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June 18, 2004

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

COMMENT

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RE: SRO Governance (69 F.R. 32326)

Dear Ms. Webb:

Self-regulation has survived more than 150 years of skepticism because industries have a *business* reason to support it. Like shoddy products, unethical behavior repels customers, especially in the futures community that no one is compelled by law or nature to use.

Self-regulation can range in nature from proclamations of "best practices" that rest on the honor system, to complex and sophisticated legal systems for the genuine enforcement of business standards. The organized exchanges have been able to construct the latter model for a variety of reasons:

- membership is a valuable asset that most participants will not place in jeopardy through misconduct. Expulsion could mean forfeiture of a member's most valuable possession.

- standards are set through collective deliberation and action, the result of consensus rather than compulsion.

- as centralized physical meetingplaces, exchanges have been able to enlist their members to donate substantial personal time after trading hours to developing ethics rules, to reviewing staff investigations, to holding disciplinary hearings, and to dispensing justice.

The central issue today is not *whether* self-regulation works but whether, as the physical marketplace gives way to disembodied electronic facilities that may be owned and run by people who are neither traders nor market intermediaries, and where participants have little at risk for misbehavior beyond getting cut off from the system, self-regulation will any longer be *feasible*. I am enclosing my article *Getting to grips with self-regulation in the new e-markets* (International Financial Law Review, June 2000) elaborating on that threat.

With respect to traditional futures self-regulation, the Commission will receive some suggestions to separate those who police from those who are policed, putting an end as a practical matter to self-regulation itself. That could be achieved in either of two ways:

- place control over the program in the hands of third parties while requiring the industry to underwrite whatever that costs. Recall, however, that we fought both a Revolutionary and a Civil War to end social systems that allow one group to decide while another bears the burden of those decisions.

- increase substantially the budget and staff of the Commission to perform those functions. This would reverse the trend in recent years by the Commission to outsource to the industry many functions to conserve scarce Government resources.

The first approach is confiscatory and tinkers with a fading model that screen dealing on independent platforms should displace. The second approach is contrary to the Commission's prevailing philosophy and direction but, if the electronic scenario occurs, may nevertheless be inevitable.

Sincerely,

Philip McBride Johnson

June 2000/A Euromoney Publication www.lawmoney.com

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Getting to grips with self-regulation in the new e-markets

Philip McBride Johnson of Skadden, Arps, Slate, Meagher & Flom looks at the move of the US futures markets towards electronic trading and argues that the implications for self-regulation are wider than have been recognized so far

Admitting the existence of change is no substitute for proper preparations. Within a very short period of time, the American futures markets will complete a metamorphosis from floor-based trading in a facility owned by the leading traders to a cyberspace matching engine having public shareholders. The existing law, the Commodity Exchange Act, contemplates the old business model and is not equipped to handle a publicly-owned commercial electronic trading system. As a result, the laudable efforts of the Commodity Futures Trading Commission (CFTC) to respond positively to the new e-markets using tools from the pre-Depression era have taxed everyone's ingenuity and, frankly, scream out for a better way. Here are my suggestions.

The traditional exchange model

Let us recall what the brick-and-mortar exchanges have looked like. Perhaps the most notable feature of those institutions has been the pivotal role played in all aspects of their operations by the traders or brokers who own them. Figure one depicts that relationship and shows how close has been the bond between the market, broadly expressed, and those who rely on it for all or part of their livelihood.

These owners, called members, have controlled exchange governance, have written the rules and designed the trading contracts, have funded the clearing house, have determined who will have access to the trading floor, and have volunteered their free services to adjudicate disciplinary charges as well as commercial disputes involving their fellow members and colleagues. From these latter functions has come the phrase "self-regulation."

Bear in mind, that the presence of a closed trading floor has meant that end users (outside customers) could not interact directly with the market but had to hire members for that purpose. Commonly, their orders would be relayed through several layers of members, and their employees, before and after execution; the supporting funds changed hands less often but were entrusted to members as well.

Figure two depicts the chain of dependency that can develop in those circumstances.

