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April 16, 2001 COMMENT

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations – Proposed Rules, 66 *Fed. Reg.* 14262 (March 9, 2001)

Dear Ms. Webb:

The Committee on Futures Regulation ("Committee") of the Association of the Bar of the City of New York ("Association") is pleased to submit the following comments on the Commodity Futures Trading Commission's ("Commission" or "CFTC") proposed rules ("Proposed Rules") implementing a new regulatory framework for certain trading facilities in accordance with amendments to the Commodity Exchange Act ("Act") adopted in the Commodity Futures Modernization Act of 2000 ("CFMA").[1]

The Association is an organization of over 21,000 lawyers. Most of its members practice in the New York City area. However, the Association also has members in 48 states and 51 countries. The Committee consists of attorneys knowledgeable concerning the regulation of futures contracts and other derivative instruments and has a history of publishing reports analyzing regulatory issues critical to the futures industry and related activities. The Committee appreciates the opportunity to comment on the Proposed Rules and stands ready to assist the Commission and its staff if further clarification is required on any of the points raised in this letter.

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1 These amendments were adopted in the CFMA, which was passed by Congress on December 15, 2000 and signed by the President on December 21, 2000. Among other purposes, the amendments to the Act were intended to codify certain of the Commission's earlier proposals to establish a new regulatory framework for multilateral transaction execution facilities, which the Commission published for comment in June 2000, 65 *Fed.Reg.* 39008 (June 22, 2000), and promulgated as final rules in December 2000. 65 *Fed.Reg.* 82272 (December 28, 2000).

In the following comments, we respond to various specific requests for comments, offer general suggestions regarding the drafting of certain provisions, and provide comments on the text of certain of the proposed rules.

I. Responses to Specific Requests for Comments.

Additional Regulatory Requirements for DTEFs. The Commission has requested comment concerning whether additional regulatory requirements, such as large trader reporting, should be imposed as conditions to trading on a "derivatives transaction execution facility" ("DTEF"). We believe that given the nature of the contracts traded on DTEFs, the special call provisions of Section 37.8 should be adequate to meet the Commission's regulatory needs, without additional routine requirements such as large trader reporting.

Eligible Commercial Entities. The Commission has proposed Rule 37.1(b) to include within the definition of "eligible commercial entity" registered floor brokers or floor traders, trading for their own accounts, whose trading obligations are guaranteed by a "futures commission merchant" ("FCM"), consistent both with the Commission's withdrawn rules and with the CFMA's inclusion of certain types of liquidity providers within the statutory definition of "eligible commercial entity." The Commission has requested comment on how and by whom market-making functions may be performed on electronic trading facilities, the similarities and differences in this market-making function and its regulation when performed on an electronic platform instead of a physical trading environment, and whether such persons should be included within the definition of eligible commercial entity. We encourage the Commission to treat persons performing similar functions in a similar fashion, without regard to the type of trading facility on which these functions are performed. To the extent an electronic market has functional counterparts to floor brokers and floor traders, these persons should also be included within the definition of eligible commercial entity. Any "eligible contract participant" ("ECP") who undertakes to maintain a bid and ask spread pursuant to an agreement with, or the rules of, an electronic trading facility should be considered an eligible commercial entity, provided that such ECP has adequate capital to meet its obligations as such. (See Section 5(d)(11)(A) of the Act.)

II. General Comments Concerning the Proposed Rules.

In light of the extensive number of new statutory and regulatory terms introduced by the CFMA and by the Proposed Rules, the Committee believes that the Commission would benefit market participants and practitioners by providing greater definitional clarity throughout the Proposed Rules. A number of terms that are used throughout the Proposed Rules are not defined in the CFMA or the proposals; clarity would be enhanced if they were defined and used consistently. These include terms such as "to execute" a transaction, to "effect" a transaction, to "intermediate" a transaction and a "participant," "market participant," "user," and "operator" of a contract market. For example, Section 15.05 addresses a "designated contract market" or DTEF permitting a foreign broker "to intermediate" or a foreign trader "to effect" "contracts, agreements or transactions." The definitions also could clarify whether trades that are entered by

or through an FCM's automated order routing system would be deemed "executed" or "effected".

