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FIA

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June 18, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

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

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations ("Proposed Agreement").[1] FIA supports the important role that exchanges and the National Futures Association ("NFA") perform as self-regulatory organizations ("SROs") and designated self-regulatory organizations ("DSROs").[2] 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, as explained in detail below, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure that would be ratified in the Proposed Agreement.

Before addressing specific aspects of the Proposed Agreement, however, FIA notes that the Commission recently issued a *Federal Register* release requesting comment on a series of questions relating to the structure and governance of self-regulatory organizations. 69 *Fed.Reg.* 32326 (June 9, 2004). The latter release, which was issued in connection with the Commission's review of SROs, requests comment on such matters as the composition of boards of directors, issues arising from different forms of ownership, regulatory structure, including the structure of disciplinary committees, and potential conflicts of interest generally.

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1 FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

2 Pursuant to Commission rule 1.3(ee), an SRO is defined as a designated contract market or a registered futures association. A DSRO is defined under Commission rule 1.3(ff) as an SRO assigned responsibility for monitoring and auditing an FCM in accordance with a plan approved under Commission rule 1.52. Significantly, designated clearing organizations are not self-regulatory organizations under the Commission's rules.

FIA recently filed with the Commission a position paper outlining several broad areas of concern in this area and will be preparing a more detailed response to this release.[3]

In our view, the Commission's review of the Proposed Agreement cannot be considered separately from the Commission's more general review of SROs. Certainly, FIA's comments below might well change depending on the Commission's response to our broader concerns. Therefore, we recommend that the Commission defer any decision with respect to the Proposed Agreement until its SRO study is complete.

A Changed Industry

The derivatives industry has undergone significant change in the twenty years since the original Joint Audit Agreement was entered into in 1984 and, in particular, in the years following enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"). Legal uncertainty surrounding over-the-counter ("OTC") derivatives transactions among qualified eligible participants has been resolved, and a burgeoning OTC market in swaps and other derivatives instruments both competes with and complements the exchange traded markets.[4] Many FIA member firms, either directly or through affiliates, are active participants in the OTC derivatives markets. Concurrently, the clearing divisions of the Chicago Mercantile Exchange ("CME") and the New York Mercantile Exchange ("Nymex") both offer to provide clearing facilities for OTC derivatives.

Moreover, exchanges have entered into direct competition with each other. BrokerTec Futures Exchange and, more recently, the U.S. Futures Exchange ("USFE"), an indirect subsidiary of Eurex Frankfurt AG, have challenged the Chicago Board of Trade's ("CBT's") dominance in futures on US Treasury instruments, leading the CBT to counter by offering futures on the German Bund, Bobl and Schatz.[5] Meanwhile, Euronext.Liffe recently began offering futures on Eurodollars, in direct competition with the CME.

Finally, not all clearing organizations are as tied to futures exchanges as they once were. The CBT has terminated its relationship with The Clearing Corporation and has been clearing transactions through the CME since late 2003.[6] The Clearing Corporation now provides clearing services for USFE and other exchanges. In addition, the London Clearing House has

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3 Letter to James Newsome, Chairman, from John M. Damgard, President, FIA, dated June 8, 2004.

4 The International Swaps and Derivatives Association ("ISDA") estimates that, as of December 31, 2003: (1) the notional principal outstanding volume of interest rate derivatives, which include interest rate swaps and options and cross-currency swaps, was $142.31 trillion; (2) the notional value of outstanding credit derivatives, including credit default swaps, baskets and portfolio transactions was $3.58 trillion; and the outstanding notional value of equity derivatives, consisting of equity swaps, options, and forwards, was $3.44 trillion.

5 As a result of its purchase of BrokerTec Futures Exchange, several of the larger FCMs own a significant interest in USFE.

6 The Clearing Corporation, of course, has always been an independent legal entity.

been approved as a designated clearing organization ("DCO"), but does not yet provide clearing services for any designated contract market ("DCM"). Although not represented on the Joint Audit Committee ("JAC"), independent clearing organizations have a clear and undeniable interest in the financial integrity of member FCMs.[7]

As the above summary indicates, the derivatives industry is anything but static. More important, the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement. Further, we submit that the Proposed Agreement should provide the flexibility necessary to accommodate the inevitable changes the industry will experience in the years ahead.