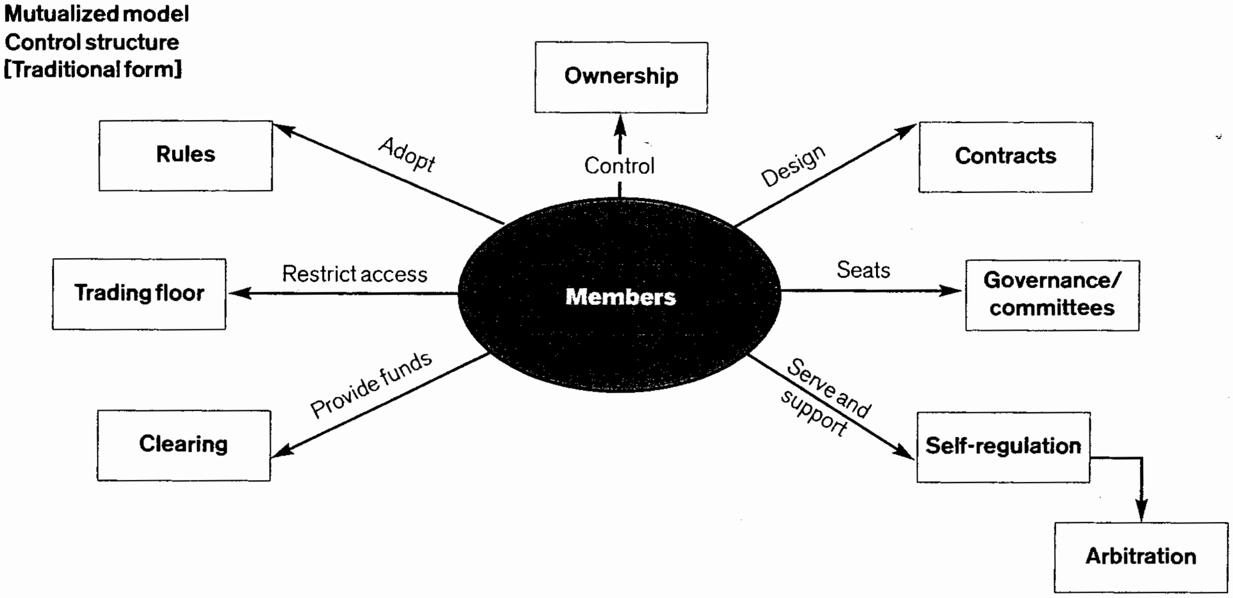
The combination of being owners as well as users of the market has created certain potential conflicts of interest in making decisions that may advantage the members at the expense of unaffiliated market users and, for that reason, the statute prohibits self-dealing by the members either on the trading floor or in the boardroom. Equally important, the statute seeks in dozens of ways to protect the remote customer from the carelessness or misconduct of those members on whom he must rely to shepherd through his orders and to safeguard his funds.

Fast forward to the upcoming e-trading model. Upcoming, ownership and control are likely to reside very far away from the traders themselves

The new electronic trading systems

Fast forward to the upcoming e-trading model. Here, ownership and control are likely to reside very far away from the traders themselves. The company, now a genuine business enterprise rather than a not-for-profit facility owned collectively by market participants, may be a listed corporation with thousands of shareholders that are situated around the world and, unless by coincidence, that are not traders at all. Virtually all of the functions formerly performed by

Figure 1: Brick and mortar exchange



member/owners will be centralized in the e-market's non-trading management - new contracts, rules, decisions on access, clearing, etc. Figure three illustrates the new lines of responsibility and authority.

The box marked "subscribers" is where the traders - formerly members - will reside, which is radically different from the dominant role they have played in the brick-and-mortar exchange.

