could become a license to dictate business solutions rather than oversee them. We do not share that view.

We recognize that there must be some safeguards to make sure that the exchanges have the broad discretion to apply

the core principles. We think one way is to fashion an appropriate mechanism for resolving the differences of interpretation in core principles.

From my experience both as a regulator and a regulatee, I know that there may be different views on occasion between the Commission and the exchanges. I think these differing views will be infrequent, but when they do occur, they should be resolved in a manner that is balanced, expeditious and consistent.

Simply stated, the exchanges or the businesses want to know an answer, they want to know it swiftly so that they can move forward with their business under the interpretation of the core principles.

The current law would seemly resolve those disputes through contentious, drawn out and costly legal proceedings. In our view, there should be a new mechanism reflecting the underlying tenet of the Commission's proposal, I return to the concept of broad, flexible core principles.

There are a variety of alternative resolutions, ways to resolve these differences. We encourage the Commission to consider and work with all of us and with others in the

marketplace to ensure a flexible resolution of when differences might occur.

I'd like to just address two other comments very quickly and that is that again, consistent with the broad, flexible concepts that are embodied in the core principles and in the new proposed regulations, we'd ask that the Commission consider including the flexibility to allow for the future expansion of commodities that might be considered under any of the new market schemes.

We recognize that there are some questions at this time that may remain to be answered about particular commodities that may fit under any of the marketplaces. What we suggest is that the flexibility be included at this time so that when those questions are resolved, they can be quickly and swiftly included so that the exchanges may use the new market mechanisms to compete

And of course, we will be providing more detailed comments on various aspects of the proposed regulations, but again, I want to compliment the Commission on the broad, flexible concepts that have been presented.

We support this framework, we believe it holds great promise for the exchange and the industry. As a former regulator and regulatee, I commend you on your efforts. It's the most business-oriented, forward-thinking proposal really to emerge from the Commission in some time.

We are eager to see the framework put in place, to begin to use it. We think it provides us with a great number of opportunities, combined with our new proposed for-profit business venture, which has been noted that our members will be voting on tomorrow and we plan to move forward with. We think it's the best hope for us to restructure our business to meet the enormous challenges ahead.

Again, I thank you for the opportunity to appear. I commend you on your work, I look forward to working with you in the future to finalize your concepts and look forward to answering your questions and engaging in any discussions with you on these issues. Thank you.

CHAIRMAN RAINER: Thank you very much, Dennis. Next we have Mark Fichtel. Mark is the President of the New York Board of Trade. Prior to that, he was American Stock Exchange and before that, many years at Kidder, Peabody where we intersected a long time ago. Mark?

MR. FICHTEL: Mr. Chairman, I thank you and your fellow Commissioners for the opportunity to provide comments from the New York Board of Trade on your proposed reform of the regulatory schematic used in the futures industry.

In general, we're very pleased with your work, as it provides regulatory relief while maintaining the necessary oversight and requirement for financial integrity, as well as enforcement. In our view, it does strike a balance between the self-regulatory and the federal regulatory responsibilities and it does move away from a prescriptive regulation, to give our markets greater flexibility, to adapt to a changing marketplace, to meet competitive challenges and to remain innovative.

I would like to touch briefly, however, on -- don't panic on this one -- eight separate issues. One item that we believe should be included in this proposal for regulatory reinvention, because it is important in an era of exchange restructurings and de-mutualizations, is that successors to existing designated contract markets, whether by merger, consolidation or other reorganization, should be eligible for RFE status without having to make full application to the CFTC and that is personal in that we've got the New York Board of Trade would be granted RFE status because of the Coffee, Sugar, Cocoa and the Cotton exchanges.

On the subject of what is in the proposal for regulatory reinvention, we are pleased that the CFTC is willing to consider, on a case-by-case basis, granting DTF status to non-enumerated agricultural markets, such as our world

sugar contract, on the basis of surveillance history and other characteristics of the relevant contract and in particular, we applaud the Commission for having deleted the mere threat of manipulation as the operative standard for making such case-by-case determinations.

Secondly, the proposal states that a DTF, even if it is limited exclusively to commercial traders, could not trade agricultural commodities enumerated in Section 1(a)(3) of the Act. We're still considering this provision as it applies to our products.

We are somewhat concerned that it may represent lost opportunities resulting from these restrictions, and if that's the case, we certainly are going to have some concerns with them. We will provide further details as we work through these in our final written comments.

Third, a DTF we do not believe should have to provide a physically separate trading location for all of its products. As an example, we trade our Sugar 11 and our Sugar 14 contracts in the same ring. The Sugar 11 contract can trade 20, 40, 60,000 contracts a day, we're lucky if the Sugar 14 trades 1,000 a day and we don't believe that it makes sense to force the brokers to either choose which

contract they will execute or to race back and forth between rings.

Fourth, in the proposal, both RFEs and DTFs, which give access to foreign brokers as intermediaries, would be deemed the agent of such foreign broker and its customers for purposes of service of process, unless there is an FCM in the chain.

We have concerns over whether exchanges would be in a position to compile information needed to effectively serve as such an agent and in fact, we believe this provision should be left open by the CFTC until other options can be considered, as in fact it runs counter to the concept of deregulation of the exchanges.

Fifth, the proposal states that on a DTF, a floor broker with less than $1 million net worth or $10 million total assets may have access to trade only through an FCM clearing member with $20 million in capital so that the broker can be provided with disclosures and other protections.

We believe that this particular provision represents some overkill. We see no reason to distinguish between floor brokers, since their level of sophistication regarding futures and options transactions should not be measured by the net worth or their total assets.

Your proposal actually has in it the comment that this really should be a test of sophistication and we agree with that and yet there is also a monetary test thrown in.

And on the same point, it is not clear what "access" means. We're not sure whether it means orders would be entered with the FCM and then the FCM arranges the execution or whether the floor broker would still be able to execute for his or her own account, as long as he carries the account with the requisite type of FCM, which provides those extra disclosures.

The next to the last point, under Part 38, an RFE must have rules addressing the protection of customer funds, which the guidelines suggest should address the segregation of customer and proprietary funds, the custody of funds and investment standards.

That language seems to create some new and onerous burdens for exchanges, since the current scheme does not require contract markets to have rules in such areas, but rather the CFTC imposes them directly.

While this may on the surface represent a lessening of the federal deregulation, it could also result in some chaos, as each exchange may adopt different guidelines for

competitive purposes in an era where we may all be competing with one another down the road.

And finally, the Commission should keep in mind that some aspects of transparency of a market will be effected by whether it is electronic or open outcry. For example, bids and offers may only be available for dissemination in an electronic market, since they're not automatically captured by open outcry trading methods, to the level of transparency must be appropriate to the method of order execution.

Now, with all of these frankly mostly minor nit-picks aside, I want to reemphasize that we are overall very positive on your effort. We applaud what you've done so far, we urge you to push very hard on this to get it through the requisite parts of the rest of the government.

I know certainly I'm more than happy to come back on your behalf and testify anywhere we have to, to get this moved forward before the election if we can, and I would just ask that you again redouble your efforts to get rid of Shad-Johnson and also from the agricultural standpoint, would you please give it another look and see what you can do to loosen up some of the terms -- some of the regulations that the agriculturals are still operating under, even under your new proposals. Thank you very much.

CHAIRMAN RAINER: Thank you very much. That's very helpful, Mark. Next is Jim McNulty, the President and CEO of the Chicago Mercantile Exchange. He joined the Chicago Mercantile Exchange in February of this year, bringing 25 years of experience in global financial markets.

Prior to the CME, Jim was a general partner with O'Connor & Associates and when that was bought by Swiss Bank Corp., he developed a lot of experience there. Jim?

MR. McNULTY: Thank you very much, Chairman. Chairman Rainer, Commissioners and members of the staff, I'm delighted to be here today and it's an honor to be able to present this testimony.

As Chairman Rainer said, I've had 25 years of experience in this full range of financial services and products and I have sensitivity to the needs of technology change and I hope that this testimony reflects that sensitivity.

The Commission also has the complete support and backing of the Chicago Mercantile Exchange in its efforts to streamline the CEA and its regulations as applied to multi-lateral execution facilities like the Exchange.

We believe that the departure from the one-size-fits-all regulation of the past is justified and necessary to permit

us to compete. We are in the process of preparing a written response to the proposal, which will include our technical and detailed comments.

For purposes of this meeting, I would like to focus on two issues. First, the Commission's foresight in recognizing the need to tailor provisions for exchanges that cater to commercial users and second, its reluctance to use its exemptive power to permit non-exempt security derivatives to be traded on RFEs or DTFs.

Let me start with commercial boards of trade. Proposed Part 37 permits the CME to create a Derivatives Trading Facility restricted to eligible commercial participants which can trade a broad range of commercially important commodities, excluding agricultural products covered by 1(a)(3) and security linked derivatives subject to Section 2(a)(1)(B).

The Commission created this category based on clear evidence of the rapid growth of electronic business-to-business trading engines that are replacing brokers and other traditional transaction paths.

While it is difficult to place a firm number on such enterprises, it is likely that there are more than 1,000 announced and operating commodity markets. Some would say that there are 12 a day being opened up.

The Commission found and we agree that many of these trading facilities are expected to replicate electronically various aspects of today's commercial markets, including trading exclusively between principals and direct negotiation and documentation of trades.

It is evident, however, that these new markets will do more than electronically replicate existing commercial practices. Technology drives these markets to emulate exchange auction markets and to add derivatives to their product use. This is because there is a need to create centers of liquidity in order for these marketplaces to be commercially relevant.

These markets are trading in electricity, plastics, paper, chemicals, metals and I even now understand violins and cellos. These products are not eligible for trading on an ordinary DTF. It is our understanding that the participants in such markets do not believe that the costs of subjecting themselves and their markets to CFTC jurisdiction will be offset by the benefits of federal regulation.

Moreover, this attitude does not depend on whether the products traded are regularly delivered and qualify for a

forward transaction exemption or whether the obligations among the parties are offset by some form of payment that make them look like futures contracts. Very few of these markets have any inkling that they are now or soon will be operating under the penumbra of the CEA.

Our exploration of opportunities in this business space has suggested four areas in which this proposal can be improved. First and foremost, commercial boards of trade should be permitted to operate as exempt MTEFs.

The commercial reality is that there are a staggering number of electronic exchanges coming on line to trade commodities. Those exchanges will inevitably migrate toward derivative trading. Especially the successful ones.

The reasons for limiting MTEFs to manipulation-proof products do not apply to commercial boards of trade. The MTEF will be populated by commercial users and brokers of the product with substantial information respecting the demand curve, sales and production of the products.

The Commission found that this type of eligible commercials-only market structure lessens many of the regulatory concerns regarding manipulation ordinarily present with contracts for tangible commodities.

The Commission's jurisdiction to enforce the Act's prohibition against manipulation of commodities is not diminished by this exemption. In fact, since the

Commission has rarely exercised its anti-manipulation authority in existing pure cash markets, it is likely that inducing these B-2-B exchanges to acknowledge that they are exempt MTEFs will enhance the Commission's ability to fulfill its statutory responsibilities.

Second, the list of eligible participants in a commercial board of trade needs to be clarified. Section 37.1(b) limits participation to parties listed in 35.1(b)(1), (b)(2), (b)(6) and (b)(8) who incur risks in connection with the underlying product in connection with their business and to a person who is a dealer that regularly provides hedging, risk management or market-making services to the foregoing entitles.

