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Securities Industry Association

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COMMENT

April 17, 2001

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RECORDS SECTION

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

Re: *Regulatory Reinvention: A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations*, and *Opting Out of Segregation, Commission Rule 1.68*

Dear Ms. Webb:

The OTC Derivative Products Committee (the "Committee") of the Securities Industry Association (the "SIA")[1] is submitting this comment letter in response to the Commodity Futures Trading Commission's (the "CFTC") releases published March 9, 2001, and March 13, 2001,[2] regarding proposed Parts 36-38 of the CFTC's regulations (and related amendments) and proposed Rule 1.68 of the CFTC's regulations (the "Proposed Rules").

The Committee is pleased to have this opportunity to comment on the Proposed Rules and wishes to commend the CFTC for promptly acting to implement the provisions of the Commodity Futures Modernization Act of 2000 (the "CFMA") relating to derivatives transaction execution facilities ("DTEFs"), exempt boards of trade and exempt commercial markets. In addition, the CFTC is to be commended for its faithful implementation of the administrative framework contemplated by the CFMA with respect to these markets.

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1 The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member firms (including investment banks, brokers-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: http://www.sia.com.)

2 *A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations*, 66 Fed. Reg. 14262 (March 9, 2001); *Opting Out of Segregation*, 66 Fed. Reg. 14507 (March 13, 2001).

The Committee supports the Proposed Rules generally, and has taken this opportunity to comment on a few specific issues raised by the Proposed Rules.

1. Requirements for Transactions on DTEFs.

The Committee strongly supports the CFTC's decision to treat all excluded commodities (as defined in section 1a(13) of the Commodity Exchange Act (the "CEA")), including government securities and other exempt securities, as eligible underlying commodities for futures trading on a DTEF pursuant to section 5a(b)(2) of the CEA. As Congress and the CFTC have recognized, futures contracts on such securities are traded in highly developed, liquid markets. The regulatory framework contemplated for DTEFs, together with the nature of these markets, provides an appropriate level of regulatory oversight for trading in such contracts. The Committee notes that the CFTC has requested comment as to whether large trader reporting or similar requirements should be imposed as a condition to trading in contracts involving exempt securities. The Committee believes that any large trader reporting requirement should be consistent with market practice in the relevant cash market, if any, and should only be required upon the request of the CFTC.

With respect to commodities on which futures contracts could not be traded on a DTEF without a determination by the CFTC pursuant to section 5a(b)(2)(E) of the CEA and proposed Rule 37.3(a)(3), the Committee believes that it should not be necessary in all cases for the DTEF to submit a demonstration with supporting data that addresses each of the factors set forth in proposed Rule 37.3(a)(3)(ii)(B). With respect to some commodities, some or all of these factors may not be relevant, and compilation of all of the required information may be costly, time-consuming and ultimately unnecessary to the CFTC's determination. As a result, the Committee believes that such a demonstration and supporting data should be provided at the option of the applicant or upon request of the CFTC, if the CFTC or its staff determines that such a demonstration is warranted following its initial review of an application.

The Application Guidance to Part 37 would require that transactions executed on a DTEF, if cleared, be cleared through a registered derivatives clearing organization (a "DCO"). The Committee notes, however, that section 5a(g) of the CEA and proposed Rule 37.4 would permit the trading on a DTEF, on an opt-in basis, of contracts, agreements or transactions otherwise excluded or exempt from regulation under the CEA. Such transactions are not explicitly required to be cleared through a DCO under the CFMA, unless they are futures contracts or commodity options that meet the conditions set forth in section 5b(a) of the CEA. The Committee believes that the discussion in the Application Guidance should be modified accordingly to conform to the provisions of section 5b(a) of the CEA.

The Committee supports proposed Rule 37.9, which would limit the risk that a transaction on a DTEF would be unenforceable or subject to rescission because of a violation of the CEA or CFTC regulations by the DTEF itself or because of certain CFTC proceedings against the DTEF. The Committee would suggest that the introductory wording be revised as follows to conform more closely to that in section 22(a)(4) of the CEA:

> "No agreement, contract or transaction entered into on, or pursuant to the rules of, a registered derivatives transaction execution facility shall be void,

voidable or unenforceable, and no party thereto shall be entitled to rescind, or recover any payment made with respect to, such an agreement, contract or transaction, based solely on: ...".