Rank heresy number one

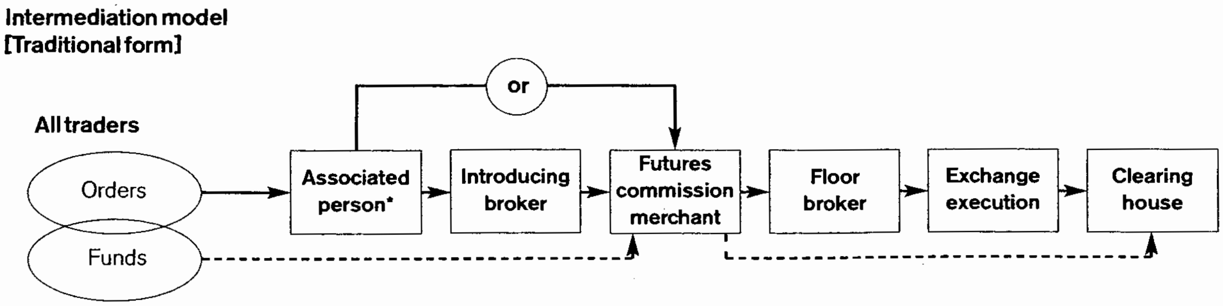
If we examine the vertical pole only of figure three (from "public shareholder ownership" to "subscribers") and ignore the wings to right and left, this organizational structure involves a publicly-held company simply providing remote users with a more efficient way to negotiate and to complete transactions. This is not the first such structure of course. Think of the telephone company or any internet service provider like eBay, Amazon.com or Priceline.com. None of them operates either of the two wings nor are they expected to do so. Why, then, is the same business model required to maintain a self-regulatory capability (the left wing of figure three) and a third-party clearing guarantee (right wing) if it offers the same services to buyers and sellers of futures contracts? I would suggest the blasphemous answer that it should not have to do so, and that these requirements live on through regulatory inertia. Even so, the psychological conversion of regulatory attitudes to giving normal commercial treatment to e-markets in the futures world will take time and patience.

The use of an electronic trading system suggests that the historical reliance of outside customers on member intermediaries in order to complete a trade may diminish as well. Figure four shows various new routes through which orders, and supporting funds, may travel in an e-market environment which could avoid intermediaries entirely or, at a minimum, collapse dramatically the chain depicted in figure two.

Indeed, a large institution or corporation might enter trades directly into the matching engine and may be willing to settle financially directly with its counterparties. The futures commission merchant (FCM) will continue to exist when that level of counterparty comfort does not exist, but principally to stand financially behind its customers' trading obligations. And, most non-institutional orders are likely to be routed through the FCM so that it can monitor and impose limitations on the activity that it is now guaranteeing. Insofar as perhaps more text is devoted in the Act to policing intermediaries against abusive conduct toward dependent customers than on any other subject, a simplified routing system should translate into fewer federal offences as well.