The list omits floor traders and the definition of a dealer may be too restrictive to recapture floor traders. Our experience strongly suggests that a floor trader or his or her electronic equivalent who is well-capitalized or properly guaranteed can perform an invaluable service, providing liquidity by means of intertemoral mediation.

We think that it's this kind of liquidity that will cause acceleration of these B-2-B verticals and allow them to be successful in the first place.

Third, the exclusion of agricultural commodities may be intended to protect agricultural producers, but it is more likely to deny them useful markets. A commercial board of trade is not a substitute for a futures exchange, nor will it replace such markets.

A DTF's contracts need not be standardized by the operator of the facility. This is not necessarily a high priority for us and we respect the Commission's deference to the agricultural community on this issue.

Finally, we do not believe that there's a statutory requirement to preclude trading of security indices on DTFs.

That gets us to Shad-Johnson issues and we could say that the Commission adopted in Section 36.3 to ensure -- and this will get somewhat dense -- that 2(a)(1)(B) continues to apply to transactions and persons otherwise subject to that provision.

This restriction was based on the Commission's conclusion that the language of Section 4(c) of the Act limits the Commission's authority to exempt transactions from the application of Section 2(a)(i)(B) of the Act.

It is clear from the proposed rulemaking that the Commission's interpretation of Section 4(c), not public interest considerations, politics or deference to other agencies, is the sole reason for requiring that all non-

exempt security related contracts be traded on old fashioned designated contract markets.

We do not believe that the Commission's interpretation is consistent with language of Section 4(c). Section 4(c) permits the Commission to exempt designated contract markets from any of the requirements of Section 4(a) or from any other provisions of this Act, except Section 2(a)(1)(B).

We understand the purpose and language of this section to prohibit the Commission from exempting a contract market from any of the requirements of 2(a)(i)(B). Congress did not want the Commission to use its exemptive powers to reverse any of the requirements and preconditions for trading stock index futures contracts.

The requirements of Section 2(a)(i)(B) that may not be waived by the Commission are narrow and specific. The contract must be cash settled; trading shall not be readily susceptible to manipulation; the index should fairly reflect a segment of the market; the SEC must be given a right to block trading if it believes the conditions are not satisfied, subject to judicial review; the Board of

Governors of the Federal Reserve must have power over margins.

Given those narrow conditions, nothing in the legislative history or in the language of Section 4(c) prohibits the Commission from exempting a designed contract market in a security index which continues to meet the requirements of Section 2(a)(i)(B) from the requirements of such other provision of the Act.

For example, there is nothing in the underlying policy or language of Section 4(c) that precludes the Commission from permitting block trading in security indices.

In short, we think that the S&P 500, NASDAQ E 50 and other indices in the equity arena could be traded in a DTF.

I'd also like to mention some technical and drafting issues. The Commission and its staff undertook this important de-regulatory initiative and produced a detailed proposal in record time.

The Act and existing regulations are a complex background against which to draft this thorough regulatory revision. We think we understand the Commission's intent, but we need the allotted time to complete our review to ensure that the drafting accomplished those goals.

For example, we know that the Commission intended to preserve its exclusive jurisdiction and the preemption provisions of Section 12(e) for the benefit of DTFs, but we

need to assure ourselves that the exemption granted by Section 36.2 does not negate the protection of Section 12(e). We're concerned about the application of state law to CTAs that use DTFs and MTEFs.

We're in the process of carefully reviewing the releases and we will submit a response detailing any technical and drafting issues and we will work with the Commission carefully and closely to resolve any of the questions that we may have.

I want to thank you again for the opportunity to include our testimony today in this hearing and we will submit comments to you by August 7.

CHAIRMAN RAINER: Thank you very much. We now will hear from Pat Thompson. Pat is the President of the New York Mercantile Exchange and has worked closely with me and others over the months that I've been here in helping us frame these arguments. Pat?

MR. THOMPSON: Thank you, Mr. Chairman. I do think that before I begin my prepared remarks there are a few commendations in order. You've heard a number of them, but I'll put NYMEX's spin on them a bit.

We really do think that the proposal of the Commission for this level of deregulation, that you've really got it right here. We really think that you've really shown a great deal of intellectual honesty about the markets that are being regulated, about the participants that are being regulated within them, about what the regulatory issues are that need to be addressed by the overall regulatory scheme.

So we commend you, because this is probably the most thoughtful exercise that we have seen by a regulatory body and certainly in the time that we've witnessed recently.

I now can say proudly and disclose proudly that I am a former employee of the Commission, a status that oftentimes could cloud one's reputation, but I do say that certainly practicing in front of this Commission now is certainly an honor and a pleasure.

Getting into some of the overall underpinnings of the proposal, we understand that there are four policy goals that underlay the structure. I think it was important for the Commission to begin from that framework, try to figure out what we were trying to accomplish in this exercise from a policy standpoint and then trying to look at how the current Act and the ability of the Commission to exempt areas from regulation or to change the areas of regulation, how that could fit that proposed structure.

The four basic policy goals were shift from direct to oversight regulation; modernize the current regulation; ensure that regulations address regulatory goal; and I think most importantly, ensure that the regulatory burden is commensurate with the nature of the markets that are being regulated. We strongly endorse these policy considerations and we believe that the Commission has gotten it right.

We are in a tremendous period of rapid and profound change and we are all, certainly the exchanges in particular are reevaluating our organization, reevaluating how we can complete, reevaluating how we can keep pace with these changes that are going on.

Just one week ago our members voted overwhelmingly, something in excess of 97 percent, to approve a proposed de-mutualization plan under which NYMEX would shift from being a not-for-profit corporation, organized under New York law, to a for-profit corporation, organized under Delaware law, that would be established as a part of a holding company structure.

Following that vote, our Chairman noted that the approval was "just the first step in repositioning the

Exchange as a 21st Century business enterprise that would create and pursue profitable new opportunities, react rapidly and decisively in the increasingly competitive marketplace and explore interests by outside investors."

That's a lot of business on the table for us right now and it's important that the regulatory structure that we operate in support that type of growth and innovation.

Prior to the vote, we announced last month that we were undertaking the formation of E-NYMEX, which is an E-Commerce venture that's intended to become the premier global exchange for OTC trading and clearing of a wide range of standardized physical and derivative products and so we must view this regulatory structure that has been proposed by the Commission in light of not only our existing business, trading standardized futures and options contracts, but also our intended business, which we think will support that and compliment it tremendously, of trading over-the-counter instruments and hopefully being permitted, as we will talk about tomorrow, to join together the clearing operations of our regulated products with the clearing operation intended for the over-the-counter products that we hope to be able to bring to the marketplace very quickly.

Under the Commission's proposal, you are replacing one-size-fits-all regulation with broad and flexible core

principles, establishing three regulatory tiers. You've indicated that that new framework was intended to provide the U.S. futures exchanges with the flexibility needed to respond to the challenges now facing the industry and we agree that you have accomplished that, if these regulations are ultimately passed.

We understand that this transition is going to involve a great deal of uncertainty. I think some of the issues have been surfaced today about enforcement, about specificity and the like and clearly we see those as challenges and probably as risks, but we do believe that what we gain in this system is something that will allow for competition to flourish and the issues of legal enforceability, the issues of legal definiteness are things that can be left for us to work out in the future, when actual problems might crop up.

One of the issues that we've always faced and found to be very, very difficult is the issue of prior approval and in the process of prior approval, one seems to try to hypothesize about what potential problems might happen. Let's not fall into that trap in this regulatory process.

There are potential problems here, but we see so much good coming out of this, let's deal with those problems

when they arise in some kind of an embodied problem as opposed to a hypothetical problem.

I've been asked some questions over the past weeks about whether or not energy products should be included in the list of excluded products that might be subject to MTEF-style regulation and we thought long and hard about it and certainly the quick answer might be that we would like to be able to be included as an MTEF.

But the more we began to think about our past testimony and the honesty we hope we brought to this regulatory review that's been going on and the fact that we do believe that there are areas, particularly in physical commodities, where a level is regulation is something that is necessary in certain cases, desirable in many cases I would say, we believe that the flexibility that we've been given to move some of our products into the middle category is sufficient for us to be properly competitive in the marketplaces that we serve.

I think some of the examples that we cited, in terms of areas of regulation, are areas that the Commission has adopted, such as because our markets are so important to the price transparency and price basing of the underlying commodities, the systems that produce those prices that are relied upon by the industry may have to have some level of regulation.

We also agree we're clearing and financial guaranties ultimately where there is potential for systemic risk, that those are areas were there is an appropriate level of regulation.

Once again, I don't want those comments to be taken as in a sense looking for the continuance of the existing scheme of regulation. The regulatory scheme that you're proposing is one that's broad and flexible and within that framework what I've just said is true.

Were we to revert to a prescriptive type of regulation and try to regulate those areas by rule, by specific requirements, everything I just said I would retract at a future date, but I am saying very clearly now given the broad flexibility that exists in the core principles that have been proposed by the Commission, we believe that the scheme of regulation will be appropriate for both energy and metals, as we've traded them now, and we do think that it provides a very good framework for the development of over-the-counter, both physical and derivative trading and clearing to occur at the exchange level.

One area that we would like to have the Commission reconsider and that is an area that Jim brought up, is the

exclusion of floor traders and floor brokers from the exempt category. It is important to understand and I think again looking back at the regulatory goals the Commission might agree ultimately with this principle.

Clearly, floor traders and floor brokers are experts in the field -- as a class, are experts in the field that they do business in. They are sophisticated, they understand their markets, they are there each and every day of their working lives, understanding those marketplaces. So sophistication is certainly not the issue of excluding them from participating.

We also recognize and I think the Commission itself recognized as well, either directly or indirectly, that physical markets need greater liquidity. The financial markets are broadly liquid and certainly we understand that they have a tremendous amount of inherent liquidity that exists in those marketplaces.

Physical markets do lack some depth to them and clearly the floor trader provides a great deal of depth and expertise in those marketplaces and we would like to have the Commission reconsider the exclusion of them from the exempt class.

I think those two principles are the most important, sophistication and the liquidity that they provide. Just to give you some numbers, the number of personal account

trades by percentage done in the crude oil contract on the exchange by the local is 55 percent. The value to the marketplace of pushing the bid and the offer together, the value to price transparency and the value to market efficiency overall I think far outweighs any concerns that financial considerations might have.

Clearly we believe that they either must meet the net worth requirements of individuals or be properly guaranteed by a market participant so that those issues of financial integrity are taken care of one way or the other, but under those circumstances, we believe that the Commission would be better served in reconsidering the inclusion of floor traders in the list of exempt parties.

Finally, one other and I consider it to be a minor area, I think it's something that we will be able to work out over the coming months, we do believe that the record keeping requirements of 1.31 should be modernized to permit a greater use of electronic technology to maintain records and if we can take a look at that over time, we think that that would add a great deal to the modernization of these regulations.

So in conclusion, I do want to commend the Commission, I want to commend the Commission staff. I do believe, having personally participated in this review, that the suggestions that we've made have really been listened to, that you've considered them for what they are and for what they can bring to the overall program and I appreciate that that might be considered a bit of a change in attitude, but I think it's a dynamic change that really has served the Commission well in this whole process. Thank you very much.

CHAIRMAN RAINER: Thank you very much, Pat, and let me encourage again each of you and those in the audience how important it is to follow this up with more detailed comment letters, if you so choose to do so, they'll be considered carefully by us and reviewed very carefully as we try to refine and polish this product.