Voting Eligibility

Paragraph 3 of the Proposed Agreement provides that "[o]nly 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." Neither the Proposed Agreement nor the *Federal Register* release requesting comment explains the reasons underlying this provision. On its face, it appears to have no rational basis.

What regulatory purpose is served by granting voting privileges to AMEX Commodities Exchange and the Philadelphia Board of Trade, neither of which currently list products for trading, while denying voting privileges to USFE? Certainly, the distinction cannot be based on the decision of USFE to subcontract certain of its self-regulatory responsibilities to NFA. A review of the Commission's *Selected FCM Financial Data* as of May 31, 2004, indicates that, with a few exceptions, DSRO responsibilities are performed by only three self-regulatory organizations—CBT, CME and NFA.[8] Without further explanation, the provisions of paragraph 3 relating to voting eligibility appear to have no purpose but to assure the continued dominance of the "old exchanges" over the "new exchanges."

Under the Commodity Exchange Act ("Act"), all DCMs have self-regulatory obligations that they are required to meet. Further, although the Act clearly contemplates that DCMs may delegate these obligations to a registered futures association, such as NFA, or another registered entity, the Act also provides that that DCM "shall remain responsible for carrying

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[7] As noted in footnote 2 above, DCOs are not self-regulatory organizations under the Commission's rules. Nonetheless, DCOs have an obvious interest in the financial integrity of their member FCMs. Therefore, procedures should be developed to assure that DSROs provide independent DCOs the same access to financial and other relevant information obtained by a DSRO with respect to a member FCM as the DSRO now makes available to DCOs that are divisions of a DCM. In addition, consideration should be given to inviting independent clearing organizations to participate, if not vote, in meetings of the JAC.

[8] Of the 178 registered FCMs: NFA is the DSRO for 97 FCMs; the CBT is the DSRO for 40 FCMs; the CME is the DSRO for 29 FCMs; Nymex is the DSRO for 10 FCMs; and the Kansas City Board of Trade and New York Board of Trade are the DSRO for one FCM each.

out" these obligations.[9] As long as a DCM has statutory self-regulatory obligations that it is required to meet and, consequently, may be held responsible for the manner in which a DSRO performs these obligations on its behalf, FIA believes that each DCM should have an equal voice in matters that become before the JAC.[10]

Allocation of Firms Among DSROs

As noted earlier, the CBT, CME and NFA serve as the DSROs for essentially all registered FCMs. Further, either the CBT or the CME is the DSRO for all but two of the twenty largest FCMs by amount of segregated funds held.[11] FIA is not concerned that these three entities perform the majority of DSRO activities on behalf of other DCMs. To the contrary, particularly in the area of financial audits, we believe that the expertise demanded of audit staff effectively requires that these responsibilities be exercised by a small number of qualified SROs. Nonetheless, two aspects of the Proposed Agreement cause concern.

First, the Proposed Agreement provides no means by which an FCM may participate in the selection of its DSRO. In addition, once assigned to a DSRO, an FCM may not be reassigned, except with the consent of that DSRO. As we discussed at the outset of this letter, exchanges and their FCM members are increasingly engaged in activities that appear to compete with each other. Consequently, an FCM may find that its activities are being audited by an exchange that is, or at least appears to be, its competitor. In these circumstances, and in order to avoid even an appearance of a conflict of interest, an FCM should have the ability to change its DSRO.[12]

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[9] Section 5c(b) of the Act.

[10] Paragraph 3 of the Proposed Agreement also provides:

> If two or more Parties become commonly owned through a merger or acquisition, the surviving Party is entitled to one representative on the JAC; provided, however, that any Party which maintains a separate legal entity after an acquisition, will retain their representative on the JAC.

FIA agrees that, if two or more DCMs become commonly owned, they should be entitled only to one representative and one vote on the JAC in all instances. The fact that a DCM is maintained as a separate legal entity following an acquisition should not entitle that entity to representation or a vote.

[11] Based on the Commission's *Selected FCM Financial Data* as of May 31, 2004, these twenty firms hold in excess of 85 percent of all customer segregated funds. Of these firms, the CBT is the DSRO for 12, the CME is the DSRO for six and Nymex is the DSRO for two.