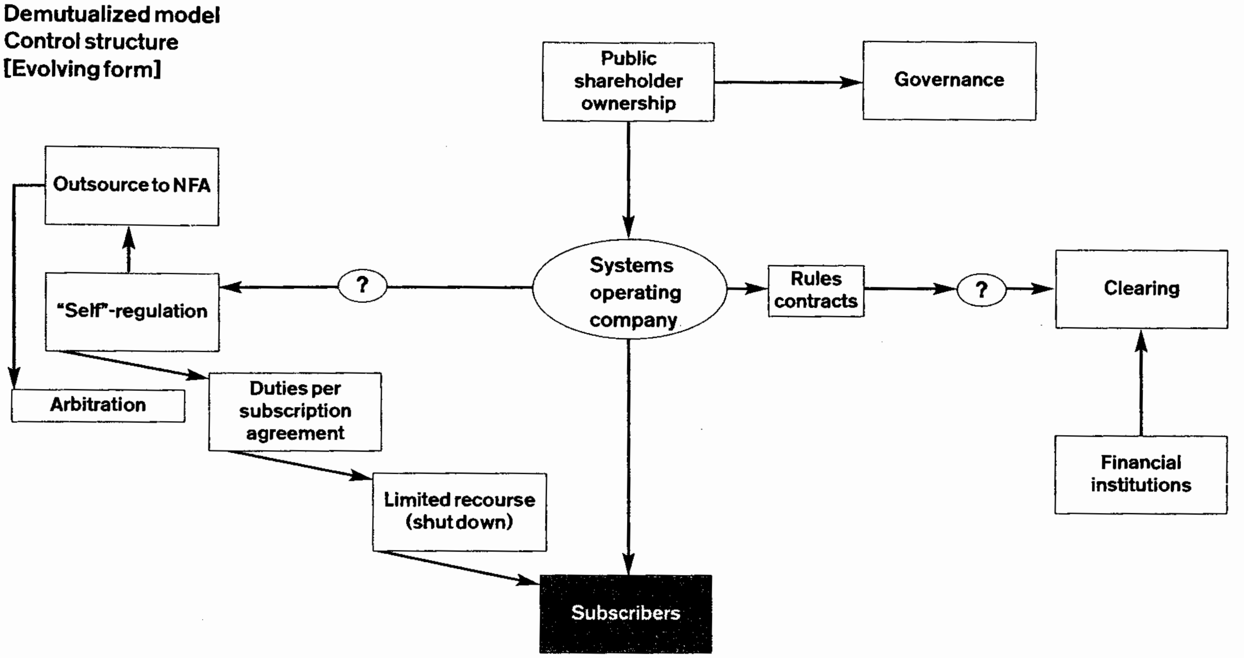
The demise of self-regulation

Figure 2: Brick and mortar exchange



* Might be a commodity trading adviser or commodity pool operator instead

Figure 3: E-trading exchange



Identifying the problem

Most telling, and least adaptable under existing law, is the relegation of the market user (the former member) to that of a system subscriber who is tied to the company only by an access agreement in the same manner as signing up for America On-Line or a cable TV service and who will have no meaningful role to play in either the operation or policymaking of the enterprise other than to withdraw if unhappy. In that new and diminished capacity, it will be unrealistic to expect subscribers to volunteer their time to support a self-regulatory program of the old tradition (indeed, as they no longer own or control the exchange, the exchange has no "self" left to regulate). And, because it will be equally impracticable for the company's own shareholders to perform these roles, we discover that the new e-market is simply unable to replicate what the law says must exist: a system of private regulation operated by, for and among market traders.

This disability exists not merely by reason of the new business structure that largely eliminates the market user from the decision making chain, but because the company itself has virtually no power over subscribers with which to conduct an effective disciplinary program. The classical system of self-regulation worked through at least three features that are now gone. First, the standards of conduct were agreed collectively and collegially by the market users themselves in a common pact that would bring disgrace if ignored. Second, trading (or brokering) on the exchange was an important part of the members' livelihood; they would not lightly jeopardize their principal occupation. And, third, in every case the exchange held the valuable equity interest

