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FIA

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COMMENT

RECORDS SECTION

February 24, 2006

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

Re: February 15, 2006 Hearing on Self-Regulation in the U.S. Futures Industry

Dear Ms. Webb:

The Futures Industry Association submits this letter to supplement the record of the hearing on "Self-Regulation in the U.S. Futures Industry" conducted by the Commodity Futures Trading Commission on February 15, 2005. FIA greatly appreciates the Commission's devotion of considerable time and effort to this important issue.

Sometimes in the cross-talk and press of time at a public hearing, certain fundamental points may get overlooked. FIA has prepared this letter to reinforce these central themes and to respond more completely to some of the issues raised at the hearing.

In our view, the most important statement at the hearing came from Chairman Jeffery in his opening remarks: "Ultimately, self-regulation becomes irrelevant unless it fosters public confidence that SROs are fair and impartial, notwithstanding pressures that could potentially compromise the execution of their regulatory duties."[1] Since Congress has made "effective self-regulation" the stated purpose in Section 3(b) of the Commodity Exchange Act, Chairman Jeffrey is correct that the Commission can not allow self-regulation to become "irrelevant" and must be vigilant to ensure that self-regulation fosters public confidence in its fairness and impartiality. With that framework as the backdrop, FIA offers the following comments.

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1 Opening Remarks of Reuben Jeffery III, Chairman, Commodity Futures Trading Commission Hearing on Self-Regulation in the U.S. Futures Industry, Washington, D.C., February 15, 2006

1. Board Composition.

No one at the hearing offered any substantive reason why an exchange's board could not or should not be comprised of at least 50% non-industry directors.[2] As FIA has observed, the Chicago Mercantile Exchange is close now to that benchmark, with 7 out of 20 of its directors being non-industry participants. Harkening back to Chairman Jeffery's statement, would adding three more non-industry directors make the CME, at a minimum, seem to be more "fair and impartial," thereby instilling greater public confidence in its self-regulatory activities? And would adding those new directors, still leave 10 industry participants as directors, with significant knowledge and experience in the operation of the markets? FIA believes the answer to both questions is "yes." Surely that same answer would apply with even greater force to other exchanges, like the Chicago Board of Trade which has only two non-industry directors on its seventeen-person board or the New York Mercantile Exchange which has five non-industry directors on its now twenty-five person board.

Non-industry directors, of course, should not be confused with those that are "independent" of exchange management under the application of the New York Stock Exchange listing standards. While the NYSE standards are appropriate for assessing the independence of directors in a normal corporate context, exchange boards with self-regulatory powers and duties should be subject to a special "non-industry, public director" standard in order to foster confidence in their actions. This is critical to achieving the goal identified by Chairman Jeffery. No exchange member subject to the regulatory power of the exchange can or should ever be deemed to be a truly "independent or public" director of an exchange's board of directors for purposes of self-regulation.

Some testimony at the hearing concerned actions taken by an exchange's Executive Committee, rather than its Board of Directors. In some cases, the Executive Committee acts as a surrogate for the Board. For these reasons, FIA believes that non-industry directors must comprise no less than 50% of an Exchange's Executive Committee as well in order to share effectively the power of the industry directors on that Committee.

2. Regulatory Oversight Committees ("ROC").

FIA found the testimony of Dean Susan Phillips, a former Commission Chairman, to be compelling and convincing. Her experience as Chairman of the ROC at the Chicago Board Options Exchange provides a sound model for the Commission to rely upon in fashioning appropriate standards for the futures industry. The key to an effective ROC program is complete independence of the ROC's members through non-industry directors and complete independence of compliance staff, including hiring and compensation, from exchange business operations. FIA also believes that the Commission should consider strengthening the CBOE model by giving the ROC meaningful rulemaking authority in the areas of its self-regulatory responsibility, like

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[2] Some concern was expressed that smaller exchanges would find it too expensive to add a significant number of non-industry members to their boards. FIA believes smaller exchanges should first try to accomplish the 50% goal and then petition the Commission for an exemption if it becomes prohibitively expensive. Of course, any concerns raised by smaller exchanges do not justify failing to apply the 50% standard to the larger, major exchanges.

trading practices. Documentation of the ROC's activities and recommendations, subject to Commission oversight, would also provide greater public confidence in SRO actions and policies. Meetings between the ROCs and the Commission should be encouraged.