I believe I'll go last again on the questions. Commissioner Holum?

COMMISSIONER HOLUM: I have no questions, thank you, Mr. Chairman.

CHAIRMAN RAINER: Commissioner Spears?

COMMISSIONER SPEARS: Thank you, Mr. Chairman. I have a comment first and then I have two questions. First off, I appreciate the various comments in regard to the ag contracts that were made by the various panelists.

As I announced earlier, we plan to have an Agricultural Advisory Committee meeting in the near future and we would hope to receive more comments from the agricultural community.

In that vein, I'd like to look forward to a discussion regarding the points that you've raised. I'd also like to make the invitation that we'd welcome comments from the individuals at that meeting with regard to the ag contracts and hope that you would participate in that discussion with the rest of the agricultural community.

The first question I'd like to ask the panelists--and I'd like to ask each of them for their various opinions--is that we've talked about how the new regulatory framework allows flexibility in the structure of your business. It gives you a lot of options and choices.

My question is, what do you see as the most difficult choice you have to make as you restructure your business under the new framework? I might start with Pat, we'll go in reverse order, so if you don't mind, Pat, going first?

MR. THOMPSON: I think one of the most difficult things, and these are things that are really more business

judgments than anything else, that we face is trying to do what we do well and do it right and stick with it.

One of the things that exchanges are -- probably the most important thing that an exchange brings to trading in a commodity is its liquidity and there are a number of reasons for that, some of them are standardization to the products, whatever it might be, the liquidity of locals and the like.

I think that we've got to get over the feeling that the industries that we serve are our competition, that we are actually a service organization and that if we're given the flexibility to be able to properly serve, that we will have a long period of success to come, but it's important that we understand where our strengths are.

MR. McNULTY: Thank you. I think the greatest difficulty was something that was mentioned in the previous panel and that is that the futures exchanges today must change their business model to be relevant going forward and the way that we have addressed that is by realizing that the mutual model is really a model that is focused on the members of the exchange and all of the great businesses of the world have tended not to be focused on the employees of the business, but more -- or the members of a mutual society, but have really been focused on the end users and the needs of the end users.

So one of the things that we have begun to do is to change the culture to be intensely client-focused and that means going out on a daily basis and listening to what our end users need and want and what our complimenters also need and want.

The other thing that we've done is put in place a framework which is a shareholder value framework where we realize that we only have so many resources and that our shareholders are going to expect us to get a return on invested capital that is greater than the cost of capital that they're putting up.

By using these two disciplines, we're actually finding that it's becoming easier and easier to address all of what would otherwise be very difficult issues and that for 102 years have been hammered out in 225 committees with 38 board members supervising and so basically what we're finding is the cultural change starts out being somewhat difficult, but it is gaining momentum at a very rapid pace and using these two frameworks, intense client focus and also a shareholder value framework has been very helpful for us. Thank you.

MR. FICHTEL: Engineering a ten-year bull market that will quadruple our volume just as the stock market has managed to do.

That's a facetious answer, but in reality our cost structures are way out of whack and if we think we've had problems in the past, when we start really spending on technology the way the stock and the options markets have, we are really going to be hurting with the volumes that we all have.

We're going to have to find a way to resolve that part of it, maybe reengineering our business models. It will be combinations, it will be alliances and it will be development of new product. That's why it's very important that you look as deep as you can into letting us have as much flexibility to develop product, because our cost structures and our volumes are going to be way out of whack in a year to three years and we can't support technology spending. None of us can.

MR. DUTTERER: You had asked what's one of the most difficult changes we face as we restructure the exchange. One of the greatest assets that our exchange and indeed any of the exchanges are the individual traders, those who provide the liquidity and who make the markets.

I think one of the challenges that we will face is that as we move to a business model, which we must, we must have

the traditional governance, we must have the customer focus, we must have cost controls. One of the challenges that we face as we move to this type of business structure is to ensure that the market makers, the liquidity providers who really are our market and have been at the Board of Trade for 152 years, continue to provide that asset, which is what will be needed in the new market structure.

MR. BAGAN: I think the greatest challenge that the Minneapolis Grain Exchange faces with respect to doing business within this new regulatory framework is dealing with our tradition of historically only listing agricultural contracts.

We need to develop new markets. We have a challenge in that developing new markets is not necessarily palatable to the majority of our membership. The majority of our membership are from the old time ag commodity giants and we need to branch out, move into new markets.

COMMISSIONER SPEARS: One more question if I might, Mr. Chairman, as a follow up to a point that Pat just made a minute ago. I'd be interested in any comments from the panelists in regard to whether, as certain markets move to

a DTF or an exempt MTEF status, you expect that the physical commodities that remain at RFE status will suffer from any loss of liquidity or any other ill effect on those markets that may stay at RFE status?

MR. THOMPSON: I'm not sure whether we know enough right now, but my concern is that time has shown us that regulation does exact a cost on the business that is undertaken and if that cost is so great that it does inhibit its ability to compete, I think we will find that regulation is becoming a barrier to true competition.

So I think what we have to do, while this is a good first step, I mean it's a tremendous first step, is that we can't think that we've completed the job now. I think we have to continually look at this regulatory structure as it forms, as it begins to work and become kind of an organism and to see whether or not it's really lived up to its billing and how it can change or it needs to be changed as time goes on.

I think it's set a great foundation, though, for competition to begin to flourish better than it has in the past and we're going to have to tweak it and adjust it as time goes on.

COMMISSIONER SPEARS: Would any other panelists like to comment in regard to that?

MR. FICHTEL: Yeah. I have to tell you, I worry a lot more about the dot com exchanges because dot com seems to be an unregulated and I think there's a lot of risk as we go forward that that's going to draw off liquidity.

You know, it's interesting, the SEC a couple of years ago encouraged in a Concept Release the growth of the ECNs. They were cautioned to be careful about how they went about it because they would fragment order flow. They went ahead, despite all the cautionary comments, didn't change a thing and now their latest Concept Release is examination of fragmentation of order flow.

In our markets, fragmentation of order flow will be really serious, if it occurs, because a lot of our markets don't have nearly the liquidity that stocks have, number one, and number two, I think from the standpoint of what you all are going to have to deal with, you don't want to let this train get too far out of the station before you hop on board so you can look at the passengers.

MR. McNULTY: I have a comment in that I think there are four issues that people look at when they use our marketplace, it's liquidity, transparency, credit worthiness and cost effectiveness.

I think that the dot coms are going to have some liquidity, because I think they'll be able to create transparency and also credit worthiness by partnering with different types of institutions to get that credit worthiness and they'll have cost effectiveness and I think what I would worry about is that if the other products don't have the same cost effectiveness, you will begin to see that break down in the marketplace, you'll begin to see the liquidity spread around and at that point, they may begin to lose some of the transparency and liquidity.

COMMISSIONER SPEARS: Thank you, Mr. Chairman. I could ask this group any number of questions, but in the interest of time (inaudible) Commissioners and I want to thank them for their time today.

CHAIRMAN RAINER: Commissioner Newsome?

COMMISSIONER NEWSOME: Thank you, Mr. Chairman. If I may, I've got one question that I'd like to pose to the group, if you have a response, and then I've got a question more specific to Mr. Dutterer.

Does the proposed framework, in your opinion, provide the CFTC with the flexibility needed to permit products that may be developed in the future to be traded at the exempt MTEF level or would it help to add language that would specifically address the Commission's authority to

consider additional products in the future or is the current force, the exemptive authority, sufficient?

MR. THOMPSON: Good question. And I think in our written comments we'll address that more fully. I'd like to have a little bit more time to think about it, but I do believe that generally we have to be -- the whole thrust of this scheme of regulation is flexibility, to allow for things that we haven't thought about, to be able to be properly regulated, at the same time they're allowed to be competitive and allow for innovations to be made in the marketplace.

So anything that the Commission could do to embody that principle, those principles, I think would be a real help.

MR. McNULTY: I tried to address some of the answer to that question in my testimony and partly what I think is that as we go forward, technology will allow people to do things that they've never been able to do before, in terms of speed and also cost of execution.

I think that we should be prepared for an electronic marketplace that has more fragmentation than what we know today and then consolidation in the future. I think that

what we're going to see is business formation that's different than we've ever seen before.

In other words, you will have verticals that have partnerships or have service level agreements or are related in one way or another to various exchanges, whether it's for clearing, for setting rules or any number of other possibilities.

So I think that we should be flexible. I think we should look out as far as we can and try to imagine what combinations and permutations of business models may arise from this new technology and what it's bringing to the B-2-B space.

COMMISSIONER NEWSOME: Thank you, Jim. Mark?

MR. FICHTEL: Commissioner, I don't know that I can answer that in anything less than a Fidel Castro seven-hour monologue, so I'll just say obviously the more flexibility the better, but I don't want to sound like a broken record, we have to make sure that in whatever we're doing there is enough transparency so that you all can make sure that fairness is being exercised.

MR. DUTTERER: I think we would suggest the -- I believe the question was additional language or using 4(c) and I would suggest consideration be given to the additional language.

I think 4(c) carries with it some burdens of previous interpretations and given the sweeping changes that the Commission is proposing, it would be consistent with that to ensure that the flexibility is there in specific language.

COMMISSIONER NEWSOME: Thank you.

MR. BAGAN: I don't know the answer to that one, but I do know that the Minneapolis Grain Exchange certainly respects the staff of the CFTC and if they've put this forth as their recommendation, we're here to support it.

COMMISSIONER NEWSOME: Thank you, Mark. My second question, Dennis, is specifically to you. In my opening comments I talked about my opinion that certainly regulatory relief was appropriate and that also in my opinion the more flexibility we can add to the equation the better when we look at new products, business decisions of the exchanges.

However, when we address enforcement, I'm not sure that I agree that a lot of flexibility is either appropriate or necessary in that direction. I think that I understand exactly what your concern is.

My fear is that over time, if the Commission has difficulty in reaching timely enforcement action, that we may shift then back to a period of more specific rules and regs to go along with the core principles and that over time we could end up in the exact same situation that we find ourselves in right now.

So would you elaborate a little bit on your plan to solve disputes over the satisfaction of the core principles for me?

MR. DUTTERER: Well, one of the concerns that we have is that the broad flexibility which the Commission envisions in the core principles could result in the utilization of those to establish specific standards and that's really independent of any enforcement mechanism.

We don't think that is what is envisioned now and we really don't think that's what will be envisioned in the future, but because that potential is there and I recognize that there will be differences at some point in the future, we think what's important is a quick dispatch of that difference and we think that today's proceedings sometimes tend to be long and contentious and focus on this word or that word, as we all know.

I'm not suggesting -- there are a number of alternative ways that we might be able to have dispatch and we certainly can address those in other conversations. What I

think is important for us as a business and as we want to move forward is that we have a quick resolution of the differences so that we can adjust our business and make our decisions.

I would note that under any circumstance we believe that the existing Act permits the Commission to take swift action in terms of injunctive relief if we're talking about some abuse by an exchange under the core principles and we don't think that's an issue.

We're just looking for some way to have a quick -- tell us what you think the problem is, let us tell you what we're doing or why we did it and then have a quick resolution of the difference. That's what we're suggesting is necessary. We recognize you will always have the authority in an abusive situation to secure injunctive relief.

COMMISSIONER NEWSOME: Thank you very much, Dennis. Mr. Chairman, I have one more question, but I'll yield to Commissioner Erickson. If we have time at the end, I'd love the opportunity to come back up.

