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COMMENT

Ms. Eileen Donovan
Acting Secretary,
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Comment letter on "Regulatory Governance," Proposed Acceptable Practices, 71 Fed. Reg. 38740 (July 7, 2006)

Dear Ms. Donovan:

The Commodity Futures Trading Commission has requested public comment on its "Proposed Acceptable Practices for compliance with section 5(d)(15) of the Commodity Exchange Act." These proposals have resulted from years of thoughtful, extensive study by the Commission, with particular emphasis on addressing issues concerning modern corporate governance of self-regulatory organizations. The Futures Industry Association applauds the Commission's dedication to this important area and is pleased to submit these comments on the proposals.[1]

FIA's comment letter is divided into two parts. First, we respond to claims that the Commission would exceed its authority by adopting "Acceptable Practices" as a safe harbor under Core Principle 15. Then, we discuss the four main elements of the Commission's proposal: a) the definition of "public" director; b) the 50% public director board composition guideline; c) Regulatory Oversight Committees; and d) balanced disciplinary panels.

Overall, FIA commends the Commission for its reasonable and thoughtful proposed Acceptable Practices. As the Commission noted, its proposals enable designated contract markets (DCMs) to show "they are structurally capable of protecting their regulatory functions and decision making from conflicts of interest." 71 Fed. Reg. at 38743. While we have specific suggestions for improvements in some areas, and disagree with the Commission's conclusions in

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[1] FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 38 of the largest futures commission merchants ("FCMs") in the United States. Among our approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including U.S. and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators, other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members are responsible for more than 90 percent of all customer transactions executed on U.S. contract markets.

others, FIA appreciates the balance the Commission has struck in order to reaffirm how DCMs may best serve the "public interest" through "effective self-regulation," as called for under Section 3 of the Commodity Exchange Act. If adopted and implemented, FIA believes the Commission's Acceptable Practices would strengthen public confidence in the integrity and self-regulation of trading on DCMs.

1. Acceptable Practices Fit Well with Core Principles.

No one disputes that the Commodity Futures Modernization Act of 2000 added flexibility to the CEA's regime for Commission oversight of DCMs. By substituting DCM "Core Principles" for rigid statutory prescriptions, Congress replaced a "one-size fits all" regulatory structure with a more modern, elastic framework. Representative Thomas Ewing, an acknowledged architect of the CFMA, explained this new system well: "we allow U.S. futures exchanges to set their own course in operating their derivatives markets under CFTC oversight, but without the burdens of a regulatory regime designed for the mid-20th century." 146 CONG. REC. H10440 (Oct. 19, 2000).

Congressman Ewing's reference to "CFTC oversight" parallels the new statutory purpose Congress enacted in 2000: "It is the purpose of this Act to serve the public interests ... through a system of effective self-regulation of trading facilities ... under the oversight of the Commission." CEA § 3(b). As this congressional statement confirms, providing flexibility for DCMs did not mean the CFTC would become a bystander or abdicate its statutory authority. Instead, DCMs "shall comply with the core principles" in order to retain designation as DCMs (CEA § 5(d)(1)) and the Commission must oversee DCM compliance with the Core Principles.

Shortly after the CFMA was enacted, the Commission signaled how it would initiate its oversight. Rather than adopt rules and requirements that must be followed, Part 38 of the Commission's regulations contains Appendix B, entitled "Guidance on, and Acceptable Practices in, Compliance with Core Principles." For most Core Principles, the Commission fashioned both "guidance" on what a DCM application should include and Acceptable Practices for demonstrating ongoing compliance by DCMs. Appendix B explains how Acceptable Practices mesh with the statutory Core Principles:

> "Acceptable practices meeting selected requirements of the core principles are set forth in paragraph (b) following each core principle. Boards of trade that follow the specific practices outlined under paragraph (b) for any core principle in this appendix will meet the selected requirements of the applicable core principle. Paragraph (b) is for illustrative purposes only, and does not state the exclusive means for satisfying a core principle."

17 C.F.R. Part 38 (App. B)

As adopted by the Commission in 2001, Appendix B did not contain an Acceptable Practice for Core Principle 15. That statutory provision states: boards of trade operating DCMs "shall establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest." CEA § 5(d)(15). The Commission's proposal would simply add an Acceptable Practice to Appendix B for Core Principle 15. Like all other Acceptable Practices, it would provide a safe harbor for demonstrating compliance. Commissioner Michael Dunn, and the Commission itself, have explicitly confirmed that, if adopted, the proposed Acceptable Practice would not be the only method of demonstrating compliance with the Core Principle. 71 Fed. Reg. at 38743, 38750. Any fear therefore that the Commission is departing "from the CEA's clearly expressed policy directing the Commission to substitute normative regulation for the prior regime of prescriptive regulation,"[2] seems to be unfounded.

