NFA NATIONAL FUTURES ASSOCIATION

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June 16, 2004

Via E-Mail (Secretary@cftc.gov)

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

COMMENT

Re: Futures Market Self-Regulation, 69 *Fed. Reg.* 19166 (April 12, 2004)

Dear Ms. Webb:

Self-regulation plays a vital role in the futures industry. Experience has shown that self-regulation – subject to appropriate governmental oversight – maximizes regulatory effectiveness while minimizing regulatory burdens and saving taxpayers money. Having multiple self-regulatory organizations (SROs) can increase regulatory effectiveness where they regulate different entities or different activities, but it can result in unnecessary duplication when membership and responsibilities overlap, creating inefficiencies for both the SROs and the people they regulate. Since 1978, the Commission has sought to alleviate this problem by encouraging the SROs to allocate FCM auditing and financial surveillance responsibilities among themselves by assigning each FCM to a designated self-regulatory organization (DSRO). NFA supports this approach because it eliminates unnecessary duplication.

NFA has been a party to the Joint Audit Agreement (JAA) and an active participant in the Joint Audit Committee (JAC) – which is responsible for implementing the JAA – since the JAA was adopted in 1984.[1] We participated in the process to revise the JAA, and we voted to support most of its provisions. We particularly support those provisions that merge the separate sales practice agreement into the JAA. NFA

[1] Prior to that time, NFA participated in two joint audit plans that were superseded by the 1984 agreement.

dissented, however, on two significant provisions: voting rights and assignment procedures.

The current JAA worked well when it was adopted. Since 1984, however, innovation and rapid change have altered the landscape of the futures industry. Futures exchanges are now competing for business in the same products, which creates potential conflicts-of-interest in the auditing process. Many exchanges are no longer DSROs, and not all DSROs conduct their own audits. And NFA, which was still a fledgling organization in 1984, now has a proven track record of operating efficient and effective regulatory programs in a number of areas, including operational audits and financial surveillance of exchange-member FCMs.

The Commission's release asks commenters to address eight issues raised by the revised JAA. We will start with the two provisions we voted against when JAC considered the recent amendments. We will then discuss the remaining issues in order.

Issue 2: Voting Rights

All JAC members should be allowed to vote. The public interest – and, in fact, everyone's interest – dictates that SROs should conserve resources and avoid legal confusion by harmonizing rules in areas subject to joint regulation, coordinating audits, and sharing information. JAC is the vehicle for achieving these public benefits. Every SRO has the right – whether or not it chooses to exercise all of those rights – to adopt rules, perform audits, and share information. Therefore, every JAC member should be able to vote.[2]

The existing JAA states that each member gets one vote. In recent years, however, JAC has conditioned membership by new exchanges on waiving those voting rights.[3]

The revised JAA provides that only two groups of members can vote: those that are DSROs and conduct their own auditing activities, and those that became members before 2000 regardless of whether they are DSROs or conduct their own auditing activities. We voted against this provision and continue to object to it.

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[2] Since FCMs can own and carry positions on multiple exchanges, no SRO has a complete picture of the financial risk to the exchanges and their clearing organizations. Therefore, all SROs must share information to help guard against systemic risk. This makes it particularly important for all SROs to participate in JAC and have voting rights.

[3] While NFA preferred that these exchanges be voting members, we felt it was important for them to participate in JAC even if they did not receive voting rights.

The exchanges argue that the voting provisions simply maintain the *status quo*, and they are correct. They are not right, however. Just because something was done in the past does not mean it was right at the time and is certainly not a justification for continuing to do it. The grandfathering provision for pre-2000 members protects established exchanges while discriminating against new entrants. It is simply unfair to hinge voting rights on the age of the exchange.

On the other hand, we can understand why some DSROs would be concerned about giving non-DSROs an equal voice on auditing matters. We would be happy to discuss alternatives that address this concern without disenfranchising non-DSROs on other JAC issues. For example, at the February 2001 JAC meeting, NFA proposed amending the JAA to provide that only DSROs with 5 or more firms had the right to vote on issues affecting the JAC audit programs but that all members could vote on issues that affect the overall agreement. JAC never voted on this proposal.

We prefer that all JAC members have voting rights. If that approach is not adopted, however, then at least all DSROs should have voting rights. A DSRO is and should be responsible for the effectiveness of its audit and financial surveillance programs regardless of whether it conducts its own audits or outsources them to a third party. Therefore, all DSROs should have voting rights.

Issue 3: DSRO Assignments

NFA also dissented from and continues to object to the provision that governs how FCMs are assigned to a particular DSRO. The existing JAA does not specify how DSRO assignments will be made, while the revised agreement would codify the assignment procedures that JAC follows in practice. This proposed amendment to the JAA is out-of-step with the rapid changes in the futures industry.

We believe it is a bad idea to codify assignment procedures in the JAA. The need for flexibility is demonstrated by the very fact that the JAA has not been amended in twenty years even though the industry has undergone rapid change. Furthermore, the JAA provides that it cannot be amended without the signature of each party. Therefore, although amendments don't necessarily require a unanimous vote, any party can stymie them by simply refusing to sign the revised agreement. Codifying the assignment procedures in the JAA will eliminate any flexibility to adapt those procedures as the industry changes.[4]

Leaving the assignment process out of the JAA will also give JAC and the Commission time to consider the viability of various alternate assignment processes. For example, one possibility is for all the SROs of which the FCM is a member to meet at least once a year and decide how to divide up those FCMs, with any disagreements

[4] We do believe that the assignment procedures should be reduced to writing and formally adopted by JAC, however.