Figure 4: E-trading exchange

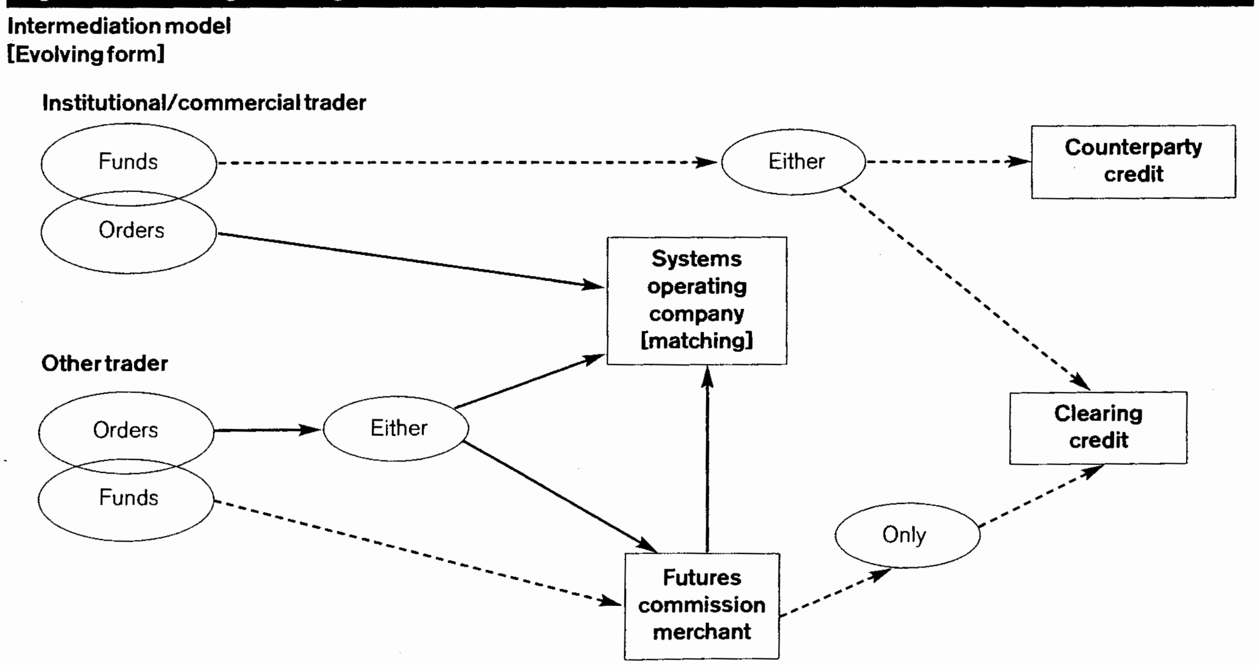
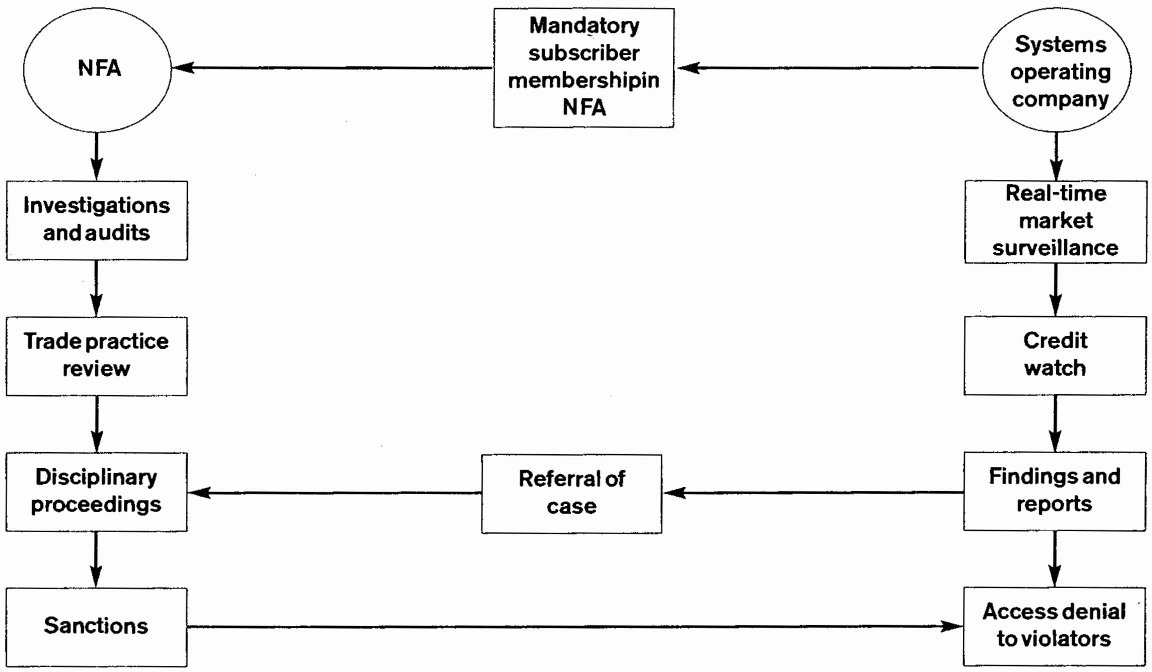


Figure 5: E-trading exchange

NFA enforcement model
[Evolving form]



("seat") of the member as collateral for any accrued debts, including disciplinary penalties. As a result it was rare for a member to snub the self-regulatory system.

But what leverage does the e-market have over the subscribers? True, it can terminate access and service if misconduct is detected. But, because most subscribers are not likely to view market activity as their principal occupation and because the company lacks possession of any valuable asset of the subscribers against which it can levy for nonpayment of fines or other obligations, the e-market has no assurance that sanctioned subscribers will comply with its demands voluntarily. Indeed, the odds seem to favour noncompliance because the e-market's only recourse in that case is to conduct protracted litigation against the subscriber, an expensive process and a distraction from its core business as a neutral communications system and order-matching engine.