The Committee notes that the CFTC has requested comment on whether persons that act in a capacity similar to floor brokers and floor traders on electronic markets should be included in the expanded definition of eligible commercial entity in proposed Rule 37.1(b). The Committee believes that eligible contract participants that act in the capacity of a market maker on an electronic DTEF should be treated as eligible commercial entities, but notes that most corporate entities in that category would already fall within the statutory definition of eligible commercial entity.

2. Exempt Boards of Trade and Eligible Commercial Markets.

The Committee supports the CFTC's attempt to clarify the standard for eligible commodities for futures trading on an exempt board of trade under section 5d(b)(1) of the CEA. The Committee agrees that excluded commodities (as defined in section 1a(13) of the CEA), other than securities and groups or indices of securities, should qualify. The Committee does not, however, believe that qualifying commodities should be limited to such excluded commodities (in addition to those commodities that the CFTC approves by rule, regulation or order), as proposed Rule 36.2(a)(2) implies. The CFTC does not need to foreclose the determination that other commodities could satisfy the statutory standard for eligibility or to require in all cases that such a determination be made by the CFTC, where such a determination is not required by statute. As a result, the Committee recommends that this section be revised to conform to the approach taken for DTEFs in proposed Rule 37.3(a)(1)(iv), which provides that excluded commodities would satisfy the statutory requirements without effectively providing that other commodities could not satisfy those requirements absent CFTC approval.

The CFTC has requested comment as to whether exempt boards of trade and exempt commercial markets should be affirmatively required to disclose to traders that the facility is not regulated or approved by the CFTC. In light of the institutional character of these markets, the Committee believes that such disclosure is not necessary. The requirement included in the Proposed Rules, that the facility not represent that it is regulated or approved by the CFTC, provides sufficient protection against misunderstanding.

3. Antifraud Authority.

The Committee does not object to new Rule 1.1 as proposed by the CFTC, which would prohibit fraud in connection with retail foreign currency transactions, including those entered into on a principal-to-principal basis, other than those offered or entered into by a person in one of the categories of directly or indirectly regulated entities set forth in section 2(c)(2)(B)(ii) of the CEA

The Committee notes that Commissioner Erickson, in his concurrence to the issuance of the Proposed Rules, requested comment as to the need for a more comprehensive antifraud rule applicable to principal-to-principal transactions, in light of recent court decisions calling into question the scope of the CEA's existing antifraud provisions in the context of such

transactions. Although the Committee's views would of course depend on the particular terms of any proposed rule, the Committee does not object in concept to an attempt by the CFTC to clarify its antifraud authority with respect to principal-to-principal transactions, so long as any such proposed rules are consistent with the CFTC's rulemaking authority under the CEA, as amended by the CFMA,[3] and the conduct prescribed is, but for the extension to principal-to-principal transactions, consistent with that prohibited under the CEA's antifraud provisions as they have traditionally been interpreted. In particular, the Committee does not believe it would be appropriate to incorporate in the commodities law antifraud regime disclosure obligations or other prohibitions that may exist under the securities laws but are fundamentally inconsistent with the function of the futures markets and the policy objectives reflected in the CEA applicable to such markets.

4. Dispute Resolution.

The Committee supports the CFTC's decision, as evidenced by proposed Rule 166.5, to reevaluate its existing restrictions on pre-dispute arbitration agreements in light of the CFMA and evolving market practices for other financial products. The proposed elimination of many of the existing restrictions in the case of eligible contract participant customers is an important first step. The Committee has seen no evidence of a trend by market participants to attempt to impose on customers arbitration forums that are biased or otherwise unfavorable to customers, and eligible contract participants are in a position to protect their interests in this regard. For these reasons, however, the Committee does not believe that it is necessary to maintain the requirement in the case of eligible contract participant customers that futures commission merchants ("FCMs") not make signing a pre-dispute arbitration agreement a condition to opening an account or otherwise using the services of the FCM. Although the CFMA may not directly address the issue, new section 14(g) of the CEA does permit FCMs to require eligible contract participant customers to waive their rights to a reparations proceeding under section 14 of the CEA as a condition to opening an account. The policy behind this provision would seem equally applicable in the case of pre-dispute arbitration agreements generally.

