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Paul H. Bjarnason, Jr.
4712 Montgomery Street
Annandale, VA 22003
bearson@crosslink.net
telephone #: 703-941-0926

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VIA ELECTRONIC DELIVERY

COMMENT

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Washington, D.C. 20581
secretary@cftc.gov

Re: Futures Market Self-Regulation; 69 Federal Register 19166 and 69 Federal Register 22599

Dear Ms. Webb:

From 1983 – 1999, I was the Deputy Director for Audit and Review in the Commission's Division of Trading and Markets, the predecessor to the Division of Clearing and Intermediary Oversight. I was in charge of the Commission's program, which assessed the effectiveness of the audit and financial surveillance programs executed by the self-regulatory organizations ("SROs") of the futures industry, i.e., the futures exchanges and the National Futures Association ("NFA"), over their member futures commission merchants ("FCMs"). During my tenure, I attended most meetings of the JAC. Since my retirement, I have remained interested in the work of the Commission and have served as a consultant to the World Bank, the Peoples Republic of China and entities in the futures industry, regarding financial regulatory matters. The central issue is the exchanges acting as auditor, as opposed to a non-exchange entity, i.e., which entity should act as the designated SRO for an FCM – an exchange or a non-exchange entity. There are several facets to this issue, which I discuss separately below.

Conflict of Interest and Independence

Regarding the Joint Audit Plan, the biggest area of concern appears to be the so-called "conflict of interest" issue, which is the notion that an exchange, that is the DSRO of an FCM, may not do a good job auditing an FCM, merely because it is an exchange. That is, some fear that, perhaps, a DSRO which is an exchange ("exchange-DSRO"), somehow, would intentionally "look the other way" regarding deficiencies found in an audit of an FCM or, perhaps, just not be diligent. Examination of the facts will show that the exchange-DSRO has a natural combination of incentives to do a good job on a financial audit of an FCM, whereas the non-exchange SRO has none. Also, the actual conflicts of interest lie with the non-exchange DSRO, instead. All things considered, the vaunted "independence" of a non-exchange SRO does not exist, because it is a membership organization, with no countervailing incentives. This is discussed below.

If an FCM fails, the clearing organization may lose a lot of money and, not only that, there could be tremendous damage to the exchange's reputation and franchise. This is true, regardless of whether the exchange/clearing organization is one where the risk is "mutualized" (i.e., owned by its members) or is a public company. By doing a good audit of a clearing FCM, the risk of loss through a member's failure is lessened, due to possible earlier detection of financial problems. To bear out this point, there are historical examples of cases where exchanges have, voluntarily, paid off the customers of failed member firms. The fact that exchanges have made customers of failed firms whole, when they were not legally obliged to do so, is proof positive that exchanges care deeply about preserving the value of their franchise.

Conversely and by the same token, a non-exchange SRO would, in fact, have the greatest potential conflict of interest and, actually, lack independence. The reason is that a non-exchange SRO is a membership organization and, of course, will act in the best interests of its membership. The membership of the futures industry's only non-exchange SRO is comprised largely of FCMs and other registered entitles. While there are "public" board members, this does not change the fundamentals of the situation, which is that the non-exchange SRO is a trade organization and acts to serve its members. Other than the threat of government sanction or public embarrassment, not only does this non-exchange SRO have no structural incentive to do a good job, it has no financial exposure to its members and no valuable business franchise to protect. Also, the futures industry's only non-exchange SRO has never bailed out a member firm or otherwise made customers whole out of its own pocket! This is not just a theoretical dynamic – it is one that I observed in practice, during my years running the Commission's SRO review program. Therefore, as a government oversight matter, a non-exchange SRO requires closer scrutiny than an exchange-SRO. But, close oversight cannot really make up for the lack of incentives, as audit omissions can only be caught by the Commission, if it actually does its own audit of the FCM and compares its audit results with the SRO's audit results. So, the strongest system of DSRO allocation is one that harnesses the natural incentives which reinforces doing a good job auditing.

Regulatory Costs

Regulatory costs are a consideration in the DSRO allocation scheme. In this connection, it is important to note that, if audit responsibilities were taken away from the exchange-DSROs, it is very likely that there would, nonetheless, remain a need and desire for the exchanges to continue to do some audit work at their clearing member firms. In particular, the exchanges would probably wish to do enough audit work to verify the financial health of their clearing member firms. But, this is the same general goal as the auditing conducted by the DSRO. Thus, if the DSRO function were taken away from the exchange-SROs and given to the futures industry's non-exchange SRO, it would result in the same duplication of auditing effort that the Commission sought to eliminate, when it originally approved the Joint Audit Plan.

