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June 17, 2004

Ms. Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, D.C. 20581

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COMMENT

Re: Futures Market Self-Regulation

Dear Ms. Webb:

The Committee on Futures Regulation (the "Committee") of the Association of the Bar of the City of New York (the "Association") is pleased to submit to the Commodity Futures Trading Commission (the "CFTC") the following comments on the Request for Comment published in the Federal Register on April 12, 2004 (69 Fed. Reg. 19166) (corrected April 26, 2004 (69 Fed. Reg. 22599)) (the "Notice") regarding proposed amendments to a cooperative agreement among various futures self-regulatory organizations ("SROs") that are members of the Joint Audit Committee ("JAC").

The Association is an organization of over 22,000 lawyers. Most of its members practice in the New York City area. However, the Association also has members in nearly every state and in over 50 countries. The Committee consists of attorneys knowledgeable in the regulation of futures contracts and other derivative instruments and it has a history of publishing reports analyzing regulatory issues critical to the futures industry and related activities. The Committee appreciates the opportunity to comment on the Notice and stands ready to assist the CFTC and its staff if further clarification is required on any of the points raised in this letter. This letter represents a consensus view of the Committee. Not every member agreed with each point made in this comment letter.

The Committee supports the concept of self-regulation and a system for allocating regulatory responsibilities among the various self-regulatory organizations in the futures industry. Along with providing cost efficiencies, the SRO system has also provided the benefit of a regulatory structure comprised of parties that offer product knowledge and market insight as well as an understanding of the public policy concerns that mandate the need for regulation and justify its existence.

The changing competitive landscape in the futures industry in recent years, including new market structures and lines of business at exchanges and futures commission merchants ("FCMs"), has created the potential for new conflicts of interest. It is in this context that the Committee believes the CFTC should review the proposed agreement drafted by the JAC (the "Proposed Agreement") to ensure that any final agreement will best serve the public interest by requiring, among other things, that a mechanism exists to effectively resolve conflicts of interest. In this regard, the Committee has identified two issues that it believes the CFTC should carefully consider. These issues concern voting rights and the allocation of designated SRO ("DSRO") responsibilities.

I. With respect to voting issues, the Proposed Agreement states:

"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."

Voting rights include the right to vote on approving new JAC members and the design and implementation of the examination programs used by each DSRO as well as decision-making with respect to minimum examination practices and procedures. JAC members with voting rights may have a disproportionate amount of authority on matters that ultimately impact every FCM, including those for whom those voting members are not the DSRO. Even if non-voting members have the opportunity to be heard at JAC meetings, they may nonetheless perceive that they lack an effective voice on decisions taken with respect to the examination process and other matters by which they will be directly impacted. If a non-voting member outsources its self-regulatory responsibilities to a party that is already a voting JAC member, however, this effect could be mitigated. Presumably the non-voting member can contract with its voting member SRO to have its interests sufficiently represented.

The Commodity Futures Modernization Act of 2000 ("CFMA"), which was intended to foster competition, specifically permits the outsourcing of self-regulatory responsibilities. Moreover, since the CFMA was enacted, several new exchanges have been created, and have, in fact, outsourced their self-regulatory responsibilities. Under the Proposed Agreement, these exchanges could not vote because they were not members of the JAC prior to the year 2000 and would not perform their own auditing functions as a DSRO. It is unclear why reference is made to the year 2000 or what its significance is. The CFTC should clarify this point with the JAC members.

Clearly there are a number of competing concerns with respect to the voting rights issue. Current JAC members with voting rights that perform their own regulatory, auditing and surveillance activities may take the view that new exchanges that do not maintain staff to

perform these functions should not have the right to exercise a vote on issues that concern how these functions are carried out. Exchanges that outsource their SRO function, on the other hand, might view themselves as being excluded from a process of which they are supposed to be a part. The CFTC should effectively address both concerns with the goal of creating an agreement that avoids the potential for power to be concentrated in one entity or a small group of entities. The CFTC should examine this issue in the context of the various relationships among all parties to the Proposed Agreement. The Committee suggests that the CFTC require the JAC to articulate a rational basis for any arrangement that limits participation by any party on the JAC.

II. With respect to the allocation of DSRO responsibilities, the Proposed Agreement 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 Party will be permitted to become, or continue to be, the DSRO for that existing or new member FCM. Exchanges will have the right of first refusal to be the DSRO for any FCM which is not a member of another exchange.”

The Committee suggests that the CFTC carefully consider whether this arrangement best serves the public interest. As with voting rights, this provision as currently drafted may give a disproportionate amount of authority to a subset of Parties to the Proposed Agreement. Existing Parties that conduct their own audit activities with respect to exchange member firms could have a disproportionate number of firms assigned to them. Similarly, the current practice of automatically assigning National Futures Association as DSRO for non-exchange member FCMs should also be considered in the context of whether this allocation is fair to the other parties to the Proposed Agreement.

The Committee understands that the current practice is to assign firms to the exchange where they do the largest volume of their business. Where an FCM's trading activity constitutes a significant percentage of the trading volume on an exchange, that FCM poses a relatively greater risk to the exchange and its clearing organization than an FCM that engages in a nominal level of trading on that exchange. Current JAC members that perform DSRO functions seek to continue having oversight responsibility for firms that make up a significant amount of volume on their respective exchanges. Monitoring and auditing these firms first-hand helps an exchange satisfy its obligation to ensure the financial integrity of the transactions on its markets. Given that one of the JAC's specific mandates is to promote information sharing, the CFTC should consider whether the Proposed Agreement adequately addresses this process. This concern could be alleviated by requiring that the final agreement contain provisions to ensure that information is shared timely and in a coordinated fashion.

Ms. Jean A. Webb  
Commodity Futures Trading Commission  
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The CFTC should also consider whether to allow certain interested outside parties, such as the FCMs themselves, a voice in the decision-making process with respect to assigning DSROs. In particular, the CFTC should consider whether and under what circumstances an FCM could have the ability to change its DSRO. In considering this issue, the CFTC should ensure that any process that provides FCMs with a mechanism to change DSROs includes safeguards to discourage firms from exercising this right arbitrarily or for improper purposes. The Committee notes that in situations where an FCM and exchange are competitors in some aspect of business, the exchange's obligation to minimize conflicts of interest in its decision-making and to have a process to resolve conflicts must be taken into consideration.

With respect to both of the issues discussed above, the CFTC should also ensure that the final agreement is not inconsistent with Section 15 of the Commodity Exchange Act, which, in addition to assessing costs and benefits, requires the CFTC to endeavor to take the least anticompetitive means of achieving the objectives of that Act.

In addition, although comment on this matter was not specifically requested, the Committee suggests that the CFTC consider the extent to which clearing organizations that are separate from the exchanges for which they clear, should be members of the JAC.

\* \* \* \* \*

The Committee stands ready to assist the CFTC with further information or other assistance regarding this important matter.

Very truly yours,



Rita M. Molesworth

Association of the Bar of the City of New York  
Committee on Futures Regulation  
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Deborah A. Tuchman, Secretary

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Michael Piracci

\* Member of special subcommittee that drafted this letter of comments.

\*\* Chair of special subcommittee that drafted this letter of comments.

$\Phi$  Mr. Obie abstained from participating in this letter of comments.