The proposed Acceptable Practices would be central to the Commission's DCM oversight powers. As the Commission recognized, Congress evidenced its commitment to a "system of effective self-regulation" by, among other things, requiring DCMs broadly to "minimize conflicts of interest in the decision making process." CEA §§ 3(b) and 5(d)(15). Consistent with those statutory provisions, the Commission's Preamble to the Acceptable Practices frames its purpose well (71 Fed. Reg. at 38749):

> "All designated contract markets ("DCMs" or "contract markets") bear special responsibility to regulate effectively, impartially, and with due consideration of the public interest, as provided for in Section 3 of the Act. Under Core Principle 15, they are also required to minimize conflicts of interest in their decision making processes. To comply with this Core Principle, contract markets should be particularly vigilant for conflicts between their self-regulatory responsibilities, their commercial interests, and the interests of their management, members, owners, customers and market participants, other industry participants, and other constituencies."

Surely each of the areas covered by the proposed Acceptable Practices -- the independence and composition of a DCM's board of directors, the creation of a special independent committee for self-regulatory oversight, and balanced disciplinary panels -- are rationally related to achieving a system of effective self-regulation based on a decision-making

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[2] Letter from Jerrold E. Salzman, on behalf of the Chicago Mercantile Exchange, Inc. to Ms. Eileen Donovan, Acting Secretary, Commodity Futures Trading Commission (July 17, 2006).

process that minimizes conflicts of interest. Thus, adoption by the Commission of its proposed Acceptable Practices for Core Principle 15 would be well-grounded in the agency's statutory authority.

2. The Commission's Four-Pronged Proposed Acceptable Practice for DCMs.

The proposed Acceptable Practices contain four basic elements: defining public directors, 50% Board composition, Regulatory Oversight Committees, and balanced disciplinary panels. FIA realizes that the Commission's proposal does not address every issue that might be raised in the area of conflicts of interest and self-regulatory organization governance.[3] However, FIA agrees with the Commission that its proposal does cover many key areas that are critical to effective self-regulation.

This conclusion stems from an almost universal endorsement of the need to address the inherent, structural conflict of interest many modern exchanges face. Traditionally, exchange boards of directors have faced conflict of interest considerations when an exchange attempts to self-police its members, their firms, or their customers. Those conflicts have been handled by exchanges through the adoption and application of sometimes controversial policies for the recusal of individual board members and other decision-makers. The purpose of these measures has been to ensure that each exchange board member acts in the best interest of the exchange as a whole, and not his or her own business interest or the interest of one group of members at the expense of another group of members.

In recent years, these kinds of "episodic" conflicts have been exacerbated by another form of exchange conflict, one that is institutional in nature. As exchanges have demutualized and become for-profit enterprises, a DCM's Board of Directors regularly confronts the following conflict, real or perceived: How to reconcile each Board member's legal duty to serve the interests of the exchange and its shareholders with that Board member's legal duty to serve the public interests through effective enforcement and performance of statutory self-regulatory functions? When these two legal duties conflict, how is the conflict resolved?

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[3] For example, the Commission's proposal does not provide a conflict of interest acceptable practice for a DCM when it acts to change contract terms and conditions in contracts with open interest. The Commission also has not proposed an acceptable practice for dealing with the conflicts of interest facing individual DCM directors or committee members which typically arise in a wide range of exchange activities, from emergency actions to exchange disciplinary matters. 71 Fed. Reg. 38743 n.27. FIA understands that the development of acceptable practices is, like self-regulation itself, a dynamic process and looks forward to the Commission's pro-active guidance on other issues as warranted.

Many futures exchanges have argued that this question presents a false choice because the interests of exchange shareholders and the public interest always are parallel. As the Commission documents, however, a world-wide consensus of opinion rejects that argument. 71 Fed. Reg. at 38741 n.10. Any DCM board "may have to make decisions in circumstances where its role as a fiduciary to the shareholders conflicts with its duty as a custodian of the public trust." 71 Fed. Reg. at 38745. Supporting examples abound: Should a DCM adopt an expensive, zero-tolerance rule enforcement and compliance infrastructure when doing so will erode exchange profitability and potentially share value? Should a DCM ease up on rule enforcement for traders that bring substantial trading fee revenue to the exchange? Should a DCM change trading rules for an already trading contract in order to benefit certain members or traders that bring substantial trading fee revenue to the exchange at the expense of those who trade less often?

These questions are not mere theory. Recent press reports describe one DCM that is now considering a plan to "slash expenses," including in the compliance area, as it prepares a "much-anticipated initial public offering this fall."[4] Members of that DCM are said to have concluded that its compliance department has "a bloated cost structure with tons of excess fat." Perhaps the DCM's compliance department does have too many resources, and perhaps it does not; that is not the point. The point is that board consideration of these kinds of decisions involves a trade-off between the shareholder's interests in maximizing profit and the public interests. As a result, DCM boards face exactly the kinds of institutional or structural conflicts the Commission and other objective observers have cited.[5] Those fundamental conflicts could taint DCM self-regulatory efforts no matter how long or how loud each DCM complains, "it would never happen here." It could, and someday it might. The Commission should not wait for that day before acting.