Audit Expertise

When it comes to expertise, exchange auditors have an advantage over auditors who work for other entities. Some might say that any SRO audit organization can hire the right expertise to effectively audit complex FCMs. However, it is necessary to continually hone this expertise. Working for a major exchange, as opposed to a non-exchange SRO, is the best place for an auditor to do this honing, because of the regular exposure to large firm issues and operations. An auditor working for a non-exchange SRO will not have the ready access that an exchange's auditor does, to internal exchange and clearing house data systems, position data, margin status information, and clearing and settlement status and cash flows. Exchange auditors are, also, on the front lines of the "fire drills" which occur during a volatile market. The exchange audit staffs, because they work for an exchange, also have very good (and regular) access and exposure to the people running the firms.

Effectiveness in Handling a Financially Troubled FCM

In regard to the inevitable occasional FCM failure and what can be expected from the exchanges, it is useful to remember that in the middle of a financial crisis, fast and accurate assessments of the situation are imperative. An exchange which does not feel that is has a good window on a situation, i.e., an exchange which does not have its own auditors in the firm looking at the books, will be less likely to "step up to the plate" and bail out the customers, to facilitate a transfer of the accounts to a solvent FCM. In addition, absent an audit responsibility for the FCM, the exchange may, also, feel that it is less connected or, somehow, less responsible for the firm. As correctly noted in the exchanges' comment letter to the Commission, the exchanges' audit staffs have always performed in an outstanding manner, in handling the occasional financially troubled FCMs, which have occurred over the years.

Allowing an FCM to Select its DSRO

As a related aside, I notice that in the "Study of Self-Regulation Position Paper", issued by the Futures Industry Association, June 8, 2004, it is suggested that: ". . . a member firm should be able to change its DSRO within the narrow band of CFTC pre-approved providers." I think such a policy would be foolish, as common sense suggests that to permit this would encourage FCMs to "shop" for the most lenient DSRO available. Moreover, the first time a DSRO found a problem at an FCM, the FCM would probably look for another DSRO. This happens all of the time in the public accounting profession, where entities (like Enron) would seek an accounting firm that would be "cooperative". Thus, I would strongly advise the Commission against adopting this suggestion.

Demutualized vs. Mutualized Exchanges/Clearing Organizations

Also, the Futures Industry Association study states that there are "some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses" and that this problem is "potentially . . . exacerbated by demutualization and the move to for-profit structures." I disagree with this view. First, I have no idea what "actual" conflicts of interest the study could have been referring to, which could apply in the context of a financial audit of an FCM. Second, exchanges of any legal form exist for one reason only, which is to make a profit for their owners. The legal form is incidental to an exchange's economic purpose, and every exchange is, in some way, financially exposed to the insolvency of its member firms. While there, surely, is competition between exchanges and clearing organizations, there is no conflict of interest at all between the business function and the DSRO role, as already discussed above. Exchanges of both forms are "on the same page", respecting FCM financial stability and auditing to assure it. This is precisely why the present Joint Audit Committee system of giving DSRO preference to an exchange, rather than the non-exchange member, has worked as well as it has, over the years.

Efficiency of Audit Program Design

It is wasteful, I believe, to have two sets of audit programs used by SROs in the futures industry. NFA does not use the Joint Audit Committee's master set of audit programs. Rather, it has its own set of programs. Therefore, every year two sets of audit programs must be updated by the SRO staff and, then, reviewed by the Commission's staff. Inasmuch as, ultimately, the futures industry bears the cost of the SRO side of this and the public bears the cost of the Commission's dual reviews, this duplication should be eliminated. The Joint Audit Committee's program is more robust and has been developed and honed over the years with the inputs of all of the exchanges, not to mention the Commission's own audit staff. Therefore, in the interest of regulatory efficiency, my recommendation is that the Commission should have NFA adopt the Joint Audit Committee's master set of audit programs. If this were done, of course, it would be appropriate for NFA to have a vote on any changes to the Joint Audit Committee's programs.

In conclusion, I believe the Commission would be wise to encourage the major futures exchanges, which maintain an audit function, to maintain their DSRO status for any FCMs, which are exchange member firms. The present design and function of the Joint Audit Committee has stood the test of time, and should not be changed in any major way at this time.

Very truly yours,

Paul H. Bjarnason, Jr.
Financial Regulatory Consultant