CHAIRMAN RAINER: Commissioner Erickson?

COMMISSIONER ERICKSON: I will try to wrap this up quickly. One of the things I think that exchanges have expressed some concern about historically is large trader reports in certain contexts.

In my opinion, I think it's a relatively unheralded tool available to the Commission. It provides insight on not only concentration of markets, but also is effective for exchanges as well as the Commission, from a financial integrity perspective of the market.

As we look to the new world of DTF marketplaces, I think they could be wildly successful, if implemented. But those may well be the commercial markets of the future.

Currently as envisioned, the Commission is not retaining large trader report requirements for those marketplaces, and I was just wondering if you might have some comments about that.

I tend to think that that information might prove valuable to the Commission certainly, but it might also alleviate the need to go back in, as Commissioner Newsome suggested, with more prescriptive requirements down the road. If you would care to comment, I know you've had some concerns about those in the past.

MR. THOMPSON: If I could comment on behalf of NYMEX, we found, at least for our own internal purposes, that large trader reporting is very, very valuable. Our markets,

because of seasonality, political influences, environmental influences on them, often come under price stress because information effecting the pricing is not as transparent.

As we're in this information age, still there's a great deal of misinformation that effects the marketplace. It's important to know where your risks are, it's important to understand the character of the players that are in your marketplace. Large trader reporting provides not only a listing of positions and size, it allows you to become familiar with the business practices of the participants in the marketplace so you can assess the risks not just on a quantitative level, but on a qualitative level.

And so as I said in my testimony, we were always and would have always been prepared to accept a level of regulation in areas where we think there are clear benefits. I think any businessperson who is taking a financial risk or is engaged in a marketplace that entails financial risks wants to know where those risks are and who is providing those risks and what their profile is. So we fully intend to retain large trader reporting, with or without a requirement to do so.

COMMISSIONER ERICKSON: Anyone else?

MR. McNULTY: I could echo what Pat said, we think that maintaining management information allows us to do a number of things, including market integrity, clearing house integrity. We think it's very important. It's not just large trader reports, but it helps us understand the nature of our business better.

COMMISSIONER ERICKSON: Thanks.

MR. FICHTEL: I would certainly agree it's just good business practice and if anything, I would anticipate that as all exchanges are moving into a more and more competitive world, that requirement will become even more and more necessary, particularly as new products are developed where you really have to watch the cross trading among the products.

MR. DUTTERER: We too would endorse that and we have used that, both at an exchange level and the clearing houses use that and I know tomorrow you'll have the opportunity to ask them the question about that.

But it serves two purposes. One is a market activity, in terms of a manipulation and indeed, you could have a large market participant may not present a risk problem, simply has enough money to carry it, and then the second is indeed risk.

And I think you will find that the exchanges, as they change and regardless of what business activity they move

into, will utilize all the tools available to them for both purposes. So it's in their interest to use every tool available and I think they will continue to do that.

COMMISSIONER ERICKSON: Mark?

MR. BAGAN: Large trader reporting, as well as all position reporting, are probably one of the most vital pieces of our market surveillance program in Minneapolis, as well as probably everywhere else.

We have daily position reports, as well as weekly reports that the Commission provides us. Whether we remain an RFE, which we anticipate doing, or we move into the next tier up, we would definitely continue to utilize such reports.

COMMISSIONER ERICKSON: Thank you. I guess I would just follow up a little bit on that. I know our regime is different than the UK's regime, but what I would not really welcome seeing is a situation like they found with respect to Sumitomo, where you had a trader who was able to blindly amass very large positions without that information being either at the exchange or the regulator.

I thank you very much for your comments. I appreciate it.

CHAIRMAN RAINER: Is that all you want to --

COMMISSIONER ERICKSON: Yes.

CHAIRMAN RAINER: Okay.

MR. THOMPSON: Mr. Commissioner, if I could just add one thing to that, which I think is important, over the years while there has been a number of objections to large trader reporting, which seemed to emanate from concerns about the confidential nature of the information and whether or not it might be disclosed in some way, we've found that I think we've all been able to develop significantly good relationships and I think good reputations for keeping that information as confidential as it is and I think those concerns and objections that we've heard in the past we're hearing less and less now.

COMMISSIONER ERICKSON: Okay. Thanks.

CHAIRMAN RAINER: Why don't we give Commissioner Newsome a couple of minutes to scratch that itch of his with his question.

COMMISSIONER NEWSOME: I'll be very quick. Pat, a comment you made earlier suggesting that energy products should be traded at the DTF level.

Obviously, there have been some who have suggested that under certain circumstances, energy products could be traded at the exempt MTEF level.

In your opinion, should the DTF level of modified to be more attractive to these products or do you think it's fine the way it is now?

MR. THOMPSON: I think on a case-by-case basis it could be and that's why we believe that the structure that's been proposed by the Commission is probably adequate at this point.

If it turns out not to be, we would come back and ask for an adjustment, but we believe that -- as I said, that we would undertake, just for our own good business sense, many of the types of regulatory -- what are called regulatory protections that are in many cases just good business practice and that on a case-by-case basis we may find ourselves able to work down to one of the lesser tiers of regulation.

But not all energy markets are the same. I think we recognize that. For instance, the world crude oil market, with the liquidity and the breadth of participating, is quite a different market than the New York Harbor reformulated gasoline marketplace, which is its own niche.

So we know that special care has to be taken and each market is somewhat different from the other and while I

think the three levels provide us with a good level of guidance of the level of regulation, there are some sort of interstitial levels of regulation that we may move to on an individual basis.

COMMISSIONER NEWSOME: Thank you.

CHAIRMAN RAINER: Okay. Let me thank each of you. This has been a remarkable panel and I thank and commend you for your candor and frankness. It's been very helpful to me and I suspect I can speak on behalf of all of us, that this has been a very useful experience and I thank you for your time and your generosity of your comments. Thank you.

We will reconvene at 2:30.

(Lunch recess.)

CHAIRMAN RAINER: Welcome back. Maybe we should get started. First, let me welcome our five panelists this afternoon. The topic is, broadly speaking, the over-the-counter markets and how our proposal impacts on that market and opinions therewith.

We're very appreciative that each of you could make it today. We had two panels this morning, the first one was a general overview panel and the second one was a panel where we had the leaders of five exchanges on the panel and they were both very helpful, as I'm sure this panel will be.

Let me just say before we turn it over to the first panel member that we're very appreciative of your being

here. We've tried to make this a very open process, we've had a number of formal meetings and dozens of informal meetings with people like yourself and others and June 22 we published our rule proposal under a 45-day comment period and we will have two days of hearings that should be considered as part of that process, this is day one, tomorrow we'll have two more panels on day two, as we head down to the August 7 end of the comment period and let me just add that we will be receiving comments from anyone who wants to send us comments and if you want to expand on your testimony or follow up this testimony with formal additional comments, we would urge and welcome you to do so prior to the end of the comment period.

With that, let me just say for the benefit of those who haven't been here earlier, our format is for each of you to take about ten minutes, preferably not longer than ten minutes, to provide oral testimony, after which time each of us will take about five minutes to ask questions.

You'll provide your testimony first and then questions following that. We've organized this in alphabetical order, starting from your right to your left and what we thought we would do is start with Ruth Ainslie.

She is the Senior Director for Policy for ISDA, that is the International Swaps and Derivatives Association. Ruth, with that, why don't we get started with you. Thank you.

MS. AINSLIE: Thank you very much. Chairman Rainer and members of the Commission, I'm Ruth Ainslie, Senior Policy Director for ISDA.

Our more than 475 members include most of the world's dealers in over-the-counter derivatives. Our members also include many of the businesses, governments and other end users who rely on the over-the-counter derivatives markets to hedge the financial and commodity market risks inherent in their core economic activities with a degree of efficiency that would not otherwise be possible.

Let me say at the outset that ISDA welcomes the Commission's decision to propose the new regulatory framework. Chairman Rainer, in testimony before the Senate Agriculture Committee last week, you and your fellow members of the President's Working Group emphasized both the dramatic growth of over-the-counter derivatives during the past 10 to 15 years and the importance of these risk management tools to the American economy as a whole.

This growth did not occur in a vacuum. It was fostered by this Commission in a series of actions, commencing with the release of the Swaps exemption in 1989 and continuing

with the Promulgations of the Swaps and Hybrids exemption in 1993.

These latter actions were of course consistent with the intent of Congress as reflected in the 1992 amendments to the Commodity Exchange Act. ISDA and its member firms believe the proposed new regulatory framework can and should be viewed as another and vital step in implementing the commission's enlightened policy in this area.

One of ISDA's principal goals has been to promote legal certainty for over-the-counter derivative transactions. My focus today will be directed, therefore, toward those portions of the proposal that seek to provide increased legal certainty.

It's important to note, however, that our dealer members are among the principal users of the regulated futures exchanges and ISDA therefore is also very supportive of the Commission's decision to propose comprehensive regulatory relief for those exchanges. Let me now turn to the specific portions of the proposal that deal with legal certainty.

First, we welcome the decision to expand and simplify the swaps exemption. Financial innovations occurring since

1993 make this action necessary to ensure that new and evolving risk management tools will enjoy comparable legal certainty with those products that were available when the swaps exemption was originally issued seven years ago.

Under the exemption for bilateral transactions, the swaps exemption would be expanded to encompass all bilateral contracts, agreements and transactions between eligible participants, to eliminate certain other requirements and to permit exempted transactions to be cleared.

We strongly support these proposed changes. They are consistent with the policy judgments reached by the President's Working Group in 1999 and they will eliminate significant sources of legal uncertainty under the existing swaps exemption.

As you know, bilateral contracts involving non-exempt securities cannot, under current law, quality for the swaps exemption. For this reason, we believe that the Commission should move promptly to update swaps policy statement to incorporate the principles embodied in the swaps exemption. As so-revised, the swaps policy statement should, in our view, be reissued simultaneously with the final version of the new regulatory framework.

The swaps exemption applies only to bilateral contracts and we therefore have a direct interest in the proposed new

exemption for transactions executed on a multi-lateral transaction execution facility or MTEF.

We believe this new exemption will promote financial innovation and efficiency by providing legal certainty with respect to transactions effected on certain electronic trading systems.

In connection with the exempt MTEF rules, let me note that the 1992 legislation made clear that Congress intended that the eligibility of any class of contracts for an exemption does not create any inference that the exempted contracts were otherwise subject to the Commodity Exchange Act.

We're pleased that in structuring this new self-executing exemption, the Commission did not subject exempt MTEFs to rules that would create uncertainty concerning the Commission's view, either as to the scope of the Commodity Exchange Act or the classification of one or more categories of off-exchange derivative contracts under the Act.

ISDA also has an interest in those portions of the bilateral exemption in the new regulatory framework that are intended to deny to eligible participants in the over-

the-counter derivatives markets the right to invoke the Commodity Exchange Act to repudiate their contract obligations based solely on the failure to comply with the swaps exemption and similar exemptions and statutory interpretations. These provisions will, in our view, increase legal certainty and we welcome their inclusion.

Let me make two brief points about the non-repudiation proposals. First, we are pleased that these proposals apply to transactions structure in reliance on the swaps policy statement and the hybrid interpretation. This will ensure that transactions involving non-exempt securities enjoy enhanced legal certainty, even though they cannot under existing law quality under either the swaps exemption or the exempt MTEF rules.