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[4] Zachery Kouwe, *NYMEX To Slash Its Work Force Before IPO*, New York Post, Aug. 22, 2006, http://www.nypost.com/php/pfriendly/print.php?url=http://www.nypost.com/business/nymex_to_slash_its_work_force_before_ipo_business_zachery_kouwe.htm

[5] 71 Fed. Reg. at 38741 n.10. Commissioner Michael Dunn has raised the issue of conflicts of interest on the boards of registered futures associations. 71 Fed. Reg. at 38751. The only such association, NFA, is not a for-profit enterprise and has no shareholders. Under Section 17 of the CEA, NFA also is not subject to Core Principles, making Acceptable Practices a difficult concept to apply to NFA. NFA does, however, perform self-regulatory functions for some exchanges that are for-profit. Nevertheless, NFA does not appear to raise the same types of conflict of interest concerns as DCMs and therefore should not be included in the Commission's current proposal. But Commissioner Dunn's point is well-taken that self-regulation generally involves potential conflicts of interest and NFA therefore is not excused from that concern. FIA supports the Commission's decision to consider that issue separately in the future. 71 Fed. Reg. at 38740 n.4.

Another common futures exchange refrain is that competition prevents substandard regulatory performance; if an exchange elevates trading revenue and share value over market integrity and enforcement, it will lose its market to competitors that offer fair, well-regulated, and reliable trading markets. These exchanges argue the Commission need not provide structural exchange reforms to protect "effective self-regulation" because competition will do the job. To be sure, the CFMA was predicated on the promise of more direct product competition among exchanges and, as the Commission has noted (71 Fed. Reg. at 38740 n.8), competition among exchanges has increased in some areas. But generally an exchange that provides a liquid trading market in a particular product knows that its liquidity advantage will prevent any direct competitor from capturing trading volume, especially if the dominant and liquid market offers an efficient trading mechanism like electronic trading. Any exchange with a product that is traded on a liquid market can afford certain actual or perceived, regulatory or systemic, failures without a great risk of losing business. Thus, the fear that poor regulatory performance may cost an exchange competitively is more theoretical than practical, at least for now.

With this backdrop, the Commission's proposed Acceptable Practices can best be assessed in terms of how they address the perceived institutional or structural conflict of interest that permeates any demutualized, for-profit DCM's decision-making process. On balance, FIA believes the Commission has proposed a fair way, but not the only way, to minimize that conflict of interest.[6]

A. Public Directors Defined.

Before addressing the acceptable level of public director representation on an exchange's board, it seems best to consider who should qualify as a "public" director. The Commission has proposed a two-fold practice for DCMs. First, a public director must be found by a DCM's board and nominating committee not to have a "material relationship" with the DCM. A material relationship "is one that reasonably could affect the independent judgment or decision making of the director." Proposed Acceptable Practice 15(b)(2)(A), 71 Fed. Reg. at 38749.[7]

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[6] FIA reiterates that it would not support as a solution to this conflict of interest, at this time, either disbanding DCM self-regulation altogether or delegating all DCM self-regulation to a third party, independent professional regulatory body. FIA believes DCM self-regulation retains considerable value and that the Commission's proposal represents a balanced approach to promote and strengthen DCM self-regulation.

[7] The text of the proposed Public Director Acceptable Practice is as follows (71 Fed. Reg. at 38749):

"(A) To qualify as a public director of a contract market, an individual must first be found, by the board of directors on the record, to have no material relationship with the contract market. A "material relationship" is one that reasonably could affect the independent judgment or decision making of the director.

(B) In addition, a director shall not be considered "public" if any of the following circumstances exist:

(Continued...)

Second, the Commission has proposed a series of relationships that would bar a director from qualifying as a "public" director. The disqualifying relationships include individuals who are a DCM's officers, employees, members (or persons affiliated with or employed by a DCM's members). Proposed Acceptable Practice 15(b)(2)(B), 71 Fed. Reg at 38749. The proposal also would disqualify any individual who receives more than $100,000 in payments from the DCM or DCM affiliate (excluding compensation for serving as a director), or a DCM member or affiliate. *Id.* Each of these disqualifying circumstances would be subject to a one-year look back. Last, each DCM would list its public directors for the Commission and provide the basis for the determination that the listed directors meet the Acceptable Practices for public directors.