It also would be helpful if the Commission could clarify the relationship between excluded commodities and commodities that have a "nearly inexhaustible" deliverable supply or no cash market, in particular, whether "excluded commodities" are a subset of commodities with a nearly inexhaustible deliverable supply or no cash market. The Commission would also assist practitioners and market participants by providing examples of exempt commodities and a definition of "agricultural commodities."

III. Comments on Specific Proposed Rules.

Findings Concerning Price Discovery and Other Matters. Proposed Rules 36.2(c)(2), 36.3(c)(2), and 37.3(a)(3)(ii) provide that the Commission may render findings as to whether a facility serves as a significant source for price discovery or whether trading in a contract or option is highly unlikely to be susceptible to the threat of manipulation through the submission of "written" data, views and arguments. Oral hearings in appropriate cases should be provided for.

Part 37 – Derivatives Transaction Execution Facilities. Proposed Rule 37.1(b) defines the term "eligible commercial entity" to include a registered floor trader or floor broker whose trading obligations are "guaranteed" by a registered FCM. It should be sufficient if the floor trader or floor broker is simply "qualified," i.e., that an FCM has agreed to accept all of the broker or trader's trades, instead of being fully guaranteed.

Proposed Rule 37.3(a)(iv) is unclear. If the Commission intends to provide that the commodities defined in 1a(13) of the Act are eligible for trading on DTEFs without any further requirements, this should be stated explicitly and in a separate section.

Further, the Commission should make clear that a non-ECP may access a DTEF that is limited to Eligible Traders under proposed Rule 37.3(a). Under the withdrawn rules, non-ECPs were permitted to access a trading facility through certain intermediaries, and the CFMA appears to allow such access through any FCM or broker-dealer acting on behalf of its customers. (See CFMA Section 5a(b)(3)). Similarly, the Commission should make clear that Section 37.3(b) is intended to permit a non-eligible commercial entity to access a commercial entity DTEF through any FCM or broker-dealer.

Proposed Rule 37.4 allows a DTEF to trade agreements, transactions, or contracts that are excluded or exempt from the Act pursuant to Sections 2(c), 2(d), 2 (g) or 2(h) thereof. Is the DTEF required to establish a separate legal entity or maintain physical separation for such excluded or exempt markets? If so, the Commission should provide guidance as to what has to be done to ensure that the non-regulated market can remain outside of the CFTC's jurisdiction.

Proposed Rule 37.5 could be clarified in several respects. The caption should read "Registration by Notification." The introductory paragraphs of Proposed Rules 37.5(a) and 37.5(b) would be clearer if they read "A _____ which proposes to act as a designated transaction execution facility must . . . ." Proposed Rule 37.5(a)(ii) requires the entity to file a copy of its rules. Proposed Rule 37.5(d) could be clarified by having the first sentence read: "If, during the thirty day period . . ., it appears to the Commission that . . ., the Commission shall notify the applicant . . . ." The provision should specify when the withdrawal becomes effective.

Proposed Rule 37.6(d) states that a DTEF "may" meet the following core principles in the manner specified. The Committee recommends that the Commission make clear that the means specified represent safe harbors but are not mandatory. In Proposed Rule 37.6(d)(ii), further specificity concerning the type of information the Commission believes is called for would be helpful.

Proposed Rule 37.6(b)(2)(iii) should specify the period referred to by explicit cross-reference to paragraph (b)(2)(i) of this section.

Appendix A to Part 37 in Registration Criterion 3 provides that the rules of a board of trade qualifying as a DTEF may authorize FCMs "acting as principals, to enter into or confirm the execution of" a futures contract if the contract is reported, recorded or cleared in accordance with the applicable rules. The scope and purpose of this provision are unclear. It appears that an FCM could be permitted to act as principal opposite customers on DTEF contracts. It would be helpful for the Commission to clarify the intended scope of this provision.

Appendix B to Part 37 states that the Appendix provides guidance only and is not intended to be a mandatory checklist. It omits the sentence that appears in the corresponding provision applicable to contract markets in Appendix B to Part 38, which states that: "Boards of trade that follow the specific practices outlined under subsection (b) for any core principle below will meet the applicable core principle." In other words, compliance with the "guidance" provides a safe harbor. The Committee recommends that a similar sentence be included in Appendix B to Part 37.