In addition, it would also be appropriate to review the dispute resolution restrictions generally with a view to making them more consistent with the rules and practices governing pre-dispute arbitration agreements in the securities industry. Harmonizing the requirements for pre-dispute arbitration agreements will be particularly important for the trading of security futures products by dually registered broker-dealer-FCMs, who may otherwise be potentially subject to inconsistent requirements in connection with their account agreements.

5. Opt-Out from Segregation.

The Committee also generally supports the provisions of proposed Rule 1.68 pursuant to section 5a(f) of the CEA. Section 5a(f) authorizes DTEFs to permit eligible contract participants trading on DTEFs through FCMs to opt out of the segregation requirements of

[3] For example, we note that the CFTC's antifraud authority is limited, in the case of transactions subject to section 2(h)(4) of the CEA, to the statutory antifraud provisions, such as section 4b of the CEA, whereas in the case of transactions subject to section 2(h)(2) of the CEA, the CFTC's antifraud authority includes rulemaking authority under section 8a of the CEA.

section 4d of the CEA and CFTC Rules 1.20 through 1.30 in connection with such transactions. This option will provide flexibility to FCMs and their institutional customers, for whom the traditional protections of the segregation requirement may not be desirable or appropriate, and will facilitate the development of DTEFs that differ from the traditional contract market model.

Nonetheless, the Committee believes that some provisions of the proposed rule may sweep too broadly. In particular, the Committee does not believe the CFTC should prohibit customers that opt out of segregation from using third-party custody accounts or obtaining security interests in their property carried with an FCM. For similar reasons, while it would be appropriate to provide that an opt-out customer is not entitled to the same priority as customers covered by the segregation requirements, it does not necessarily follow that opt-out customers should be treated as general unsecured creditors of the FCM. As a general matter, the Committee believes that the nature of the relationship between an opt-out customer and an FCM, including the priority with respect to other creditors of the FCM and the use of custody accounts or security arrangements, should be determined by those parties and constrained only to the extent that such a relationship would directly interfere with the segregation regime and statutory priority for futures customers.

In addition, it is not clear that the proposed rule comprehensively addresses the issues presented by permitting customers to opt out of segregation. For example, it is quite possible that property specifically identifiable to an opt-out customer would be provided by the carrying FCM to a clearing organization to margin transactions of that customer. The CFTC needs to provide for the appropriate treatment of that property, including as to the purposes for which or the circumstances under which it would be treated as customer property in the event of the insolvency of the carrying FCM or the clearing organization.

Finally, while the Committee acknowledges that the proposed rule is intended to implement the statutory mandate permitting opt out from segregation in connection with transactions on DTEFs, it is not clear whether as a practical matter the unavailability of this option in connection with transactions by eligible contract participant customers on contract markets will undermine its utility.

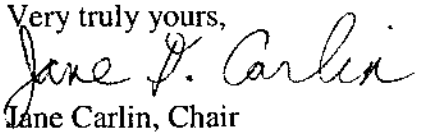
6. Further Rulemaking Initiatives.

The Committee supports the CFTC's stated intention in the Proposed Rules to revisit certain of the rule amendments related to intermediaries for commodity interest transactions that it adopted in December 2000 as part of its "New Regulatory Framework" and then withdrew following the enactment of the CFMA. As the CFTC notes, certain of these amendments continue to be appropriate following the enactment of the CFMA in light of the continuing evolution of the derivatives markets. The Committee stands ready to work with the CFTC staff and other interested parties in reevaluating these amendments in light of the CFMA.

* * *

The Committee appreciates the opportunity to comment on the Proposed Rules and, as always, would be pleased to work with the CFTC staff and other interested parties to address the issues discussed herein. Please do not hesitate to contact the undersigned (212-762-7122) or the Committee adviser, Jerry Quinn (212-618-0507), or our counsel, Edward J. Rosen (tel. 212-225-2820) or Geoffrey B. Goldman (tel. 212-225-2234) of Cleary, Gottlieb, Steen & Hamilton, if you have any questions regarding this letter.

Very truly yours,



Jane Carlin, Chair
OTC Derivative Products Committee

cc: The Honorable James E. Newsome
The Honorable David D. Spears
The Honorable Barbara Pedersen Holum
The Honorable Thomas J. Erickson