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NQLX

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

COMMENT

Re: CFTC Request for Comment on Proposed Amendments to the Joint Audit Agreement

Dear Ms. Webb:

NQLX, LLC (NQLX) is submitting this letter in response to the Commodity Futures Trading Commission's (CFTC) request for comment on proposed amendments to a voluntary cooperative agreement, the Agreement for Services, amongst various futures self-regulatory organizations (SRO) that comprise the Joint Audit Committee (JAC). The proposed Amended Agreement for Services (Proposed Agreement) was published in the Federal Register on April 12, 2004, and corrected on April 27, 2004 (69 FR 19166 and 69 FR 22599). NQLX appreciates the opportunity to comment on the Proposed Agreement.

NQLX believes that self-regulation is the most appropriate and effective approach to market oversight. It is a tried and proven regulatory model for achieving market and financial integrity. The various self-regulatory programs at the SRO level and through cooperative agreements among SROs have enabled exchanges to meet their respective obligations under the Commodity Exchange Act (Act) in an efficient and effective manner while avoiding duplication of efforts. The effectiveness of the self-regulatory programs can be seen in the high degree of customer confidence in the safety and soundness of the markets, which has translated into continued growth in the futures industry.

I. Background

The JAC Agreement, signed in 1984, establishes and governs a voluntary, cooperative arrangement for the allocation of supervisory responsibilities and the sharing of relevant information among JAC members. It has been an effective legal instrument for providing structure around the JAC's operations and the delegation of DSRO responsibilities, including the financial and sales practice surveillance obligations under the Act. However, since 1984, the markets have changed dramatically. NQLX applauds the CFTC's initiative to "[assess] the impact of changes in the futures industry, such as new entrants being designated as [designated contract markets], ... upon the DSRO system and its examination programs." [1]

II. Outsourcing Self-Regulatory Functions

Prior to the Commodity Futures Modernization Act of 2000 (CFMA), which resulted in a major overhaul of the Act, contract markets seeking designation built and operated their own surveillance programs in-house. Exchanges invested millions of dollars to purchase and/or develop, and maintain technology for automated surveillance systems that identify potential violations. As a result, the contract market designation process was extremely costly and time consuming.

The CFMA, among other things, added a provision to the Act, Section 5c(b), Delegation of Functions Under Core Principles, which permits a contract market to "comply with any applicable core principle through delegation of relevant functions to a registered futures association or another registered entity."[2] This provision effectively shortens time to market for a new exchange by eliminating the time needed to develop and implement a full-blown surveillance program in-house. Instead, the market is free to hire a qualified third-party service provider to supply all facets of a surveillance program that are necessary for contract market designation, including financial, trade practice and market surveillance. The ability to outsource has helped double the number of contract market designations and, consequently, has promoted competition, a primary goal of the CFMA. Since the implementation of the CFMA less than four years ago, the CFTC has granted designation status to eight new contract markets. In the twenty years preceding the CFMA, the CFTC designated only seven contract markets.

This is the surveillance model that NQLX and other new contract markets have adopted in order to meet the requirements for designation in the most cost effective and timely manner. [3] Additionally, new markets are choosing to outsource because this model provides a higher degree of separation, and therefore greater independence, between the compliance program and exchange governance. There is no real or apparent conflict of interest on the part of the independent third party service provider relative to its responsibilities for monitoring the markets and identifying potentially violative activity. There is clear separation of functions using this model.

III. Comment on Proposed Agreement

The Proposed Agreement in many respects is a document that NQLX readily supports. It effectively avoids duplicative regulatory burdens on Futures Commission

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[1] 69 FR 19166 at 19168 (April 12, 2004).

[2] 7 USC §7a-2(b).

[3] NQLX has outsourced its auditing functions to the NASD. NASD is registered with the Securities and Exchange Commission and is a skilled regulatory services provider with years of experience in conducting financial and sales practice audits as the Designated Examining Authority for numerous 5,400 broker dealers. All of NASD's regulatory programs for NQLX have been reviewed and approved by the CFTC.