FIA is generally supportive of the Commission's proposal, although we had proposed a more stringent public director standard of no involvement with the futures or derivatives business. The "no material relationship" test has been used by other self-regulating exchanges, like the New York Stock Exchange, the Philadelphia Stock Exchange, the International Securities Exchange, and the American Stock Exchange, to provide reassurance that some directors are truly independent, with no preconceived bias, and will focus on serving the public

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(Footnote continued)

(i) the director is an officer or employee of the contract market or a director, officer or employee of its affiliate;

(ii) the director is a member of the contract market, or a person employed by or affiliated with a member. "Member" is defined according to Section 1a(24) of the Commodity Exchange Act and Commission Regulation 1.3(q). In this context, a director is affiliated with a member if the director is an officer or director of the member;

(iii) the director receives more than $100,000 in payments from the contract market, any affiliate of the contract market or from a member or anyone affiliated with a member, provided that compensation for services as a director will not be counted towards the $100,000 threshold test;

(iv) a director shall be precluded from serving as a public director if any of the relationships above apply to a member of the director's "immediate family," *i.e.*, spouse, parents, children, and siblings; and

(v) an affiliate includes parents or subsidiaries of the contract market or entities that share a common parent with the contract market.

(C) All of the disqualifying circumstances described in Subsection (2)(B) shall be subject to a one-year look back.

(D) A contract market shall disclose to the Commission which members of its board are public directors, and the basis for those determinations."

interest. Public directors that meet the "no material relationship" standard also help to remove any perception that the exchange board is the captive of any form of private interest, including a specific group or class of shareholders or members.[8]

FIA notes that at least one exchange -- the International Securities Exchange -- has adopted a more stringent set of disqualifying factors than the Commission has proposed. For example, ISE would not allow a director to be consider "public" if the director received any direct or indirect compensation from the exchange (exclusive of remuneration for serving as a director). For example, ISE would not allow a public director to serve as a paid consultant to the exchange in any way. The Commission's Acceptable Practices would allow a director to receive from the DCM $100,000 annual compensation for consulting or other professional services to the DCM and still qualify as a public director.

FIA believes the Commission should consider revising its safe harbor to adopt the "no payment" from a DCM approach. If a DCM decides to retain someone who is, or might become, a DCM director, and pays that person $100,000 for his or her services, it seems wrong to consider such a person to be eligible to be a public director as having no material relationship with the DCM. Surely someone retained by the DCM for $100,000 would have some allegiance at least to its management, and that allegiance could affect the independence of his or her judgment. Consistent with the goal set by the Commission of structuring every DCM "in a way that best fosters public confidence in the integrity of its organization" (71 Fed. Reg. at 38741), FIA urges the Commission to prevent any person from qualifying as a public director under the proposed safe harbor if that person has received any payments from a DCM or its affiliates.

Other issues arise from the proposal to disqualify any individual who "receives" from a DCM member or its affiliates "more than $100,000 in payments from ... a [DCM] member or anyone affiliated with a member." Proposed Acceptable Practice 15 (b)(2)(B)(iii), 71 Fed. Reg. at 38749. What does "receives payments" mean? For example, if an accountant or attorney did not receive payments directly from a DCM member, but the accountant or attorney was an employee of, or partner in, a firm hired by the member and that firm received more than $100,000 in payments for services from the DCM member, would the accountant or attorney be disqualified as a public director? FIA understands the $100,000 payment rule to disqualify any one who directly receives more than $100,000 in payments from a DCM member (or affiliate of

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[8] As FIA has noted in prior comment letters, while it is important that directors be "independent" of exchange management as required in public company listing standards on securities exchanges, those listing standards alone are not a sufficient test of "independence" for purposes of a DCM's board of directors. The Commission now has recognized too that the NYSE and NASDAQ listing standards "are not designed for public companies that also bear a special responsibility of public protection and fair and effective self-regulation." 71 Fed. Reg. at 38746.

the member), but not to disqualify an individual who is an employee or owner of a firm that receives more than $100,000 in payments from the DCM member. When the potential director's firm, rather than the director, receives the payment, it is unclear whether any, and if so how much, of the DCM member's payment was allocated to the individual who may serve as a public director. In those circumstances of "indirect payment or compensation" from a DCM member, FIA believes individuals should be eligible to be considered to be public directors under the no material relationship test.[9]

In addition, FIA asks the Commission to reconsider the proposed one year look back. The NYSE has a three year look back. The National Association of Securities Dealers relies on a two year look back for compensation to "public arbitrators." That "cooling off period" seems to be more in keeping with the thrust of the Commission's proposal. It is hard to imagine that a person who receives $1 million from a DCM today, for example, would be eligible to be considered a public director of that DCM only a year later. We recognize that the DCM's board would still need to vote to approve such a director as having "no material relationship" with the DCM, but we believe that allowing that director to be even considered a potential "public" director could undermine the purpose of the Acceptable Practices. A two year look back would be more realistic and effective, in our view.