Core Principle 6 states that a DTEF must have appropriate fitness standards for certain persons but then goes on to set forth "minimum standards," which include the bases for refusal to register under Section 8a(2) of the Act or a history of serious disciplinary offenses such as those specified in Rule 1.63. This provision states that natural persons who "directly or indirectly" have greater than a 10% interest in a facility should be required to meet the same fitness standards as are applicable to members with voting rights. It is not clear why a natural person who is merely a passive investor and who does not exercise voting rights or have any official privileges, obligations or responsibilities should be subject to these fitness standards.

The Committee also recommends that the Commission make clear that the CFMA does not require a DTEF to clear through a derivatives clearing organization if it chooses to clear its

contracts. A DTEF should be permitted to clear through any recognized clearing organization, including, e.g., clearing organizations supervised by domestic and foreign banking authorities.

Proposed Rule 38.1 provides that a designated contract market may operate an exempt board of trade but Proposed Rule 37.1(a) does not include the same proviso. Section 5d(f) of the Act allows a DTEF to operate an exempt board of trade by establishing a separate subsidiary. Proposed Rule 37.1(a) should be revised to include a proviso recognizing that a DTEF may operate an exempt board of trade. Clarification also would be helpful concerning whether a designated contract market that wishes to operate a DTEF must establish a separate legal entity for a DTEF as a part of the physical separation requirement.

We also note that Proposed Rule 37.4 brings exempt commercial markets within its reference to Section 2(h), as exempt commercial markets are described in Section 2(h)(3) of the Act. The Commission may wish to clarify how an exempt board of trade that is operating as an electronic trading facility may operate an exempt commercial market, including whether they must be physically or legally separated.

Part 38 – Designated Contract Markets. Proposed Rule 38.3(b)(4) requires minimum fitness standards for "participants," a term not defined, having "direct access" to the facility (even though they do not necessarily have voting or any other type of governance rights) and for persons that directly or indirectly have a greater than 10% "ownership interest," even if they do not have access to the market. These requirements appear to reach beyond the governance fitness requirements of Section 5(d)(14) of the Act. Furthermore, the term "direct access" should be clarified. For example, does it include a customer of an FCM who places an order through that FCM's automated order routing system?

Proposed Rule 38.4(c) allows a contract market to apply to the Commission for review of its rules solely under Section 15(b) of the Act, with respect to antitrust considerations, without having to seek plenary approval. The Committee strongly supports this proposal.

Appendix A to Part 38 in Paragraph (a) of Designation Criterion 5 states that a designated contract market should set appropriate minimum financial standards for "users and/or members." The Commission should make clear that a contract market is not required to establish minimum financial standards for customers of intermediaries.

Appendix A to Part 38 in Designation Criterion 6 states that a contract market must have authority to discipline "market participants." It should be made clear that this does not apply to customers of members.

Appendix B to Part 38 in paragraph (a), Core Principle 6, states that, a contract market should have procedures and guidelines to carry out emergency decision-making "without" conflicts of interest. That concept is then carried forward in the statement that the contract market should have procedures and guidelines for notifying the Commission about "preventing" conflicts of interest. However, nothing in the Act requires a contract market to act without conflicts of

interest or to prevent conflicts of interest. Core Principle 15, as stated in Section 5(d)(15) of the Act, states only that the contract market must have rules to "minimize" conflicts of interest. Accordingly, the first sentence of paragraph (a) should be changed to read as follows:

> A designated contract market should have clear procedures and guidelines for contract market decision-making regarding emergency intervention in the market, including procedures and guidelines to minimize the effects of conflicts of interests in carrying out such decision-making.

Similarly, in the second sentence thereafter, the word "preventing" should be changed to "minimizing."

Paragraph (a) under Core Principle 7 states that a contract market should have arrangements and resources for the disclosure of contract terms and conditions and trading mechanisms to the Commission, users and the public. We recommend that a sentence be added at the end of that paragraph containing substantially the same concept as the last sentence of paragraph (a) under Core Principle 8, that is, that such disclosure may be accomplished through means such as timely placement on a contract market's website.

Core Principle 13, Paragraph (b)(1), requires a designated contract market to provide for dispute resolution mechanisms. Paragraph (b)(5) provides that a contract market may delegate this responsibility to certain other organizations. The Committee recommends that the Commission clarify that this standard may be satisfied by the adoption of contract market rules requiring members to arbitrate claims brought by customers before an organization such as the National Futures Association.