Merchants (FCM) and it facilitates the sharing of relevant financial and risk information amongst the various SROs. The Proposed Agreement, however, includes certain provisions that would impact directly NQLX and other SROs that have chosen to outsource regulatory services to a qualified, independent third party provider. These particular provisions, which would isolate designated contract markets (DCM) that choose to outsource, are not necessary to serve the public interest, and are inconsistent with the spirit of the CFMA.

One important area of concern within the Proposed Agreement is the provision pertaining to voting eligibility. Specifically, with respect to voting rights, the Proposed Agreement provides:

> "Only those Parties which were members of the JAC prior to the year 2000 or which conduct their own auditing activities as a DSRO (rather than subcontracting such responsibilities) shall be eligible to vote."

This provision effectively eliminates the voting rights of all new DCM members of JAC. It favors members with their own auditing department over SROs that have chosen to outsource regulatory services puts them in a position to vote on decisions that may obstruct competition.

Also, the provision related to DSRO designation in the Proposed Agreement acts against SRO that have chosen to outsource regulatory services. That provision states:

> "Any exchange which conducts its own auditing activities as a DSRO for any FCM will have the right of first refusal to be the DSRO for any existing or new member FCM of such exchange, before any other Party will be permitted to become, or to continue to be, the DSRO for that existing or new member FCM."

This provision, by granting a right of first refusal to self-auditing exchanges that are DSROs, effectively precludes non-voting members that outsource regulatory functions from becoming a DSRO. NQLX may not be permitted to be the DSRO for NQLX members, even if they are not members of any other exchange. NQLX and other new DCMs, therefore, are penalized for their decision to outsource regulatory functions. They are penalized for choosing a model, which, as discussed above, responds effectively to the criticism surrounding most exchanges in the lack of independence between exchange business and regulatory functions.

Relevant Statutory Provisions

Section 15(b) of the Act requires that the CFTC "take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the Act, as well as policies and purposes of [the] Act, in issuing any order … ."[4] Every new exchange that outsources

[4] 7 USC §19(b).

regulatory functions would be subject to disparate treatment under the Proposed Agreement. Approval by the CFTC of the Proposed Agreement in its current form would be inconsistent with the spirit and purpose of Section 15(b) of the Act. All participants of the JAC, regardless of the chosen regulatory model or the length of time in business, should be on equal footing within the organization.

Exchanges, which comprise the JAC, are subject to Core Principle 18 of the Act, Antitrust Considerations. Under that provision, "[u]nless necessary or appropriate to achieve the purposes of [the] Act, the [exchange] shall endeavor to avoid – (A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; …."[5] Certainly the actions taken by the exchanges in their governing roles within JAC, which restrict the rights of members that have chosen to outsource regulatory services, cannot be interpreted as an avoidance of any unreasonable restraint on trade.

IV. Conclusion

Disparate treatment of new and developing markets by the JAC voting members give the appearance of protectionism, a policy that should not be tolerated in the context of a cooperative, regulatory organization authorized by the CFTC. It is particularly troublesome where there is no rational basis for distinguishing between members that internalize or outsource regulatory functions. The CFTC, by designating these exchanges, has determined that they meet all of the requirements of the Act for designation. Thus, there is no regulatory basis for any distinction between JAC members. The outsourcing model, which Congress specifically provided for in the CFMA, is a reliable alternative to in-house surveillance with the added benefit of eliminating conflicts of interest. An exchange that takes advantage of the outsourcing model should not be penalized for doing so. Support of the Proposed Amendment would undermine the arguments for removal of conflicts of interest within exchange governing bodies and could discourage exchanges from making the responsible decision to outsource in the interest of minimizing conflicts.

Sincerely,

Robert Fitzsimmons / ml

Robert G. Fitzsimmons
Chief Executive Officer
NQLX, LLC

[5] 7 USC §7(d)(18).