Rank heresy number two

The CFTC needs to come to grips with the fact that many e-markets will be unable to administer a private disciplinary system. Requiring them to create faux committees to conduct trials of subscribers and to hear appeals can only result in an awkward search for strangers willing to volunteer their time to sit in judgement over people with whom they have no other association. Even then, the e-market will be powerless to enforce its own rulings unless it is willing to sue every person who habitually violates the law in the style of a bill collection agency. Striving to replicate the member-based model of self-regulation is a troubling form of denial at a time when attention should be focused on how best to substitute an effective response that is compatible with the e-market business model.

Identifying the solution

A solution is not difficult to find. In existence at this time is the National Futures Association (NFA), a fully-staffed and well-funded self-regulatory body for the futures community. Because e-markets will find it difficult to internalize many of the functions supporting a private regulatory system, a number of them are expected to call upon the NFA to conduct their investigations, collate the resulting evidence, prepare reports, etc for the e-market's own use. That role could be refined further, however, to make the NFA the direct private regulator of all e-market subscribers, provided that they can be compelled to submit to the NFA's jurisdiction and face severe consequences for ignoring the NFA's disciplinary penalties. Those provisos, to be met, would require a mandate from the CFTC to e-market subscribers compelling them to join the NFA and making it a federal offence to defy the NFA's orders, including sanctions. Figure five depicts the NFA in the role as enforcement agency for the e-markets.

Whether the NFA would welcome responsibility for oversight of what is potentially many thousands of subscribers in dozens of e-market systems is uncertain, as is the source of funds to defray these new costs.

Alternatively, the CFTC could take over enforcement on its own, using the comprehensive standards of conduct and awesome powers granted to it by Congress over more than 75 years, including the threat of criminal sanctions where appropriate. The subscribers cannot, and will not, ignore the CFTC.

Here is how the CFTC-based enforcement program might work. The e-market would include within its subscriber agreement all of the ethical standards required by federal law. It would maintain a compliance, market surveillance and investigative capability (or outsource it to an expert agency like the NFA) to detect suspected misconduct by subscribers and, for good cause, to terminate their access rights. The matter and the relevant evidence would be referred by the e-market (or the NFA) to the CFTC either as or after this process takes place and, because the violations are also offences under the federal statute, the CFTC would have jurisdiction to prosecute the case. Figure six illustrates the use of the CFTC as the e-markets' enforcement arm.

I suggest that this role can be assumed by the CFTC without any strain on its budget or staff. The conversion from brick-and-mortal, trader-controlled exchanges to the new e-markets will reduce substantially many of the violations that consumed large parts of the CFTC's budget in the past. Floor-based misconduct and member/owner self-dealing would cease to be of concern, while the ranks of intermediaries where other enforcement cases have concentrated would shrink as well. Fewer applicants should enter the registration process, fewer customer complaints should be lodged, and fewer of the CFTC's routine federal enforcement proceedings should be necessary. Therefore, accepting the core enforcement role for the e-markets will simply keep the CFTC busy.

Finding or abandoning clearing.

Having found a solution to the self-regulation gap, however, does not end the conversion process. As noted earlier, the members of brick-and-mortar exchanges could be relied on to fund the clearing house as well. In most cases, the larger member firms would mutualize among themselves the overall market risk of default by contributing to a common guarantee fund. Typically, these functions were operated on a non-profit basis; the aim was simply to reduce default risk, not to make a profit. The new subscribers to e-market systems are unlikely to agree to place their capital at risk in this way, nor are the company's shareholders unless clearing can be made a meaningful profit center within the enterprise.

Because most clearing systems have operated on a break-even basis, and those which tried to be profitable (like the former International Commodity Clearing House) were displaced by non-profit clearers, it is not self-evident that a clearing house can provide an attractive return for investors. This uncertainty is compounded by the fact that the CFTC has compelled the use of a clearing system for over 70 years without regard for whether or not it can be made profitable. On the other hand, if there is demand for the clearing house's credit enhancement and people are willing to pay for it, the laws of economics should cause those entities to come into existence either under the e-market's wing or independently.

Rank heresy number three

Do we really need clearing? Like a cushion that over the years has taken the contour of our body, we are used to clearing and find it hard to visualize a futures industry without it. But clearing is not the commercial norm. There is no third-party guarantee, for example, when we buy a car or a home or artwork or a sports franchise. If our supplier defaults, tough luck. When it is recognized that clearing on the scale to which we have grown accustomed is almost unique to the futures business, questioning how metaphysically essential it is makes some sense.