Finally, FIA recommends that the Commission amend its proposed Acceptable Practices to provide that a subgroup of a DCM's public directors would serve as a nominating committee, or subcommittee, to select new or re-nominate existing public directors. This structure may assist the DCM in isolating the public directors further from the business side of the exchange. A public directors nominating committee also might be helpful in recruiting prospective qualified board members who will meet the "no material relationship" test.[10]

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[9] Under the Commission's Acceptable Practice proposal, an accountant, lawyer or other professional could receive $100,000 in annual payments from each of 10 members of a DCM (or more) and still qualify as a public director. It is not clear whether, as proposed, the $100,000 limit is per payor (DCM or its members) or a gross total amount of annual compensation. FIA believes the Commission intended an overall $100,000 cap, and suggests that the Commission clarify this point in its final rules.

[10] The Commission may also want to consider having public directors serve on DCM Board nominating committees generally. The work of those committees is extremely important to promoting effective DCM self-regulation. Adding a public director dimension to those committees would instill even greater public confidence in the nominating process and avoid concerns that DCM directors would be nominated as a reward for powerful business interests or groups at the DCM.

B. Composition of DCM Board and Executive Committee.

The Commission has proposed that at least 50% of a DCM's Board of Directors and Executive Committee (EC) should be public directors.[11] FIA strongly supports this benchmark. Any DCM with at least half of its Board and EC members having no material relationship with the DCM should dissuade any critics who believe the exchange is being run for the benefit of a chosen few or is otherwise not structured to serve vigorously the public interest in self-regulation. Robust public director representation on exchange boards would also be useful when individual conflict situations arise that may call for the recusal of many, if not all, of the industry directors on an exchange's board. FIA agrees with the Commission, however, that both Board and EC deliberations often are enhanced by the counsel and experience of Directors that are members of the industry. The Commission has proposed a balanced system that would offer DCMs a structure representing the best of both worlds.[12]

The Commission's Acceptable Practice is also readily achievable. As FIA has pointed out before, the Chicago Mercantile Exchange Board of Directors now is comprised of 20 directors with seven of those directors appearing to meet the test for a "public" director. Replacing three industry Board members with three public directors should not be a difficult transition to accomplish and would greatly enhance public confidence in the CME. Other for-profit DCMs also should be able to follow the CME's lead.[13]

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[11] The text of the proposed Acceptable Practice for Board Composition for DCMs is (71 Fed. Reg. at 38749):

"(A) At least fifty percent of the directors on a contract market's board of directors shall be public directors; and

(B) The executive committee (or similarly empowered bodies) shall be at least fifty percent public."

[12] FIA is aware that some exchanges have attempted to deal with the institutional conflict of interest issue by removing all industry directors from their Board. Every member of the NYSE Board except its Chief Executive Officer, for example, is an individual found to have no material relationship with the NYSE and, as Jeffrey Jennings of Lehman Brothers, testified on February 15, 2006, "it would be very difficult to argue that the NYSE is not viewed as a stronger institution today than it was a couple of years ago" (2/15/06 Transcript at 80). FIA would support any futures exchange that decided to adopt the NYSE model.

[13] FIA understands that some mutually owned or smaller exchanges claim they would find it difficult to meet the 50% public director threshold. Those concerns may or may not become valid once the Acceptable Practices are adopted and DCMs attempt to implement them. Any DCM that makes a good faith effort to embrace the Acceptable Practices, but is unable to do so, should then discuss with the Commission how best to structure its Board and Executive Committee to meet the goal of the 50% public director guideline. FIA would not want to see the composition requirement operate to harm smaller or mutually owned DCMs, or to reduce competition among DCMs, goals we expect the Commission would share.

Commissioner Frederick W. Hatfield has asked seven questions about the Board composition requirement and whether it is necessary. 71 Fed. Reg. at 38750.[14] Some of those questions overlap with other themes in the Commission's request for comment. FIA has attempted, however, to answer each question below.

Commissioner Hatfield's first question is the most important: "Is there an existing problem that this proposal addresses?" FIA's answer is "yes." The Commission's proposed Board Composition Acceptable Practice addresses a series of related problems. First, it addresses the problem that some futures exchanges claim that securities exchange listing standards designed to make sure that most of a corporation's directors are independent of its corporate management are sufficient to address the institutional conflicts faced by DCMs. The Commission has concluded that this claim is mistaken. See 71 Fed. Reg. at 38746. The Commission's proposals on Board Composition and the related "public" director definition directly address this problem by rejecting the exchanges' argument. Second, the Commission's proposal addresses the problem that DCM boards generally do not have nearly the same level of public director participation as securities exchanges, leaving the misimpression that futures exchanges are either less vigilant about self-regulation or are still run "by the powerful members

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[14] Commissioner Hatfield asked:

1) Is there an existing problem that this proposal addresses?

2) Will those exchanges that are not now subject to mandatory diversity requirements feel compelled to sacrifice voluntary diversity in order to increase the percentage of public directors and still maintain boards that are of manageable size, or will boards become larger? Is it feasible to comply with the acceptable practice and maintain the proper level of diversity? What are the relative costs and benefits of doing so?

3) How would the acceptable practice affect mutually owned exchanges that are subject to the mandatory diversity requirements of Core Principle 16?