Second and more broadly, the non-repudiation provisions are critical to the preservation of market stability and the avoidance of systemic risk. They need to be adopted by the Commission promptly as a safeguard during future periods of volatility in the financial markets.

ISDA will, of course, submit written comments on the proposed new regulatory framework. In those comments, we will address a range of specific issues involving the revised swaps exemption and the exempt MTEF rules.

Our comments will address such issues as whether the swaps exemption should be applicable to transactions

executed on systems that have credit screening functions, whether the exempt MTEF rules should be applicable to one or more additional categories of commodities, as well as other specific technical issues.

Today, however, we believe it is important to focus on the broader point, that the Commission proposals will contribute to far greater legal certainty. The basic policies embodied in the new swaps exemption, the exempt MTEF rules and the non-repudiation rules build upon Congressional intent and the views of the President's Working Group.

The Commission has the authority under existing law to adopt the proposals and we hope that after incorporating such modifications as are appropriate following the close of the comment period it will do so.

Let me conclude, Mr. Chairman, with the observation that ISDA believes the legislation is necessary to modernize the Commodity Exchange Act in order to provide comprehensive legal certainty for over-the-counter derivative transactions and regulatory relief for the futures exchanges.

All of us, including the Commission, need such legislation, but we cannot be sure whether it will be enacted by Congress this year and we therefore welcome the decision of the Commission to move forward now with the proposed new regulatory framework.

We believe that you, each of the other Commissioners and the professional staff of the Commission deserve much credit for the direction and scope of the proposals contained in the framework.

In particular, we thank all of you for your interest in structuring the proposals so that they would not simply avoid creating new legal uncertainties, but rather would in addition provide greatly enhanced legal certainty.

We have appreciated the opportunity to work with the Commission and the staff from the outset of the process and we look forward to continuing to do so in a constructive and cooperative manner as the comment period moves forward. Thank you.

CHAIRMAN RAINER: Thank you very much. Next we have Mark Brickell. Mark is Managing Director of J.P. Morgan Securities. Mark?

MR. BRICKELL: Thank you, Chairman Rainer, and each of the Commissioners, for the opportunity to testify here today. It's a pleasure to be here with friends and

consider the effects of this proposed rule and particularly its impact on swap activity.

I'm honored. I also must admit that I felt a twinge of embarrassment this morning when I picked up the newspaper. It was back in 1988 as Chairman of ISDA that I first met with the Commission to clarify the relationship between swaps and the Commodity Exchange Act. I'm still here with an unfinished project while others have used the same time to decode the human genome.

I was unable to be present this morning, but I understand that the Chairman also made reference to that project, I think to point out that it was the more complicated -- that this one is the more complicated of the two.

We've read the proposed rule and studied it and think it could be an important step in the right direction. It comes in part in response to a request from Congress, the 1999 letter from the Oversight Committee Chairman that asked the Commission what exemptive relief the agency could provide to futures markets using its exemptive authority.

There's much that we admire in the Commission's response. For example, the Commission has stated its

intention to replace the current one-size-fits-all regulation for futures markets with broad, flexible core principles; to establish three tiers of regulation tailored to the nature of the products and the sophistication of the participants; and to move the Commission away from micro management and toward a supervisory approach. In addition, the Commission provides badly needed exemptive relief for futures exchanges and we support that.

The Commission has also proposed changes that appear to be designed to expand on existing exemptions to extend legal certainty to more types of transactions, particularly off-exchange transactions. We applaud this effort as well.

However, in drafting various parts of the proposal, the Commission uses terms that raise questions about the scope of the Commission's jurisdiction and therefore, about the enforceability of certain contracts.

We believe that this problem could be avoided altogether by revising the rule so that it identifies the effected transactions by using the terms in the statute rather than creating new terms. This would greatly reduce the chances of doing damage to the enforceability of certain transactions.

The Commodity Exchange Act gives the CFTC authority over contract markets, boards of trade, contracts for the purchase or sale of a commodity for future delivery,

options thereon and commodity options. These are the activities that the CFTC regulates and these are the activities that the agency has the authority to deregulate. The rules should refer only to these activities and by name.

It appears that the Commission has already recognized the importance of this issue by proposing to delete existing references to swap transactions in Part 35. However, new references to swap transactions appear in Part 36 of the proposed rule.

The benefits of avoiding confusing terminology by using in the rule the same terms that appear in the statute cannot be overstated.

One area of concern to us is the treatment of recognized clearing organizations and this gives an example of the kinds of problems that can arise. It raises some questions about the Commission's jurisdiction and intent and about the enforceability of certain transactions.

As we read it, in Part 39 the Commission authorizes recognized clearing organizations to clear transactions that are otherwise exempted from the Act by Parts 35 and

36. But the source of the Commission's authority to oversee such clearing is not clear.

The CFTC has jurisdiction over clearing organizations only to the extent that they are contract markets. By law, those contract markets may only list futures and options thereon. This rule proposes to allow clearing organizations to register with the Commission as contract markets for the clearing of exempted transactions.

It's extremely difficult to avoid concluding, therefore, that those exempt transactions are futures. How else could they could cleared by contract markets? That poses a threat to the enforceability of certain transactions.

Now, I want to make the most important point in my testimony. Taking the approach that we've talked about here of using terms in the Commodity Exchange Act rather than inventing new terms provides all of the benefits of exemptive relief, both for futures and for swap participants, without raising these dangerous questions about the enforceability of other transactions.

Exempting futures from provisions of the Act would protect off-exchange transactions just as effectively as exempting the off-exchange transactions themselves. How can that be?

Well, if a court ever comes to the mistaken conclusion that one of these transactions is a futures contract, the

court would then seek to determine whether that so-called futures contract had been exempted from the exchange trading requirement and the other relevant provisions of the Act.

So the benefits of the exemptive relief in this rule would be available to these transactions at the very moment that the relief is needed, that is, the moment that a transaction is deemed to be a futures contract.

This approach would also solve another important problem. As written, the rule could mislead investors. The rule signals investors that the CFTC retains anti-fraud authority over the exempted contracts. But of a counter party, having lost a substantial amount of money, alleges fraud in an off-exchange transaction and urges the Commission to prosecute, perhaps having entered into that transaction in the belief that the anti-fraud remedies of the Act would be available, in many cases the Commission is in no position to help.

Prosecuting an alleged fraud in certain off-exchange transactions would cause a far greater injustice, since it could call into question the enforceability of billions of dollars of hedges on securities prices. It would be ironic

if an anti-fraud rule itself made a promise to investors that can't be kept. Investors deserve better treatment and using statutory terms in the exemption will send investors a clearer, fairer signal.

During the comment period we look forward to providing you with detailed suggestions about how to carry out these recommendations.

I want to thank you for the opportunity to appear before you today and for the tremendous effort that you've made to address these important issues.

CHAIRMAN RAINER: Thank you, Mark. Next we have Martin Chavez, who is the Chief Executive Officer and Founder of Kiodex; is that right?

MR. CHAVEZ: That's correct.

CHAIRMAN RAINER: Okay, Martin. Thank you.

MR. CHAVEZ: Chairman Rainer, as a fellow native New Mexican, I'd like to thank you for the opportunity to be here and I applaud all of you in the Commission and on the staff for the remarkable foresight that you've shown in the regulatory framework.

Speaking immodestly, I must say that the provisions, the goals of the DTF regulation exactly match the criteria in my own business plan. Speaking on behalf of the geeks and nerds that we talked of earlier this morning, I don't know

what a Ho-Ho is, but I will classify myself as a geek and a nerd.

We're a collection of 30 or so rocket scientists from Wall Street and the City of London, former derivatives marketers, traders. We've been around the market, we've seen a lot and we believe that there is an urgent requirement to bring the CFTC's brand of regulation into the new economy.

So it would be grossly inaccurate to say that dot coms do not want regulation or that they would seek the minimal kind of regulation or full exemption. On the contrary, we believe that the most successful exchanges will actively embrace the DTF form of regulation. If you'll allow me, briefly I'd like to go through the seven core principles of the DTF.

First of all, enforcement. Giving legal certainty to the transactions executed using our new technology is of great importance to our success and desirable for the customers, as well as the dealers.

Market oversight. New technologies make market oversight far more readily accessible to a broad variety of exchanges. Operational information will be integrated into

the operation of these exchanges as they embrace new technology.

Transparency, perhaps the most important to us. Currently the OTC markets, we must say, are like walking down a very dark alley. Not everybody who trades in those markets has the tools, the risk management, the knowledge, the control of the flow of information in order to trade these derivatives safely and fairly and we believe that new technology will offer the kind of transparency that customers deserve and that dealers need as well.

Fitness. Often you will hear the argument made that certain customers should be kept away from facilities because they are not of the same degree of credit worthiness as the inner dealers. We do not accept that argument and we believe that technology allows for the simultaneous fair dealing between dealers and customers, as well as retaining anonymity among the inner dealers.

Record keeping. Something else that comes along with the structure of an exchange, if it embraces the new technology.

Competition. I think that we need to expand what we mean when we say that we want an unbiased exchange. It is important that everybody who wants to participate in an electronic exchange be able to do so.

Far from being a reckless force, we believe that new technology offers a tremendous promise for enhancing liquidity, fairness, transparency and efficiency of these marketplaces.

It is not clear that everybody would want this, however it is clear to me that there has been change in the markets, technology has created problems, it is creating simultaneously the solutions to those problems and with the kind of technology that has been developed to yield radical transparency, we believe that we will create a virtuous cycle, there will be increased fairness, leading to more trading, more volume for dealers and more effective risk management and an explosion of derivatives in a variety of marketplaces that we can barely envision at this point.

So we welcome the flexibility that is indicated in the proposed regulatory framework and will actively work with traditional exchanges, including some of the ones that were represented here today, as well as evolving B-2-B exchanges on the internet, to create greater fairness and efficiency throughout all these markets. Thank you.

CHAIRMAN RAINER: Thank you, Martin. Next we have Ken Raisler. Ken is head of Sullivan & Cromwell's Commodities,

Futures and Derivatives Group. We remember him around here also for reasons related to his having been the general counsel at the CFTC between 1983 and '87.

Ken, thank you for coming this afternoon and we look forward to hearing your remarks.

MR. RAISLER: Thank you, Chairman Rainer, Commissioners. I am delighted to be here this afternoon to testify on this important development and I join the other panelists in applauding the Commission and the staff for absolutely an outstanding start in a very important project.

Chairman Rainer, since your speech last fall in Chicago to date, we're talking about nine months, during which time the vision you put forward at that time is starting to take shape and become a reality. As I think Mark Brickell indicated, in 1988 some of us -- actually, '87 was sort of more of a starting point for this project, it's slow in coming, it's time and we're delighted that we're moving on a faster pace.

Obviously we're moving at the Commission at the same time as we're moving on Capitol Hill and as I think Ruth indicated, we have no certainty about what's happening on Capitol Hill, but to a large extent the Commission controls its own destiny with this rulemaking and we certainly applaud moving forward on an expeditious pattern to get this done.

I too would like to pick up on where Martin spoke and talk about the DTF category because I think it's a key link between the two worlds, the OTC world as we've historically known it, starting out as a bilateral transaction world where two parties are just dealing with each other, and the exchange world in a pit trading environment as we've known it, which is the sort of traditional central market world.

Technology has opened a door for us for a new kind of business model and it is, from our point of view, essential that the Commission find the way to embrace that model.