It is estimated that 80% or more of all futures transactions are conducted by corporations or other institutions with substantial assets and resources, including human capital with expertise and sophistication in the markets. These organizations conduct much of their non-futures derivatives business without a clearing system and are comfortable doing so. The spectacular growth of the swaps community attests to the willingness of these entities to trade trillions of notional dollars' worth of derivative instruments based merely on bilateral credit arrangements rather than a third-party guarantee. Do these significant entities really need clearing or, put into more commercial terms, will they be willing to pay clearing fees of a magnitude that would make the clearing system profitable? Maybe not.

Figure 6: E-trading exchange

CFTC enforcement model
[Evolving form]

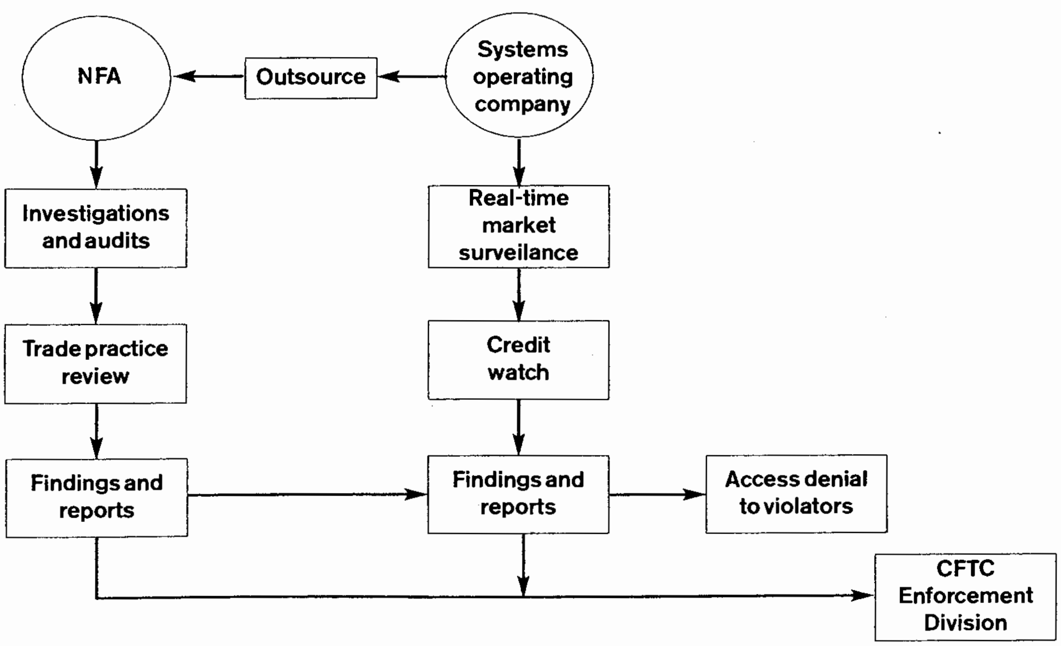
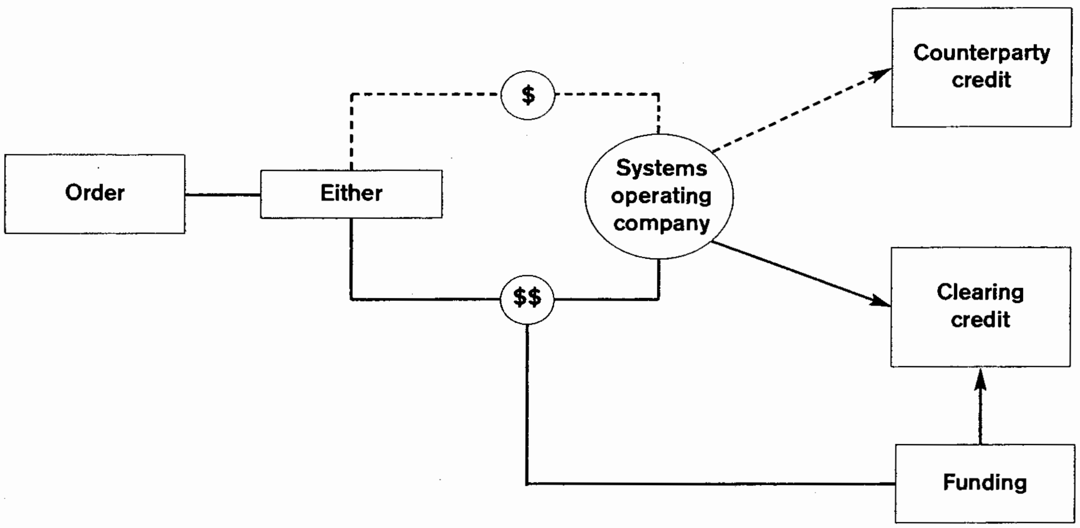