4) How would the proposed requirement that exchange executive committees have at least fifty percent public representation affect the day-to-day operations of the exchanges?

5) Is there any evidence that the proposed Board Composition Acceptable Practice will provide greater regulatory assurance than the proposed ROC and Disciplinary Panel Acceptable Practices?

6) Do the corporate governance requirements currently applicable to publicly traded exchanges, combined with properly structured ROCs and disciplinary panels and continuing Commission oversight, provide sufficient assurance that conflicts of interests will be kept to a minimum in the decision making process of those exchanges?

7) If the Commission adopts the Board Composition Acceptable Practice, should it be accompanied by a phase-in period and if so, what would be the appropriate length of time for exchanges to modify their boards?

for the powerful members," rather than to serve the public interest. Third, the Commission's proposal addresses the problem that, until now, the Commission has not provided a safe harbor Board composition guideline for DCMs under the Core Principles, resulting in disparate, and in some cases paltry, levels of "public" director participation on the Boards of even major, demutualized, for-profit DCMs.

Commissioner Hatfield next asks whether the Commission's proposal would leave some exchange constituencies without representation on the Board or require a major expansion of exchange boards. In FIA's view, neither should occur. The Commission's proposal leaves considerable flexibility to the exchange in how it wants to address diverse interest groups that populate the exchange and does not specify any fixed number of board members.[15]

FIA shares Commissioner Hatfield's concern that mutually owned exchanges not be disadvantaged by the Commission's proposal. At this stage, until those exchanges attempt to meet the 50% standard, it is unknown whether they could meet that standard fairly easily. In FIA's view, they should try first and, if difficulties arise, discuss an appropriate accommodation with the Commission. The goal of increasing public confidence in DCM decision making, however, should apply with equal force whether a DCM is, or is not, mutually owned.

Modern communications technology should be able to diminish any concerns that selected public directors could not effectively participate in regular deliberations of an exchange's EC, even if the public directors serving on the EC are not located in the same city as the DCM itself. The Board composition guideline also complements the Commission's ROC and disciplinary panel proposals by providing a pool of public director talent for each DCM to draw upon in meeting the other safe harbor elements. The Board composition standard should therefore be viewed as part of an integrated package of Commission proposals, not as a competing substitute for those other features, as Commissioner Hatfield suggests.

In terms of phasing-in the proposal, FIA would expect that each DCM and the Commission could work out an acceptable timetable for implementation. The safe harbor Acceptable Practices are not absolute requirements; they are simply one way to demonstrate compliance with Core Principle 15, as enacted by Congress.

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[15] Some commenters have already questioned whether the proposed Acceptable Practices would preclude commercial hedging or trading interests from being represented on the DCM's Board. FIA understands the Commission's proposal to allow non-member producers, hedgers or members of the trade to be considered public directors unless they are paid more than $100,000 by the DCM or its members. In our view, the Commission's proposal might actually increase trade and producer representation on DCM boards, not decrease it as some have feared.

C. Regulatory Oversight Committee.

The Commission's ROC Acceptable Practice "recognizes the importance of insulating core regulatory functions from improper influences and pressure stemming from the exchange's commercial affairs." 71 Fed. Reg. at 38744. As proposed, each DCM would establish a ROC as a standing committee of its Board of Directors. The Members of the ROC would be comprised exclusively from public directors of the DCM. The Commission lists nine DCM self-regulatory functions for the ROC to oversee (71 Fed. Reg. at 38744) as well as a variety of actions the ROC should be empowered to take.[16]

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[16] The text of the Commission's proposed Acceptable Practice for a ROC is as follows (71 Fed. Reg. at 38749):

"(A) A board of directors of any contract market shall establish a Regulatory Oversight Committee ("ROC") as a standing committee, consisting of only public directors as defined in Section (2), to assist it in minimizing potential conflicts of interest. The ROC shall oversee the contract market's regulatory program on behalf of the board. The board shall delegate sufficient authority, dedicate sufficient resources, and allow sufficient time for the ROC to fulfill its mandate.

(B) The ROC shall:

(i) Monitor the contract market's regulatory program for sufficiency, effectiveness, and independence;

(ii) Oversee all facets of the program, including trade practice and market surveillance; audits, examinations, and other regulatory responsibilities with respect to member firms (including ensuring compliance with financial integrity, financial reporting, sales practice, recordkeeping, and other requirements); and the conduct of investigations;

(iii) Review the size and allocation of the regulatory budget and resources; and the number, hiring and termination, and compensation of regulatory personnel;

(iv) Supervise the contract market's chief regulatory officer, who will report directly to the ROC;

(v) Prepare periodic reports for the board of directors and an annual report assessing the contract market's self-regulatory program for the board of directors and the Commission, which sets forth the regulatory program's expenses, describes its staffing and structure, catalogues disciplinary actions taken during the year, and reviews the performance of disciplinary committees and panels;

(vi) Recommend changes that would ensure fair, vigorous, and effective regulation; and

(vii) Review regulatory proposals and advise the board as to whether and how such changes may impact regulation."

