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June 8, 2004

The Honorable James Newsome  
Chairman  
Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, NW.  
Washington, DC 20581

COMMENT

Dear Jim,

The FIA Board of Directors recently tasked the public directors to look at the SRO process and come back with proposed recommendations. The recommendations I am forwarding to you today are the result of that process and have the support of the FIA board.

We hope these recommendations will serve as a starting point for industry discussion and comment and we look forward to working with you and the other commissioners as we continue our work to improve self-regulation in the US.

Sincerely,

John M. Damgard  
President

Cc: The Honorable Sharon Brown-Hruska  
The Honorable Walt Lukken  
Ms. Jean Webb

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RECORDS SECTION

**CFTC Study of Self-Regulation  
Position Paper of the FIA  
June 8, 2004**

**Summary**

FIA supports the important role that exchanges and clearing houses perform as self-regulatory organizations (SRO) and designated self-regulatory organizations (DSRO). Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure.

FIA believes there is merit in the existing structure worth preserving and that more extreme alternatives are not desirable and are less efficient. Nevertheless, the existing structure can be improved through greater transparency and oversight that will minimize any potential conflict of interests. To be fully effective, there must be an increased degree of confidence in the integrity and objectivity of the SRO. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the CFTC in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure.

The CFTC has been progressing with its review of the effectiveness of self-regulation in the futures industry. To facilitate this review, FIA has prepared this Position Paper to highlight key areas of concern in the hope that the CFTC will recognize the merits of these positions and take them into account in its assessment and recommendations for change in SRO responsibilities. In this regard, there are four broad issues that FIA recommends the CFTC address in its SRO Study. For each of these issues, FIA provides recommendations for specific changes to current SRO structures.

**I. Potential Conflict of Interests - There should be a division between the business and SRO/DSRO functions of exchanges and clearing houses.**

The exchanges provide a public good and public service through price discovery and a well-defined marketplace yet there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses. This problem potentially is exacerbated by demutualization and the move to for-profit structures. FIA recognizes that shareholders of for-profit structures are motivated in the long-run to ensure market integrity and their failure to do so should ultimately reduce revenues and profit; however, there may be times when specific events will override the longer-term objectives of the exchange.

Recent legislative and regulatory actions against public companies, including the enactment of the Sarbanes-Oxley Act, suggests that without specific safeguards for-profit companies may not always act in the public interest. The possibility that exchanges or clearing houses can abuse their SRO responsibilities to the detriment of market participants and the public good cannot be

dismissed. FIA believes that a more formal separation between the business and SRO functions of exchanges and clearing houses is essential to overall marketplace integrity. In that regard, we have the following recommendations.

- A Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.

FIA recommends that each exchange/clearing house have such a Board Committee of independent, non-industry directors and that the Committee have the responsibility to oversee the SRO/DSRO budget, hire and fire compliance staff, ensure adequate staff and resources, review cases, audit SRO/DSRO performance and otherwise oversee all aspects of the SRO/DSRO function. In addition, it is absolutely critical that there be a definition of “Independent” that avoids any appearance of bias, conflict or any lack of independence. FIA is not convinced that current exchange and others’ definitions of “independent” are adequate in these regards. In addition to being independent, these directors should not be currently active in the industry.

- The Board Committee should be responsible to the CFTC for its oversight of the SRO/DSRO functions.

Like independent audit committees of public company boards under Sarbanes-Oxley, this Board Committee should have real accountability. Its activities, its responsibility for the budget and the audit all should be reviewed by the CFTC at least annually.

- There should be a more formal separation between the business and compliance/surveillance staffs of exchanges and clearing houses.

Compliance and surveillance staff should report to the Board Committee. They should not be involved in the business activities of the exchange or clearing houses and should not be in a supervisory chain that includes managers on the business side of the exchange or clearinghouse. To the extent the SRO function is contracted out, it still should not report to business managers. Any other result creates conflicts of interest and undermines the recommended separation and the role of the independent Board Committee.

## **II. Appearance of Bias – A majority of the members judging proceedings should be disinterested parties.**

FIA recognizes that its concerns about SRO fairness will be reduced with the adoption of its recommendation of Board Committees of independent, non-industry directors overseeing SRO/DSRO functions. However, additional measures must be taken to address related issues of fairness and confidentiality and to ensure SRO decision-makers will be independent of business pressures. In particular FIA is concerned that disciplinary panels dominated by peers judging peers has an inherent appearance of bias. Equally, disciplinary panels consisting of only one category of market participant can be seen as unfair especially from the viewpoint of other categories of market participants subject to the panels’ disciplinary review. Market participants are entitled to a fair hearing. In this regard, FIA has the following recommendations.

- A majority of the members of disciplinary panels should be made up of knowledgeable independent panelists.

While FIA respects the experience and judgment of interested panel members, an appearance of fairness and the avoidance of bias are enhanced when a majority of disciplinary panel members are independent. Consideration should be given to permitting parties subject to discipline to request panels made up entirely of independent members.

- Interested parties should not review the records of disciplinary proceedings and settlements.

Currently, exchange committees and in some cases the entire Board of Directors reviews disciplinary records and settlements. These records reveal confidential information that should not be shared with competitors or other interested parties. The use of independent committees and the Board Committee of independent directors should address this problem.

### **III. Enhanced Transparency – The CFTC should establish clear standards for DSROs and the allocation of firms among them.**

The efficiencies of the DSRO approach are widely recognized. At the same time, providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function. The CFTC should establish clear standards for qualification as a DSRO including a process to approve new providers wishing to perform financial compliance audits. Each of these providers should be subject to periodic CFTC review of their DSRO functions. This oversight should include detailed review of DSRO audits. A mechanism should be established to make the choice of DSRO cost neutral to exchange members. Subject to CFTC adopted standards, a member firm should be able to change its DSRO within the narrow band of CFTC pre-approved providers.

### **IV. Sound Practices – The FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions.**

Given the number of exchanges that have SRO and DSRO responsibilities, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges. These sound practices should follow the model of core principles in the Commodity Futures Modernization Act. In particular, directors who serve on the independent Board Committee with oversight responsibilities over SRO and DSRO activities should be trained to apply these industry-wide sound practices.

### **Conclusion**

FIA believes that this is an ideal opportunity to improve a process that has largely been successful but may have certain conflicts and biases. FIA's hope in raising these issues and making these recommendations is to promote a dialogue that will lead to a fairer and more efficient SRO structure for the futures industry.