The markets that we're talking about are electronic markets. The markets that we're talking about have sort of come from two different directions. Today a lot of these markets are voice-brokered markets, that's certainly true of some of the more liquid markets. There are today voice brokers who via telephone put two parties together and that market is moving to technology for very obvious efficiency reasons.

Also there are a variety of business-to-business marketplaces which are, for lack of a better term, called procurement sites, where people are using technology as a central location for buying and selling goods and it's no

surprise to anyone that the idea of risk management is an important annex to that business model.

Today people in the physical commodities businesses, whether that be energy or band width or metals or a variety of other physical commodities, look at the opportunity to sell physical products to their customers, but at the same time, those customers are interested in protecting against price risk. Whether that's an airline worried about jet fuel prices or a jeweler worried about silver prices, today no company can exist without a risk management practice. It's impossible to pass through directly to the customers all of the variabilities in the marketplace and their shareholders are unwilling to accept that. So the CFTC needs to find a way to sort of open its doors to allow this kind of business to go forward.

As the Commission is aware from a variety of perspectives in the industry, we would like to see ways in which, through exemptions and exclusions, Congress can give a clarity and avoid direct regulation of a lot of this business activity.

Today we know that until that legislation is passed, we don't have the legal certainty that we would want for a lot of these businesses and if that legislation gets passed, we believe an awful lot of people will be interested nonetheless, sort of along the lines of what Martin talked

to, to come to the CFTC, to opt in to be regulated here because that regulation gives them an imprimatur that's important to their customers and is the potential for them to passport their business into a global marketplace.

We believe, just as an aside, that the concept of opting in is not one that is in any way legally infirm. It provides for the CFTC to basically regulate that activity which is otherwise subject to the provisions of the Act and we in our comment process will address that issue specifically.

The challenge for the CFTC is to design a DTF category that is embracing, flexible and accomplishes the regulatory goals of the CFTC without inhibiting the business plans of the -- not just the dot com worlds, but the procurement sites or the people migrating from voice brokerage to technology.

In this regard, I think this is really a challenge for the CFTC and it's a challenge that I think goes beyond the rulemaking draft that I've had the opportunity to read over the last several days.

I think it's essential for the CFTC not to look at this marketplace through the traditional prism of a contract

market because it really isn't. I think that there are several aspects of this point that I can illustrate.

I think instead the CFTC has to take a clean slate. Rather than saying these are the existing rules that apply to contract markets, these are a couple we can take out, I think they have to take a clean slate approach and replace those rules with core principles across the board.

As an example, there is no -- as a general matter, there is no concept of contracts in the way the CFTC sees them for contract markets that apply to the DTF space. The idea of listing contracts for trading is really not applicable and if it were applicable or tried to be applicable, it would be an astonishing development.

As an example, Enron Online, which is not a DTF type space because they only trade for their own account, they basically have 2,000 products on the system today and they add them in huge quantities every day.

In addition, the sites that we have been looking at have so-called RFQ procedures. That is, if somebody wants to sell something, he just puts it on the site as a request for quotes. The concept of a contract or submitting a contract for designation or even with a pre-approval process, the paperwork associated with the traditional concepts of contract market really don't, in our opinion, have direct application here.

The concept as well in the CFTC's rulemaking of being able to go to the people who trade on the platform and get information from them directly is, in our opinion, basically a non-starter for a successful regulatory structure.

The fact of the matter is that the platform itself is willing to be responsive to the CFTC, but in the international marketplace, the people who are commercial participants don't see themselves as being subject to regulatory inquiry and to go down that road in the way in which you would if you were dealing with a traditional futures exchange through futures brokers doesn't really get us in the right direction.

We've also talked about the concept of self-certification for a DTF rather than a pre-approval process. We think this is extremely important because if the marketplace in a competitive way is structured in such a way that you need to come to the CFTC, need to hire counsel -- not that we have a bad view of that in most respects, but need to basically create a huge infrastructure to get approval here, that will impede the kind of developments we're talking about and encourage people not to use the

United States as their forum for starting these kinds of businesses.

In addition, the proposed rulemaking identifies a number of rules in the Act that still apply to the DTF and things like cross trading rules or accommodation trading rules, disciplinary system rules really don't understand fully what we're talking about when we set up a platform for this kind of business, which basically is as a platform willing to be responsive, but does not have the kind of infrastructure that the CFTC historically has looked at when they've dealt with exchanges.

Instead, from our point of view, the way we envision the DTF structure is really to focus back to core principles and for simplification terms, we'd sort of take them down to four core principles.

Number one, there needs to be terms and conditions of trading. There may not in fact actually be rules as such on a number of these marketplaces, but some kind of procedures whereby people can execute on the platform and these can, of course, be made available to the CFTC.

There needs to be fair access to the system. That is to say it has to be on a non-discriminatory basis, of course. If there are criteria, they have to be applied fairly across all of the participants.

And the owners of the platform need to meet fitness criteria and finally, there needs to be record keeping and a willingness to be available and open for disclosure purposes to the CFTC and obviously, as part of that, the platform itself is available to be reviewed by the CFTC and would have to be strong enough to promote the fair access and the terms and conditions that are set forth above.

From our point of view, these are really the only essential criteria and if a rulemaking can be designed around those four criteria, we believe people will grab the opportunity to come to the CFTC for DTF oversight.

We believe, however, that if the existing structure or even the one suggested in the rulemaking is where the CFTC ultimately comes out, we will have too many disincentives to move into this space and given the excitement and the opportunity presented by ideas like Martin's and others out there and what we're confronting every day, we hope very much and we are very much prepared to work with the CFTC during the comment process, as well as providing comments, to get us to the right place here because I think we all agree that there's a lot of value that the CFTC can bring to this undertaking.

Thank you very much, Mr. Chairman and the Commission, for the opportunity to make these remarks.

CHAIRMAN RAINER: Thank you. Next we have Ed Rosen. Ed Rosen is a partner with Cleary, Gottlieb, Steen & Hamilton and a person we all recognize is very deep in this business.

Ed, thanks for being here and it's your turn.

MR. ROSEN: Thank you, Mr. Chairman and Commissioners. Thank you for the opportunity to be here this afternoon.

I see this proposed rulemaking really as a major step into the 21st century for this Commission. It's a forward-thinking document and it is a very comprehensive initiative. The initiative has its boundaries, it has its conditions and I'm sure that over the next couple of months we will debate where those should be and precisely how they should be formulated.

But we have really taken a very significant leap forward from where we were even two years ago, when much of the progress that had been made in the area of legal certainty was, to many of our minds, put into question.

With this proposed rulemaking, I believe that we are really on a road to address the problems that were raised in that regard and to strengthen the position of the United States as a more hospitable environment for financial innovation.

With respect to some of the particular subjects that are addressed in the rulemaking, with respect to Part 35 I think there's no doubt that the proposed revisions will greatly enhance legal certainty for the over-the-counter markets and bilateral swap transactions.

There have been uncertainties over the years as to what was necessary to constitute a swap agreement, what did it mean for something to be standardized, what did it mean for transactions to be fungible. These issues are laid to rest with this proposal, if adopted.

The inclusion of a definition for multi-lateral transaction execution facilities will bring much greater clarity, much greater certainty to market participants and the proposals to permit transactions eligible for the exemption to be subject to clearing mechanisms that are subject to oversight is an extremely positive step and together with the exemptions to create protections from contract repudiation, I think those two measures will do quite a lot to reduce credit risk in the system and to eliminate that issue as an issue that really goes to the core of the debate about health and growth in the over-the-counter derivatives markets.

The proposed revisions in Part 36 are very important because for the first time, they provide scope for the use of the emerging technologies and electronic trading for the over-the-counter markets and provide an opportunity for the development of markets independent of the Commission's traditional regulatory framework for exchanges.

This is a very positive development, very important for financial innovation in the United States.

I also strongly support the Commission's decision to establish an intermediate tier of regulation in the space I guess that has come to be called a DTF. I think it's a very important commercial space, I think I agree with Ken in this regard, and I think it's very important that the Commission permit applicants to participate in the DTF space without requiring that the Commission make a specific determination that all or any particular subset of the transactions that might be conducted on that facility are necessarily futures contracts under the Act.

This is consistent with the position the Commission has taken in connection with Part 35 and the hybrid exemption from the beginning and it's consistent with the exemptive authority that Congress gave to the CFTC earlier in the 1990s.

As I noted, I think the clearing proposals are very constructive proposals. In addition to promoting legal

certainty and promoting a reduction in credit risk in the over-the-counter derivatives markets, I've always thought that it was more rational to separate the regulation of clearing and trading facilities and to deal with them independently because of the very different issues and policy considerations that they raise.

Of course, I wouldn't be a lawyer if I left you with the impression that I thought that the proposed rulemaking was perfect in all respects. I think there are areas where we can usefully expend some energy and more thought.

In particular, I think we should look very carefully at the definition of "eligible participants" to ensure that we haven't inadvertently omitted categories that are important. I think in the context of the definition of a multi-lateral transaction execution facility some additional thought could be given to whether or not it improperly excludes really professional markets in which bilateral trading relationships are formed and through credit screening technologies, there is an ability to use matching systems to create more efficient executions, but really a market in which the relationships are essentially bilateral.

The definition of commodities that are eligible for the various exemptions, the Part 36 exemption and the DTF exemption, I think is something we need to provide, to spend some more time thinking about. I think that they are in general on target, but I think that there are some respects in which there may be products that are excluded that might justifiably be included in those exemptive categories.

It's also not entirely clear to me, thinking about the DTF category, that it is appropriate to have the same regulatory framework apply to a derivatives transaction execution facility which are limited to commercial participants dealing with each other on a principal-to-principal basis on the one hand vis-a-vis the other extreme, which is a system in which you are permitted, by virtue of the nature of the commodity that you're trading, to have the retail public participate through regulated intermediaries.

I don't mean to suggest that this is an irrational scheme, only that there are opportunities, it seems to me, to more -- to calibrate with a little greater granularity the regulatory consequences, given the differences in those two trading environments.

In addition, I think as important as these steps are, there are I think generally three additional steps that it

is extremely important that the Commission consider addressing as part of this initiative.

The first is, as Ruth was saying earlier, to update the exemption -- I should say the precedent on which market participants rely in connection with swaps on non-exempt securities and that is the swap policy statement.

That was a policy statement that was generated in the late '80s, when this market was in its infancy and I think we have learned through the evolution of the market there are respects in which that could be very usefully updated to provide greater certainty for the swaps that rely on it and I think that an initiative that of kind also goes to address some of the concerns that Mark articulated earlier about the potential adverse consequences of a determination that certain kinds of stock transactions might be futures.

Similarly, for hybrid instruments, those that involve non-exempt securities and rely on the statutory interpretation, we have similarly, as the market for hybrid instruments has evolved, observed a number of respects in which it ceases to be an effective basis for conducting business in those markets as they've expanded into the sort of equity market, credit derivatives market and the like.

Finally, I think that some thought ought to be given to the opportunities, particularly having completed the President's Working Group Report deliberations, to try to provide for the marketplace some greater clarity and unanimity of view as to the scope of the Treasury amendment.

Obviously, the Commission doesn't have within its authority the ability to grant an exclusion of the Act in its jurisdiction, nonetheless, I think there's a significant amount of positive work that can be done in that area and I think that those are three areas that really form -- are as important to the totality of result of achieving legal certainty for these markets as the exemptions themselves.

Notwithstanding those additional steps, I think that the Commission's proposals hold out very positive and tangible benefits for the financial and derivatives markets and I look forward to working with the Commission going forward to ensure that the initiative achieves all the objectives that the Commission has asked for.