being resolved by majority vote of those SROs. Another possibility is to adopt assignment procedures similar to those used by the securities options SROs under the Plan for Allocation of Regulatory Responsibilities.[5]

If the assignment procedures are codified in the JAA, however, using some variant of the current procedure, then NFA believes at the very least that all participants should have the same right of first refusal. The proposed revision gives exchanges that conduct their own auditing activities greater control over the assignment process than other DSROs have. Theoretically at least, a DSRO that already knows an FCM's operations and regulatory history should be able to conduct examinations and financial surveillance of that FCM more efficiently than a new DSRO that has to become familiar with the FCM.[6] Therefore, under an assignment process that includes rights of first refusal, all DSROs should have the same rights.[7]

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[5] The Plan for Allocation of Regulatory Responsibilities for securities options requires firms to be allocated equally among the SROs of which they are common members based on both numbers and size. Sections VI.(b) and (c) of the Plan contemplate that if three SROs share 16 members, two SROs would receive 5 members and one would receive 6 members, with each SRO receiving one of the three firms with the most activity and so on down the line. *See* 69 *Fed. Reg.* 7046, 7048 (Feb. 12, 2004).

[6] On the other hand, there are also advantages to bringing a fresh eye to those operations. For securities options, Section VI.(d) of the Plan for Allocation of Regulatory Responsibilities provides for rotating options broker-dealers among the SROs and states that a firm should not be allocated to a particular SRO if the SRO was its designated options examining authority within the last two years. *See* 69 *Fed. Reg.* 7046, 7048 (Feb. 12, 2004).

[7] We understand the exchanges' concern that audits of exchange members should focus on the risk to the exchange's clearing organization. We agree that guarding against systemic risk is a very important part of a DSRO's auditing and financial surveillance responsibilities, although protecting customers from financial, operational, and sales practice risks is an equally important goal. To the extent that the exchanges' concern is based on their vested interest in protecting their clearing organizations, however, the current system does not address that concern any differently. Exchanges regularly rely on other exchange DSROs to review the risk an FCM poses to the first exchange's clearing organization, and one of the larger exchange DSROs recently cut its ties with its affiliated clearing organization and outsourced the entire clearing process to another exchange. Furthermore, the exchanges are not the only SROs capable of assessing risks to clearing organizations. Over the years NFA has gained significant experience auditing members of those exchanges that outsource their auditing and financial surveillance functions to us (e.g., Minneapolis Grain Exchange, New York Board of Trade), and this experience includes assessing a firm's ability to meet its obligations to the exchange's clearing organization.

Issue 1: Membership

All contract markets and registered futures associations should be parties to the JAA and members of JAC to address potential systemic risk. We understand that some clearing organizations may want to become members, and we have no objection to their membership. In fact, given the importance of assessing and guarding against risk to a clearing organization, maybe all clearing organizations should be affirmatively invited to join.

Issues 4 and 5: Delegation and Outsourcing

The release asks for comments on delegation versus outsourcing of examination services and on distinctions between registered futures associations and non-registered futures associations with respect to delegation and outsourcing issues. In most cases, a delegation involves a transfer of all rights and responsibilities to the party receiving the delegation, while outsourcing is a contractual arrangement where the rights and responsibilities remain with the original party with only the functions themselves being contracted out. Because of this distinction, we believe that delegation and outsourcing should have different consequences, which in turn should dictate who an SRO can delegate or outsource to.

Section 5c(b) of the Commodity Exchange Act provides that an exchange can comply with applicable core principles through delegation to NFA or another registered entity but that the exchange retains responsibility. We believe this provision should be amended during reauthorization to authorize exchanges to delegate both the function and the corresponding responsibility to NFA or another registered entity and to clarify that exchanges can contractually outsource functions to any qualified entity – registered or unregistered – as long as the exchange retains full responsibility. This would be consistent with the Commission's position in approving NQLX's outsourcing arrangement with NASD. [8]

Issue 6: DSRO/SRO Responsibilities

The release also asks for comments on the distinction between SRO and DSRO responsibilities. As Rule 1.52(h)(1) recognizes, only the DSRO should have an affirmative responsibility to conduct audits and financial surveillance for those activities covered by the JAA. All SROs should continue to be responsible for monitoring

[8] In considering its recommendation to Congress, the Commission could determine that certain functions should only be outsourced – not delegated – so that the exchange retains full responsibility. Even where delegation is allowed, however, the entities involved could choose to enter into a contractual outsourcing arrangement rather than a delegation.

activities not covered by JAC programs and for enforcing their own rules unless they have delegated these responsibilities to another futures SRO.

Issue 7: CFTC Review

NFA believes the Commission should review JAC's governance and operation more frequently. This is a rapidly changing industry, and practices that work well at one point may be outmoded several years later. Commission staff should attend and participate in JAC meetings and keep current on those issues facing JAC. In addition, the Commission should review the JAA whenever there are significant changes to SRO activities and responsibilities.

Issue 8: Transparency

Finally, the release asks for comments on the general transparency of the DSRO system and its operation. Obviously the actual joint audit programs and most examination records must remain confidential to ensure the integrity of the audit process. However, the JAA, the assignment procedures, the list of DSRO assignments, and JAC's guidance to its SRO members on how to interpret various regulatory requirements should be made publicly available in a prompt manner.

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NFA encourages the Commission to take an active role in the DSRO process to ensure that it meets the objectives described in Regulation 1.52(g). If you have any questions regarding the comments in this letter, please contact me (312-781-1413 or tsexton@nfa.futures.org) or Kathryn Camp (312-781-1393 or kcamp@nfa.futures.org).

Respectfully submitted,

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Vice President and General Counsel

(kpc/Comment Letters/JAC Agreement)