FIA supports the Commission's proposed ROC Acceptable Practice. We believe the ROC structure, functions and powers set out by the Commission will greatly enhance self-regulation by DCMs. In particular, FIA supports authorizing, and even encouraging, the ROC to retain counsel and other professionals that are independent of the DCM. Independent professional assistance is vital to allowing the ROC to provide an informed, objective voice to the DCM Board on self-regulatory matters. FIA urges the Commission also to build into its ROC Acceptable Practice a standard of experience and expertise for the public director chosen to be the Chairman of the ROC. A good example is the Chairman of the CBOE's ROC, former CFTC Chairman Susan Phillips. Her testimony at the Commission's February 15, 2006, hearing showed that exchanges can find qualified public directors with sophisticated regulatory knowledge that will strengthen DCM self-regulatory efforts.

FIA also supports granting a DCM's ROC the power to hire, supervise and determine the compensation of the DCM's Chief Regulatory Officer (CRO), and set (or at least recommend to the Board) the DCM's annual self-regulatory budget.[17] The ROC and the CRO should work closely to make certain that a DCM allocates sufficient resources to address any self-regulatory needs. An effective ROC-CRO relationship is, we believe, vital to achieving effective self-regulation as the Commission envisions.

FIA does request that the Commission clarify its ROC proposal in one area: exchange rules. As proposed, it would appear the Commission contemplates that the ROC would merely review rule changes or new proposed rules and advise the full Board on those rules, rather than initiate rule changes or new proposals for the DCM. FIA recommends that the Commission expand the ROC's duties to play a more formal and integral role in the DCM rule adoption process. At the Commission's February 15, 2006, hearing, one area of expressed concern was the lack of transparency in exchange rule makings.[18] As discussed by Commissioner Dunn and Michael Schaefer of Citicorp, this lack of transparency often even complicates DCM compliance with existing CFTC rules. Commissioner Dunn pointed out that CFTC Rule 40.6(a)(3)(iv) requires DCMs that are self-certifying a rule to provide to the Commission: "A brief explanation of any substantive opposing views expressed to the registered entity by governing board or committee members, members of the entity or market participants, that were not incorporated

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[17] The Commission's proposal appears merely to allow the ROC to review the self-regulatory budget and to comment on it to the Board.

[18] Michael Schaefer of Citicorp Global Markets testified on February 15, 2006, that an important role for the ROC in DCM rulemakings was necessary because a DCM may even compete with the member firms it is regulating and the DCM could adopt rules to harm its member competitors. (2/15/06 Transcript at 175-176). In light of this competitive circumstance, Mr. Schaefer stated exchanges "have a responsibility not just to be fair but to observe scrupulously even the appearance of fairness."

into the rule." Mr. Schaefer explained that requirement implies a level of DCM transparency allowing it to "know what the opposing views are in order to explain it to the Commission." (2/15/06 Transcript at 206). In the absence of general awareness at the DCM of a proposed rule change, obtaining any opposing views from members and market participants is not possible.

FIA strongly supports more transparency for DCM rulemakings. No exchange replicates an Administrative Procedure Act-type, notice and comment process for its rulemakings, and the Commission is not requiring it. To address the transparency concern, however, FIA believes the safe harbor should include a provision requiring the ROC to consider and approve any new DCM rule or rule change.[19] This process should encourage the exploration of any dissenting views that are raised by members or market participants to the ROC, consistent with CFTC Rule 40.6. ROC rulemaking powers also would reduce the risk that some exchange rules would be adopted to help some market participants and hurt others.[20] Of course, the ROC could call upon the technical assistance of the CRO, his or her staff and independent professional advisors, as warranted.

If the Commission is not willing to call for ROC approval of all DCM rules and rule changes, it should consider amending its safe harbor to require the ROC to approve only those new DCM rules or rule changes the DCM decides to self-certify to the Commission. DCM rules and rule changes that are submitted for affirmative Commission pre-approval would not need to receive ROC approval. This guideline would ensure that a commercially disinterested and independent body, either the Commission or the ROC, would review and approve every DCM

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[19] Former Chairman Phillips testified on February 15, 2006, that the CBOE's ROC "does not do rule writing." 2/15/06 Transcript at 133. But securities exchanges that adopt new rules or change rules must submit them to the Securities and Exchange Commission for approval, as well as notice and comment under the Administrative Procedure Act. Since the CEA has a far more opaque and flexible scheme for DCM rule approvals based on DCM self-certification, it would be logical to empower a DCM's ROC to play a greater, more formal role in futures exchange rule makings than their securities exchange counterparts.