Figure 7: E-trading exchange

Optional clearing model
[Evolving form]



Of course, the swaps business is a relatively small world of highly-rated companies that are unlikely to default on their obligations. In a market environment open to the general public, on the other hand, the default risk is clearly far greater and participants might be willing to pay sizeable clearing fees in order to escape that danger. But, if 80% of market activity is conducted by the institutions discussed above, then only 20% (or less) is certain to demand clearing services. Can a clearing system be made profitable with that modest patronage? Maybe not.

While the CFTC has long considered a clearing house to be absolutely necessary for contract market designation - believing, in fact, that not having one would be contrary to the public interest - it may be time to re-examine that premise because the structures of e-markets do not lend themselves readily to performing this function, especially if it cannot be done profitably. As already observed, consumers are already exposed to default risk in their everyday lives, so the absence of a third-party guarantee in their futures activities should have little impact on their overall quality of life. As for the other 80% of transactors on the futures market that already conduct vast amounts of financial transactions without third-party credit enhancement, their behaviour speaks for itself.

As a result, it appears that the future of clearing will be dictated by the forces of supply and demand. It will exist if the market users - the e-trading subscribers - are willing to pay for it on a basis that is profitable for the provider(s), and it will not exist otherwise. The CFTC can attempt to dictate that feature even if it is commercially indefensible but no government can override for long the laws of economics. Recognizing that e-markets have superior qualities over the brick-and-mortar exchanges in regard to cost, speed, neutrality, and regulatory compliance, it would be bizarre for the CFTC to block these ventures and to try to perpetuate the old model simply because of an insistence on clearing which no one wants to pay for. Moreover, like creating an ineffectual mirage or hologram of self-regulation discussed above, the CFTC would be distracted from finding a real solution.

The solution is a free market one: Make clearing available but not mandatory so that those for whom the cost is justified will use it and those willing to take counterparty credit risk will demur. On this basis, suppliers such as banks and other credit institutions should be willing to step forward. Figure seven reflects this optional clearing model.

Conclusion

The transition from brick-and-mortar, trader-controlled exchanges to publicly-held, for-profit electronic trading systems is far more complicated than simply substituting another way to match orders. It cannot be finessed by referring to the new remote subscribers as members for statutory purposes, or treating the new public company as if it were an association of traders (a "board of trade" in legal terms). Regardless of how the old statute is interpreted, the fundamental problem is that the new e-market model simply cannot perform successfully the old functions that the Commodity Exchange Act expected of its brick-and-mortar, trader-controlled markets.

While existing law should remain in place until the transition is completed, there is a need now for a new regulatory statute that truly reflects the promise as well as the limitations of the emerging e-trading world. Electronic trading systems that are publicly owned and that are independent of the trading community simply cannot be expected to replicate the self-regulatory environment familiar to trader-owned exchanges, or to fund a clearing system if the demand for it is insufficient for profitability. If these functions are worth saving, new legislation is the best way to identify solutions that can actually work.

Sadly, the schedule of Congress is unlikely to accommodate such an effort in this election year. Hopefully it will be on the agenda next session. In the meantime, the CFTC should continue its open door policy and do the best it can with existing law, including the liberal use of its broad exemptive power to solve the many conundrums that it will face. ∎

Philip McBride Johnson is head of the exchange-traded derivatives group at Skadden, Arps, Slate, Meagher & Flom and a former chairman of the CFTC.