CHAIRMAN RAINER: Thank you very much and thank you all. We'll move now to our Q&A portion of the session. Commissioner Holum?

COMMISSIONER HOLUM: I have no questions, thank you, Mr. Chairman.

CHAIRMAN RAINER: Commissioner Spears?

COMMISSIONER SPEARS: Thank you, Mr. Chairman, a couple of questions, if I might. The majority of the panelists I believe commented about the likelihood of an entity going to DTF status from the OTC market. I am interested in hearing expansion upon those comments about the likelihood and the reasons why an entity might go to a DTF status that could qualify as an exempt MTEF, if you will, in addition to the international passport that I think you mentioned, Ken. And you also, I think, mentioned that you thought that the seven core principles were too much and that four is more appropriate.

I'd be interested in you expanding upon that and the other comments. Mr. Chavez, you mentioned about the DTF status as well, so if the other panelists would expand upon that point.

MR. RAISLER: I think, Commissioner Spears, that the origins of the DTF fortunately or unfortunately sort of date back to some of the legal uncertainty associated with OTC derivatives generally, but obviously when people are doing cash settled swap-related or swap-like transactions and move those to an electronic marketplace, there is legal

confusion that still exists in the Commodity Exchange Act as to what that is.

So people who are developing these kind of spaces, and those are people who are doing either the voice broker migration I talked about or the business-to-business migration, basically are then confronted with where are we as to legal certainty.

Certainly if you're a platform that has international participants on it or intends to promote itself to international participants, as well as substantial domestic legal entities, you would want to assure them that you can give them legal comfort that there are no impediments to the enforceability of the contracts entered into on that system, therefore you're sort of back to the CFTC.

Obviously, legal certainty, as part of the legislative package and part of the regulatory package, would like you to be able to be very confident in advising them that they do or don't have a problem.

I think that when we've looked at this question and the Commission very helpfully moved forward earlier this spring with the no action letter with respect to one of those platforms, it allows basically the deal to close and to move ahead.

I think the natural hope would be that the CFTC provides a hospitable forum for these kinds of innovations because

they do, as I say, transcend and fit between the OTC business and the traditional futures business. I think we will find an awful lot of legal entities wanting to go there, that the notion of getting CFTC imprimatur, if the burdens don't outweigh the benefits, are going to be significant.

The ones I highlighted are obviously if you're dealing with substantial entities that want legal certainty, the idea of being regulated and overseen is a marketing advantage for people. The idea of being able to market to international participants, the idea of being able to access in foreign jurisdictions participants on the technology, whether it be internet-based or direct access-based, in a lot of jurisdictions around the world obviously the CFTC has long been known as a leader in the regulation of derivative products, obviously, specifically futures, has an enormous amount of credibility in a lot of those jurisdictions and the idea of saying that we are subject to CFTC oversight would allow them to basically defer rather than themselves get involved in directly supervising the activities taking place in their jurisdiction.

Those are some of the interests that I see as being key, but I think it all drives back to having a forum that works. I think if the burdens are too great, most of these forums, these are technology-based, a lot of the great brains, the geeks and the nerds that Martin referred to are here, are at Silicone Valley or in the United States, but it is not difficult to set these operations up in Europe.

If you look at the profile of some of those forums, you'll see that an awful lot of the participants are headquartered themselves outside of the United States and a lot of the companies that are U.S. based have major trading operations in those jurisdictions.

So if the CFTC can be the leader here, I think that the rocket scientists are here to work with you to make that leadership really work. But if the CFTC creates too high a barrier or we can't get this sorted out effectively, I think they will go elsewhere.

That's really our reason to look to simplified structure and I think the key point there is that the people who are coming to this market are not coming from traditional futures backgrounds, do not see concepts like contract markets, disciplinary rules and the baggage that's second nature to all of us, because that's the futures business, but they don't come to this business from that perspective.

This is somebody who is selling auto parts and wants to include on their platform a derivative of some kind that can protect them against SO2 emissions or can protect them against steel prices and they look at it as just basically part of the marketing of their underlying physical product.

So we need to be creative and strip this thing down and say what does the CFTC absolutely have to have and that I think has got to be the goal of the DTF undertaking.

COMMISSIONER SPEARS: Martin, do you care to comment?

MR. CHAVEZ: Yes. I'd like to expand upon that a bit. Enforcement is obviously of great importance, but I'd like to address the questions of transparency, symmetry of information and competition.

For all of those reasons, I believe that the DTF categories are good business sense, good branding, good marketing. My company is based in New York and in London. We've looked at all the various jurisdictions and believe that if the CFTC is consistent, with a light touch in the DTF framework, that that is where these exchanges will gravitate and that is consistent with the principle of the internet, the elimination of groups and clubs and fair trading and equal information for everybody.

If you look at some of the trading sites that I believe will go for the exempt MTEF designation, they simply are silent on the subject of transparency, say very little about whether the same information will be available to all market participants at the same time. They say very little on the subject of competition.

In fact, many of these consortia are really ways to preserve a certain kind of information advantage. Rather than eliminate or rule out those kinds of exchanges, I think that we should be consistent with the free market principle and that customers will prefer to trade and will insist that they trade on an exchange that happens to have the principles of transparency and competition embedded in it and those happen to be consistent with the DTF framework.

COMMISSIONER SPEARS: Mark, did you have a comment?

MR. BRICKELL: I want to add to that, echoing Ken's thought. Regulation often has a benefit for businessmen, particularly in that it enhances the reputation of the business.

If my firm isn't known to potential customers but your agency is known, you provide reassurance to the customer by regulating me. So a businessman will often choose to be regulated in order to get that benefit and that could

happen in this case and in fact, there's a parallel in the world of lending, which as a banker I'm more familiar with.

I can lend money as either a state chartered or a nationally chartered bank, I've got a choice, but I don't have to be a bank, I could be a thrift, I could be a credit union and if I want to choose not to be regulated at all, I can issue commercial paper instead of collecting deposits, take in funds that way and make loans from a completely unregulated platform.

One challenge that inhibits the effective use of this opt in structure by the Commission is a statutory problem you have and until the statute is fixed, it will be hard for you to capitalize on your intentions here.

Because the Act requires you to regulate every futures contract, if a businessman comes to you with a proposed structure for trading derivatives and says would you please call this a DTF or an MTEF or any of the other terms you've got, it creates a tremendous potential liability for the businessman because a Commission might say, might feel itself statutorily obliged to say thanks for telling us that that activity is futures trading. Now we're obliged to come into your firm and go after every other

transaction, every other business activity that looks like that because you've just told us it's a futures.

If the statute is changed so that we can come to you and seek the benefits of your regulation without triggering a requirement that you regulate everything we do that looks like that, it will be far easier to seek your help.

COMMISSIONER SPEARS: One more quick question if I might, Mr. Chairman. It's my understanding that the majority of the people on the panel would like to see legislation passed regarding legal certainty. I think that's certainly an objective of everyone.

I'd be interested in an expansion of those views or comments. Would that legislation, as it stands, provide adequate legal certainty?

MR. ROSEN: Subject to the views that you've heard expressed at the table, I think that a complete program will provide as much legal certainty as it falls within this Commission's statutory authority to provide, but unless and until the obstacles to the exercise, for example a full exemptive authority or definitive legislative statements regarding the regulatory status of various categories of transactions is the only way that you could get complete legal certainty.

This crops up in areas such as the treatment of derivatives involving non-exempt securities and the

Treasury amendment. I think that really in order to resolve those issues definitively and single stock futures is another example, but you have to have legislation.

COMMISSIONER SPEARS: Would anyone else care to comment?

MR. RAISLER: I would certainly share Ed's view on that. I think it's absolutely essential, though, that given the uncertainties associated with the legislative process, that the Commission's undertaking, which I think we would agree may not provide absolute legal certainty but provides substantially enhanced legal certainty, be an effort made and moved through and forward diligently.

Also, I think it the extent that we are unsuccessful legislatively, it will be a good benchmark for Congress to respond to on a going forward basis. Certainly we have seen very strong support on Capitol Hill for the regulatory reform initiative and it's I think practically unique to see Congress trying to codify a regulatory proposal before the regulator in fact has codified it, so I think that's how anxious everybody is move ahead on this, so I think that both missions are very important and neither should wait for the other.

MR. ROSEN: I want to echo that. I want to echo it absolutely because I don't think that the desirability of positive legislation should in any way deter the Commission from pursuing this initiative.

COMMISSIONER SPEARS: Thank you, Mr. Chairman.

CHAIRMAN RAINER: Commissioner Newsome.

COMMISSIONER NEWSOME: Thank you, Mr. Chairman. Mr. Brickell has roots from the great State of Mississippi, however somewhere along the track north he forgot to speak where we could understand him. Mark, in jest, of course.

It appeared from some of the comments that you made that there are aspects of the proposed framework that could actually be detrimental to innovation. Would you mind expounding upon that a bit? I know that's more than you may be able to just talk about here and if so, I would love to see some of that in your written comments.

MR. BRICKELL: I'm glad that you said that you could understand me, because I was willing to repeat it all in our native tongue if that would help.

Let me amplify by making this observation. It seems to me that swap participants have relied -- well, the Commission has done a fine job of building a legally certain framework out of the tools that are available to it. It's never found that a swap is a futures contract. It's promulgated the 1989 swaps policy statement. It's

received direction from Congress that the Commission should issue a swaps exemption and it's done so.

And all of those factors have helped to develop and protect a business that's provided enormous benefit to the economy and been good for the competitiveness of the American financial institutions abroad.

It's worth noting, though, that swap participants have relied less on the content of the swaps exemption itself than on the signal that it sent, combined with these other factors, that swaps are not futures.

That combination of factors has created a sort of -- well, everybody here is either a lawyer or a scientist, so I'll use this term, it's created sort of a reassuring penumbra and within that penumbra, as you know, all day every day we write swaps that don't fit within the four corners of the swaps exemption.

Swap participants are comfortable doing that because we know that swaps are not futures. But the fact that we do this, we write transactions that are protected by the penumbra but not by the exemption itself, reminds us that it may be less important to revise the terms of the swaps exemption, which can't ever cover all of the existing

transactions we do because of statutory limitations, then it is to avoid dimming the penumbra.

I've alluded in my testimony to some of the ways in which that protection could be reduced and I think it's not hard to solve those problems and look forward to providing written suggestions about how to do that.

COMMISSIONER NEWSOME: Okay. Thank you. One more question, Mr. Chairman. This is targeted primarily to Ed and Ruth and then any others that may want to comment.

You both mentioned the swaps policy statement and the hybrid statutory interpretation in your testimony. This question has really three parts. How important, in your opinion, is it that we update this in a timely manner; what are the ramifications of taking no action; and thirdly, how would you propose that we change this policy?

MR. ROSEN: I think it's extremely important, given that the area of greatest uncertainty after this initiative is completed will remain with those transactions that involve non-exempt securities. It is extremely important that the precedents that provide the basis on which those transactions are conducted be broad enough to comprehend the scope of that activity as it's conducted.

I actually, it might come as a surprise to some, agree with Mark's observations that there is a beneficial effect of a penumbra here. It has its boundaries and for

different firms those boundaries are at different limits. But the boundaries do exist and so these limitations in the precedent do become at some point binding constraints and they bind on a very, very broad category of derivatives transactions that are used to benefit corporate America and institutional investors.