Core Principle 14 sets forth statutory language requiring the contract market to have fitness standards for certain individuals, including "any parties affiliated with" any of those persons. The Commission should clarify or provide guidance to establish a safe harbor concerning what would constitute an affiliation. The Committee suggests that parties affiliated with any person should be limited to persons controlling or controlled by that person and should not include persons who are merely under common control with such person or who are linked by some chain of equity ownership not involving control.

Part 40 – Provisions Common to Contract Markets, Derivatives Transaction Execution Facilities and Derivatives Clearing Organizations. Proposed Rule 40.2 would require a registered derivatives clearing organization to file with the Commission a copy of the rules of any product that it proposed to accept for clearing. This filing should not be necessary where those rules are already on file, such as where they had been previously submitted by the relevant contract market or DTEF.

Proposed Rule 40.6(a) states that a contract market or registered derivatives clearing organization may implement any new rule only if certain conditions have been met. One of

those conditions should be that the rule or rule amendment has been approved or deemed approved by the Commission.

Dispute Settlement Procedures. The first sentence of proposed Rule 166.5(a)(2) appears to be incomplete. Presumably, the phrase "is acting," should be inserted after the words "transacting on or through such designated contract market."

Proposed Rule 166.5(c)(5) provides that a registrant must provide a customer with a list of organizations whose procedures meet the Acceptable Practices established by the Commission for dispute resolution. In order for a registrant to comply with that requirement it would be necessary for the Commission to publish such a list and update it periodically.

Proposed Rule 166.5(g) provides that any ECP may agree to resolve any claim or grievance by any settlement procedure. The provision should be extended to include any member of the relevant board of trade, whether or not such member qualifies as an ECP.

We are concerned about the potential impact of Rule 166.5 upon FCMs dually registered as broker-dealers. Rule 166.5(g)(1) provides that an ECP may negotiate any term of an agreement with a Commission registrant relating to dispute settlement procedures "except that signing the agreement must not be made a condition for the eligible contract participant to use the services offered by the registrant." We are concerned about the following scenario. An ECP proposes to open a securities and futures account with a broker-dealer/FCM. The firm proposes that all disputes shall be subject to arbitration before the National Association of Securities Dealers, Inc. The prospective customer declines and insists that all matters be submitted to court. Is proposed Rule 166.5(g) intended to mean in this context that the broker-dealer/FCM may refuse to accept any securities business from the ECP but must accept the futures side? If the firm agrees to the ECP's request but states that commission rates will be three times the usual rate, would the Commission take the position that that is a de facto refusal to do business? The Committee recommends that, at the least, a Commission registrant be permitted to refuse to do futures business with a customer (a) who has agreed to arbitrate securities disputes with the registrant or (b) with whom the registrant, in its capacity as an SEC registrant, may decline to do business. Considerations of fairness and efficiency dictate that a Commission registrant should have the right to insist that all disputes be subject to resolution in the same forum.

IV. Intermediaries.

The Committee strongly supports the Commission's recognition that many of the withdrawn rules and rule amendments concerning intermediaries are substantially unaffected by the CFMA. In light of the Commission's statement that it intends to repropose and readopt its rules and rule amendments relating to intermediaries that are not implicated by the CFMA revisions, the Committee endorses the Futures Industry Association's recommendation that the Commission provide transitional no-action relief for the benefit of intermediaries that elect to conduct their activities in accordance with certain amendments to Part 1 and Part 3 of the Commission's regulations promulgated on December 13, 2000. These amendments: (1) expand the list of

disclosures and consents that could be provided in a single document acknowledged with a single signature under rule 1.55(d); (2) amend the definition of the term "principal" found in rule 3.1; and (3) delete the specific ethics training requirements currently contained in rule 3.34 and adopt in their place a Statement of Acceptable Practices with Respect to Ethics Training.

Conclusion

The Committee appreciates the opportunity to comment on the Proposed Rules and stands ready to assist the Commission and its staff if further clarification is required on any of the points raised in this letter.

Sincerely yours,

Susan C. Ervin

Association of the Bar of the City of New York

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