[20] FIA understands that the Chicago Mercantile Exchange has attempted to put some distance between its commercial and regulatory operations by having its Board of Directors delegate its rule making powers to the Board Chairman, the Chief Executive Officer and the Chief Operating Officer acting together. Separating commercial and regulatory operations is a laudable goal, one that would be enhanced by increasing the ROC's rule making powers beyond a mere advisory role, even under the CME's delegation structure. Of course, any new DCM rule or rule change is still subject to Core Principle 18 which calls for the DCM to avoid imposing any "unreasonable restraints of trade" or "material anticompetitive burden on trading." CEA § 5(d)(18). The Commission has not promulgated an Acceptable Practice or safe harbor under Core Principle 18 but it logically may be understood to preclude any DCM from acting to favor competitively one group of market participants over another.

rule or rule change before it goes into effect. In that way, the proposal would further isolate a DCM's self-regulatory activity from those with business activities on the DCM.

D. Disciplinary Panels.

No self-regulatory subject involves a greater disconnect between rhetoric and reality than the composition of DCM disciplinary panels. Everyone agrees that the legitimacy and fairness of exchange discipline is crucial to effective self-regulation. Everyone also agrees that the composition of disciplinary panels is a major factor in achieving legitimacy and fairness. At the Commission's February 15, 2006, hearing, every DCM witness testified in favor of diverse, balanced, and knowledgeable disciplinary panels, with some DCMs even accepting the value of including public or non-DCM members on their panels. From this testimony, no objection could be expected to the Commission's proposed safe harbor Acceptable Practice that calls for "disciplinary panel composition rules that preclude any group or class of industry participants from dominating or exercising disproportionate influence on such panels."[21]

Yet the reality reported by many futures commission merchants is that many DCMs regularly do not meet that proposed Acceptable Practice standard. According to these firms, when FCMs face charges they often find that many DCM disciplinary panels are structured to favor the interests of one set of DCM members (generally floor traders and other liquidity providers) over those of FCMs and their customers.[22] In this way, many DCM disciplinary panels convey the appearance of self-interest and the real possibility that a respondent will be judged primarily by people whose futures trading business experience is quite different from that of the respondent. In short, these panels are neither truly balanced nor knowledgeable.

These criticisms are leveled at many DCMs, but not all. FIA member firms report that the Chicago Mercantile Exchange, for example, has implemented disciplinary panel composition requirements that promote fairness, balance and informed decision-making. These reports

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21 The text of the Commission's Proposed Acceptable Practice for Disciplinary Panels is (71 Fed. Reg. at 38749):

"All contract markets shall minimize conflicts of interest in their disciplinary processes through disciplinary panel composition rules that preclude any group or class of industry participants from dominating or exercising disproportionate influence on such panels. Contract markets can further minimize conflicts of interest by including at least one person who would qualify as a public director as defined in Section (2) above, on disciplinary panels, except in cases limited to decorum and attire. If contract market rules provide for appeal to the board of directors, or to a committee of the board, then that appellate body shall also include at least one person who would qualify as a public director as defined in Section (2) above."

22 As Mr. Jennings testified on February 15, 2006: "our experience has been that there can be very high levels of concentration on panels amongst very particular industry participants or groups." (2/15/06 Transcript at 265).

confirm the Commission's findings about disciplinary procedures at the CME, including the value of having three required non-member panelists. 71 Fed. Reg. at 38747. The dichotomy of experiences reported on CME and other DCMs and the importance of this issue to effective self-regulation suggest that the Commission should reconsider its view that "significant new measures are not required at this time." Id. FIA believes that modernizing the DCM disciplinary process through Acceptable Practices can be achieved, as the CME has shown, without sacrificing experience or expertise.

Specifically, FIA recommends that more than one public, independent member of an exchange disciplinary panel should be a pre-requisite for safe harbor relief; a 50% public, independent members standard for disciplinary panels would be much more in keeping with the spirit of the Commission's Proposed Acceptable Practices. The other half of the disciplinary panels should be populated by members with different market functions and business perspectives, including some members who are part of the same category as the respondent in order to reflect better market realities and practices. The more public member participation the Acceptable Practices include (up to 50%) the more likely that safe harbor will be seen as restoring confidence in the integrity of exchange discipline.

With respect to achieving the goals of balance and expertise on disciplinary panels, FIA also would recommend adding to the duties of the ROC (or its Chairman) responsibility for approving the composition of DCM disciplinary panels. The ROC's participation should help to ensure that no group or class of industry participants is dominating or exercising disproportionate influence on such panels or is perceived to be doing so.

Conclusion

The Commission has studied the best way to achieve the congressional goal of "effective self-regulation" for many years and FIA has filed many comment letters in that process. The proposals the Commission has published represent a truly even-handed approach, consistent with its statutory authority, to minimize many forms of DCM conflicts of interest and to modernize vital DCM self-regulatory structures. FIA greatly appreciates the efforts of the Commission and its staff and looks forward to the promulgation by the Commission of Acceptable Practices in this most important area.

Very truly yours,

John Damgard
President