They are extremely important, not just in the capital markets, but as part of the mechanism of the global economy and we have just outstripped that policy statement and we have done the same thing in the context of hybrid securities and the statutory interpretation.

It was drafted with I think the conception that it would be used primarily for notes that are indexed to interest rates and currencies and gold and oil because in fact at the time, that was far and away the greatest application of those instruments.

But over the years some of the most important segments of activity involve the issuance of notes that are linked in one way or another to other securities and because of the pricing of common stock and the way that these transactions are constructed and the impact that dividends have, the current standards under the statute don't work

for those instruments and one has to go through an extraordinary amount of reengineering and making products more complicated in order to get them into the marketplace in circumstances where one could give an absolutely clean legal opinion as to their enforceability.

Similar developments have occurred with the development of products designed to promote credit risk management, where a note is issued by one issuer and is linked to the value of indebtedness of another and usually much weaker credit, the result of which is to make the standards for the issuance of the note and the satisfaction of something called the commodity independent yield test absolutely impossible and that has an extremely chilling effect on that marketplace and has caused both reengineering, stopped transactions and caused transactions to be done outside the United States.

So I think the answer to your question is this is extremely important.

MS. AINSLIE: We would support everything that Ken and Ed said about the importance of going forward with this framework, whether or not there is legislation and part of that, in order to achieve as much legal certainty as possible, we think steps that you've talked about are really critical.

Our members represent the full range of participants in the derivatives markets and they need to have as much legal certainty as possible.

MR. CHAVEZ: Simply put, the consequence of inaction is that the new internet-based DTF markets will go to London, where the Financial Services Act is all but complete and only needs the Queen's assent.

COMMISSIONER NEWSOME: Thank you.

CHAIRMAN RAINER: Mr. Erickson?

COMMISSIONER ERICKSON: Thank you. This has been very informative and I do want to maybe take a minute to put some of my comments and questions into context.

I think that this kind of a proposal has an enormous potential and, Ken, I'm going to be very interested in seeing the legal analysis that you indicate you are going to be providing with respect to the opting-in concept that we're going to be relying on.

Everyone understands there is an element of uncertainty in the markets today. Knowing that the four corners of Part 35 are fuzzy around the edges may help to explain some of the problems that we as an agency and the industry have

had in the past. I think you could say it is a don't ask/don't tell policy.

My concern when we get to DTFs is this very issue. Are we giving, potentially, some unwarranted comfort to people using those markets that we are affirmatively regulating those markets or providing some level of oversight when we aren't certain about the enforceability?

I'd just like to ask for some feedback about those feelings, about the concern that underlies. I appreciate that, and I will look forward to the more detailed analysis. Ken, go ahead.

MR. RAISLER: I think -- Commissioner Erickson, I think your point is an excellent one and I think it's one that the panel and earlier remarks focus on as well.

The problem we have -- and this sort of responds to Commissioner Newsome's earlier question. The problem we have is, to put it mildly, an imperfect statute which until we can get it fixed is something that we have to work with.

The problem that we have is people who are in business today designing products and ideas to market to people who find them to be of value, and I'm really talking about Martin's business plan and others like him who want to get out to the marketplace to offer these products through an electronic facility.

I think we're sort of at a crossroads there and I think that the answer has to be to work with what we have. I believe that there is no legal infirmity to doing that. There may be some continued penumbra don't ask/don't tell problems associated with it that I think sort of trouble all of us, which is why we're working on Capitol Hill to try to nail down more certainty.

I don't think that the marketplace that we're talking about, specifically the DTF marketplace, is looking to the CFTC so much as a regulator who will be protecting the market as a place where we can get legal certainty about the transactions on the market.

If we're talking particularly about the commercial marketplace that my testimony and I think Martin's is focused on, these are people who are extremely well-capitalized, extremely sophisticated players and what they're coming to counsel for is not to say gee, we need the help of a CFTC regulator, what they're coming to counsel for is saying we need the assurance that these transactions are going to be enforceable and so while the CFTC may not squarely, because of its jurisdictional issues, be addressing every one of those transactions as

being subject to its jurisdiction, it provides the belt and suspenders of legal certainty to say that to the extent that any of these transactions may trip into your domain, you are telling the marketplace participants that they don't have any fears about CFTC interference.

There is some oversight that you are providing to that market that people I think globally will find to be beneficial and there may over time be migration to you, but initially I would say that when people are coming to you and certainly the early efforts of people coming to you for no action relief is I think the bellwether of that.

It is not so much we are seeking CFTC regulation and in fact, if the CFTC were to declare or Congress were to declare, then I think we'd have a slightly different situation.

COMMISSIONER ERICKSON: Okay.

MR. ROSEN: I would just follow up by saying that I think there are respects in which the advantages of the role that the CFTC would play are derived just from the steps that the DTF is willing to take itself and must go through in order to qualify in that capacity, so if you are providing the transparency, then whatever your authority might ultimately be, the participants in the market are deriving the advantages from it.

If you must satisfy a fitness standard in order to occupy that regulatory category, then they are protected from that. If the category of participants in it are restricted in particular ways, the protections are automatically derived independently of what might happen at the end of a very long litigation, when someone says well, is this a futures contract or not. You've accomplished quite a lot before you've ever gotten to that point.

MR. CHAVEZ: Commissioner Erickson, I'd like to suggest that the Commission take immense comfort in the core principles themselves then taken to their logical conclusion.

Transparency and competition by themselves, in their radical form, when properly combined with risk management that's embedded in the exchange and available to customers and equally accessible to all, will go to great lengths to swage any concerns about the fairness of these markets and the kind of regulatory oversight that you're providing.

MR. BRICKELL: I have great sympathy for the point that Commissioner Erickson is making. I was alluding I think to a similar problem when I talked about the possible belief on the part of investors that they're protected by the

Commission's anti-fraud authority in circumstances where the Commission is unable to bring that anti-fraud authority to bear. Chairman Rainer has testified to this effect before the United States Senate quite eloquently.

I think it's a serious problem, a potential contributor to moral hazard and I believe it could be addressed in large part by the changes that we're going to suggest be made to the rule, by getting closer to the terms in the statute and sending a signal that's a little clearer and fairer and easier to understand.

COMMISSIONER ERICKSON: Thank you. Ruth, anything?

MS. AINSLIE: (No response.)

COMMISSIONER ERICKSON: One of the things that you have pointed out here is that the benefits just accrue naturally by the business model signing up to the core principles, which is terrific. I guess given the potential problems of actual oversight ability, is that a risk worth taking if you're in these markets? Certainly these are markets that could be just exempt MTEFs and they could voluntarily have their own core principles, relying on the sophistication of the parties.

I'm just concerned about the potential of putting the good name of a U.S. regulatory agency as a stamp of approval in a marketplace and then not being able to really

follow it up with anything. I don't know if that's a concern for a new business upstart or not.

MR. ROSEN: Usually the problem has occurred and then it's a question of what are you going to do with respect to the marketplaces. There's been, even on the traditional exchanges, some terrible event. Well, the event has occurred and vis-a-vis the marketplace, what's the remedy of the Commission.

It may be that in this extreme circumstance where if ultimately you didn't have the jurisdiction, you'd shut it down and it wouldn't be able to operate as a DTF and it wouldn't have the seal of approval, so it wouldn't really be that much worse off and I candidly am not as concerned about this issue of someone seeking an anti-fraud remedy, relying on the anti-fraud remedy under the Commodity Exchange Act and being bitterly and hopelessly disappointed by the fact that a court ultimately concludes that one of these transactions is not a futures contract.

Because quite candidly, I can't remember reading very many cases where somebody alleged and proved fraud and a judge sat there and said well, gee, let me look in my books, I don't think there's a remedy for you.

COMMISSIONER ERICKSON: Well, they may have to look elsewhere, you're right, because we run into that problem. We have a real problem in enforcing fraud cases on foreign currency transactions in the Ninth Circuit, so just being able to establish fraud doesn't always get us in the door.

Just one general question. Everything within this framework relies upon the definition of MTEF. Once you're within the definition of MTEF, you can participate in DTF markets or RFE markets. I believe you can basically pick your regulatory regime.

There are a lot of things I think in the definition of MTEF that seem to be excluded and I'm just kind of wondering, since you've looked at it, what's in, what's out, because I think those things that are affirmatively exempted from MTEF don't have the option of coming up to the DTF level, as I read it, and so I'm just kind of curious. What platforms or systems are clearly in and clearly out, as you've looked at this?

MR. ROSEN: Let's see if I can remember. One category that's clearly out is a category that I infer is intended to encompass the use of electronic technology not to create a central matching engine that replicates the interaction of independent floor brokers on a floor, but really facilitates communication that would be by telephone, but which can now be electronic, electronically captured, which

has the benefits of then having an unalterable record of the transaction which can go back to the back offices of the participating firms and basically contribute to what everyone is calling straight through processing now being an insignificant cost.

So I think that what is excluded there I see as really -- it's an over-used expression, but the use of computers as a surrogate for telephone conversation.

One of the other exceptions I read basically to carve out of the MTEF, systems in which you have a dealer who is interacting with his customers in the way that he ordinarily would, by making available an actionable bidder offer and allowing them, through technology, to see it and execute against it without having to use the telephone, but not creating a marketplace in which their orders interact with each other.

So it's bilateral in the sense it's more the conventional dealer environment gone electronic rather than a microcosm of an electronic exchange in which you have a broad range of market participants, all of whom are sort of generating a single bid.

COMMISSIONER ERICKSON: Thank you. I have no further questions. Thank you for your patience.

CHAIRMAN RAINER: Well, we've had a lot of good Q&A here. I would be interested in further comments, perhaps in a letter to us, on this topic of legal certainty, both the legal certainty with respect to the opt in or opt out method and also legal certainty provided for those entities in the over-the-counter markets that are looking for additional legal certainty than they have right now.

I'm particularly interested in really one simple standard. Is what we're coming up with better than we have today? If it's better, we should go with it, if it's worse, we should stay away from it. There doesn't seem to be complete unanimity of opinion on that one simple standard on the panel right now and so I think we want to make sure that as we move forward, we can move forward in great comfort that what we're coming out with is an improved environment in comparison with what we have today.

I don't think, and this is just my own opinion, we should make perfection the enemy of the good and so if we can do a better job at enhancing legal certainty, I think we have an obligation to do so, but I'm just one of five here.

So the real question is, is what we're coming up with an improvement or perversely, we've managed to figure out a

way to make things worse. I sense that for most of you, you're on the side that says there's no doubt in your minds. Mark, I'm not sure, but my sense is that there may be some questions in.your mind and that's fair, but we need to move ahead with great assurance that what we're doing provides comfort for the markets, additional comfort for the markets as opposed to unwittingly backsliding.

COMMISSIONER HOLUM: Mr. Chairman, I'd like to add to that. We've been talking about legal certainty, but I'm also concerned about regulatory gridlock. How far do we go to guarantee legal certainty without it creating regulatory gridlock that none of us want, so I would appreciate your comments in the letter that you just suggested sort of taking that into account also, how far do we have to go to get the necessary regulatory certainty. Thank you.

CHAIRMAN RAINER: Okay. Anybody else? Any other additional comments?

(No response.)

CHAIRMAN RAINER: This has been very helpful. Let me speak on behalf of everyone here as to how grateful we are that you took time out of your schedules to come help us out and we look forward to working with you during the

remainder of this comment period process. Thank you very much.

(Whereupon, at 3:57 p.m., the hearing was adjourned.)