3. Exchange Rulemakings and Transparency.

FIA generally believes the exchanges' rulemakings should be more transparent. Exchanges should solicit the views and opinions of all members and market participants, not just a chosen few. A more transparent process will engender greater public confidence and should lead to better, more informed exchange policies.

Some hearing witnesses offered a spirited defense of exchange powers to self-certify rules as granted in the Commodity Futures Modernization Act of 2000. FIA would like to reiterate that we have not proposed repealing those powers generally. Rather, FIA has proposed a limited, targeted change ONLY in the case of rules that would affect the price of already trading contracts or that materially affect clearing members' risks, rights and responsibilities.

FIA believes it would improve current law to allow some form of transparent, expedited Commission review and pre-approval process in those special circumstances. No witness at the hearing identified any substantive problem with changing the law to require CFTC prior approval of these two kinds of special rules.

In fact, the hearing provided substantial evidence in support of FIA's recommended statutory change. In response to questions from Commissioner Dunn, witnesses explained that as a matter of internal practice in adopting rules, exchanges do not solicit comments from all members. No exchange stated that they solicit comments from their large clearing members. Instead, exchanges may have discussions with only a few exchange members, Commission staff and even Commissioners before submitting self-certified rules. As the hearing testimony revealed, the exchanges' current practice makes it impossible to comply with the Commission's requirement that it be notified of any dissenting views on self-certified rules. No one can dissent from something they don't know anything about.[3] In addition, if exchanges typically provide self-certified rules for a pre-submission review that is private, off-the-record and *ex parte*, the current Commission-exchange practice can hardly be called transparent or fully informed.

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[3] A good example of the nondisclosure of dissenting views occurred in 2003 when the Chicago Board of Trade took the major step of changing its clearing house from the Clearing Corporation to the Chicago Mercantile Exchange and self-certified many of the rules designed to accommodate that change. No opposing view was identified in the CBOT's self-certification submissions. As the Commission's records will reflect, however, many clearing firms did oppose the process followed by the CBOT for changing its clearing entity and eventually expressed that dissent in letters filed with the Commission after a three-day, non-Federal Register, comment period on one of the related CBOT rules. The key point is that since the CBOT had not tried internally to obtain the views of its clearing member firms, it could not submit any dissenting views with its self-certification. FIA's proposed statutory amendment includes rules that would change clearing member financial responsibilities in order to avoid a repeat of the 2003 experience. Any such material change in the obligations of clearing firms should be pre-approved by the Commission after an appropriate public comment period of no less than 15 days.

The need for the modest change on self-certification FIA has proposed was underscored by the testimony of the Chicago Board of Trade. CBOT President and CEO Bernard Dan confirmed that the CBOT, before adopting its recent Treasury Position Limit rules, consulted with "a multitude of regulators," as well as a "variety of users of the market," but "not necessarily users who represent customers who access the market." He claimed through this process the CBOT heard "both sides of a multitude of issues." Mr. Dan didn't explain why the CBOT was not interested in the view of those firms who do "represent customers who access the market." He also didn't explain why, if the CBOT heard a "multitude of views," it never disclosed any of those views in its self-certification letter on June 28, 2005. Last, he didn't explain why the CBOT would have been harmed if the same regulators the CBOT consulted before it submitted the Position Limit rules had conducted an expedited, pre-approval review, including public comment, after the rules were officially submitted on June 28, but before they went into effect.