[12] We want to be clear that we are not asserting that any DSRO has acted, or would act, in a way that would constitute a conflict of interest. Nor would we anticipate any rush by FCMs to change their DSRO. To the contrary, in our discussions with FIA member firms, they are by and large satisfied with the DSRO to which they have been assigned. Nonetheless, as we noted in our June 8, 2004 position paper on self-regulation, "providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function."

We have considered various means by which an FCM could be permitted to change its DSRO and suggest that an FCM should be able to change its DSRO on a periodic basis, *e.g.*, every five years.[13] The FCM could request this change for any or no reason. Although an FCM could participate in the selection of its DSRO, the FCM would not have the unilateral right to choose the DSRO that would assume responsibility for the firm. Rather, the DSRO would be chosen from among those SROs that the Commission has determined meets clear and objective standards. Any procedure should assure and prevent any appearance that the FCM was engaging in regulatory arbitrage among DSROs.[14] Separately, FIA believes the Commission should establish procedures in rule 1.52 by which an FCM may petition the Commission to request a change in the FCM's DSRO in the unlikely event that the DSRO has engaged in egregious misconduct conduct with respect to the FCM.

Second, we believe that the exchanges should not have the unquestioned right of first refusal with respect to the allocation of DSRO responsibilities among exchange member firms. As discussed above, in light of the potential appearance of conflict of interests between an FCM and its DSRO, FIA believes that procedures should be considered to permit NFA or another non-exchange entity to serve as an FCM's DSRO, *provided* that entity meets Commission approved standards.

Confidentiality

The information that DSROs obtain in the course of their examinations of member firms and the records they prepare obviously contain confidential proprietary and business information that an FCM would not otherwise disclose. FIA is concerned that the confidentiality provisions set forth in paragraph 8 of the Proposed Agreement do not provide sufficient assurance that such information will not be shared with other divisions of the DSRO or with other SROs except for appropriate cause. Since FCMs are not parties to the Proposed Agreement and otherwise appear to have no cause of action against an SRO that may improperly disclose confidential information, it is particularly important that the responsibilities of SROs in this regard be clearly circumscribed.[15]

In a press release dated February 6, 2004, the Commission announced that it has "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-

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[13] No FCM, however, would be required to change its DSRO under this procedure.

[14] As noted in our June 8 position paper, FIA believes that a mechanism should be established to make the choice of DSRO cost neutral to exchange members.

[15] Again, FIA is not asserting that the audit staffs of any exchange or other SRO have inappropriately shared otherwise confidential business information.

regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures."[16]

Consistent with the Commission's recommendations, FIA respectfully submits that the Proposed Agreement governing confidentiality of FCM proprietary and business information should be revised to describe specifically the limitations on the use of such information. In addition, FIA believes the Commission should consider adopting a rule requiring the confidential treatment of all proprietary and confidential information collected during an examination. Such a rule would assure that violations of FCM confidentiality would be subject to appropriate penalty.

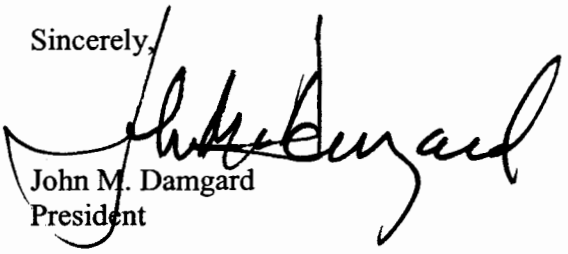
Commission Review

In light of the constant change that is the hallmark of the derivatives industry and the potential conflicts of interest that are inherent in any self-regulatory structure, FIA encourages the Commission to play a more active role in overseeing the activities of the Joint Audit Committee.

Conclusion

FIA appreciates the opportunity to submit these comments on the Proposed Agreement. If you have any questions concerning this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,



John M. Damgard
President

cc: Honorable James E. Newsome, Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Sharon Brown-Hruska, Commissioner

Division of Clearing and Intermediary Oversight
James L. Carley, Director
Thomas J. Smith, Associate Director

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[16] FIA supports the Commission's request that SROs examine their policies and procedures designed to protect the confidentiality of member information and make these policies and procedures public. FIA is not aware that any SRO has responded to the Commission to date. We recommend that this information be made publicly available as soon as possible in order to afford FIA and others an opportunity to submit comments in response to the Commission's June 9, 2004 *Federal Register* release.