Mr. Dan's testimony reconfirms that some market participants had inside knowledge of the CBOT's consideration of changes to the Treasury contracts and some (who represent customers) did not. He did not describe whether any of the participants the CBOT consulted actually held positions in the affected contracts, nor whether any of them was even cautioned against using the information obtained from the CBOT to their advantage. Because the rule change was adopted under the self-certification procedures, we will never know what conflicts might have existed and how they were handled by the exchange.

This situation illustrates well the kind of conflict of interest and unfair competition concerns the current self-certification regime and exchange practices seem to allow. It also illustrates why both Core Principles #15 and #18 on conflicts of interest and unfair competition are implicated whenever an exchange changes materially the rules of the game for an already trading contract. Prior Commission approval, as recommended in the FIA proposal, would be an effective way of addressing these concerns through an expedited CFTC approval process, which would include a conflict of interest analysis akin to what the Commission conducts when an exchange takes emergency action.[4]

4. Disciplinary Committees.

FIA continues to believe that increasing the participation of non-industry parties as decision-makers in the exchange disciplinary process is essential to enhance the credibility and at least perceived fairness of that process. National Futures Association seems to have found a

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[4] FIA agrees that the statute now authorizes exchanges to self-certify rules in the two special areas we have highlighted, including where the rules change contract terms and pricing dynamics for already trading contracts. But Congress in 2000 also directed Designated Contract Markets in Core Principle # 6 "to provide for the exercise of emergency authority." No witness at the recent hearing attempted to reconcile why Congress would have wanted exchanges to have emergency authority which they could always side-step through self-certification for non-agricultural contracts. FIA's recommended statutory amendment would not change exchange emergency powers in any way. It would therefore resolve the tension in current law by allowing exchanges to choose whether to adopt emergency measures for already trading contracts without Commission prior review or to self-certify other non-emergency rule changes for already trading contracts with Commission prior review.

sufficient number of qualified independent decision-makers to sit on disciplinary panels. If NFA has an adequate supply, it is difficult to imagine the exchanges would be hard pressed to tap into these independent sources as well. At the same time, exchange disciplinary panels should be constructed so that industry panelists bring to a particular proceeding relevant experience. It would make little sense for a panel comprised only of floor traders to sit in judgment of a futures commission merchant and vice versa. In order to address this issue of balancing independence and relevant market experience, FIA has suggested that the ROC, or the Chairman of the ROC (an non-industry Director like Dean Phillips), be charged with deciding who should sit on these panels. Based on the hearing testimony, that still seems to be a viable solution to address the concerns that have been raised about the disciplinary process. Finally, no exchange witness offered a substantive reason why "non-industry" persons could not or should not sit on disciplinary panels. FIA has proposed as a best practice that disciplinary panels should be comprised of at least 50% non-industry persons. In contrast, many exchanges have no "non-industry" panelists on disciplinary panels, as the hearing testimony confirmed. In today's world, the absence of any independent voice on these panels does not instill public confidence in self-regulation.

Conclusion

FIA again thanks the Commission and its staff for their work on these important issues. Our suggestions have been designed to achieve the common purpose of making self-regulation work better and increasing public confidence in its effectiveness. Chairman Jeffery recently observed in a speech to market participants, "as Vince Lombardi said about "winning, in the world in which you operate, 'reputation isn't everything; it's the only thing!'"[5] FIA agrees. Each of the reforms we have recommended should enhance the reputation of self-regulation throughout the futures industry consistent with the mandate Congress has given the Commission to make self-regulation "effective." We would be pleased to answer any further questions the Commission may have and to assist its deliberations in any way the Commission thought would be productive.

Sincerely,

John M. Damgard
President

cc: Honorable Reuben Jeffery, Chairman
Honorable Sharon Brown-Hruska, Commissioner
Honorable Michael Dunn, Commissioner
Honorable Frederick Hatfield, Commissioner
Honorable Walter L. Lukken, Commissioner

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5 Address by Reuben Jeffery III, Chairman, Commodity Futures Trading Commission, Managed Funds Association, February 7, 2006

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