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16 April 1999

COMMENT

Dear Ms Webb

PROPOSED RULES ON U.S. ACCESS TO OVERSEAS AUTOMATED BOARDS OF TRADE

Introduction

The Financial Services Authority (FSA) has read with interest the Commodity Futures Trading Commission's (CFTC) proposed rules relating to permitting the use in the United States (U.S.) of automated trading systems providing access to electronic boards of trade otherwise primarily operating outside the U.S. (proposed rule 30.11) and also to permitted customers wishing to trade on or subject to the rules of the automated trading system located in the U.S. (proposed rule 1.71a). The purpose of this letter is to give the CFTC our considered response to the draft rules.

The globalisation of financial markets and the development of cross-border electronic commerce represent a major challenge to financial regulators and legislation which – at least for the foreseeable future – will continue to be constituted on national lines. The release of these proposed rules has had the useful effect of raising the many associated issues for debate, not only in the U.S. but also internationally. In addition to the FSA's own regulatory interest in this issue, there is clearly a strong and separate commercial interest on the part of many market institutions. The CFTC's recent correspondence with Brian Williamson, Chairman of LIFFE, and those from the British Embassy in Washington demonstrate just how much importance LIFFE and the other UK exchanges attach to this matter.

The FSA supports the CFTC's attempt to bring clarity to this area of regulation. We hope that there is general recognition of your efforts from other interested parties so that you will be able to implement the new framework with minimum delay. We fully appreciate that the CFTC will need time to consider its response to comments it receives, including those that are set out below. However, we hope that the significant amount of time that you have already devoted to consultation on this issue (particularly in last year's concept release)

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means that your response, and the final rule, can be published soon after the end of the 30-day comment period. Certainly, we feel that the points that we raise can be dealt with quite quickly, particularly if the CFTC feels that it can place greater reliance on the FSA as a comparable home regulator.

Against the background of a continuing freeze on interim relief to allow U.S. access to non-U.S. automated exchanges, the speed of the CFTC's response is particularly relevant to those exchanges waiting for the new framework to be in place before placing terminals in the U.S.. Consequently we welcome your commitment to treat all exchanges equally, namely by assessing all exchanges against the new framework.

Guiding principles

It is important to establish from the outset why the FSA is making comments on the CFTC's proposed rules. First, the cornerstone of the proposed approach is an assessment by the CFTC of the comparability of the regulatory regime in the home country of exchanges petitioning for an exemption to place screens in the U.S.. Thus, to the extent that UK exchanges petition the CFTC, the FSA's approach will have to be assessed for comparability. Therefore it is essential to extend our views on those aspects of the proposed rules that will impact directly on us.

Second, we believe that it is essential to work with the CFTC (and other regulators) to ensure efficient regulatory outcomes for all those affected by the proposed rules – investors, intermediaries, exchanges and, given ever increasing demands for scarce regulatory resources, ourselves. Thus we support the CFTC's general approach of assessing whether an overseas regulator's regime delivers comparable protection for U.S. investors and subsequently relying on that regulator. That said, we believe that the approach set out in the proposed rules will involve some unnecessary duplication of regulatory efforts for the CFTC, the FSA and the exchanges.

We have therefore set out below some practical suggestions as to how we believe the CFTC's proposed rule could be modified easily while leaving the basic premise – that U.S. investors should enjoy comparable protection when the entry of an order occurs on a computer or other automated device of an overseas exchange in the U.S. – intact. In addition there are a number of issues on which we would welcome some further clarification.

Comparable regulation

We have noted, and support, the CFTC's intention to recognise certain regulatory regimes as providing protection to U.S. investors comparable to that provided by the CFTC. We presume that the CFTC considers the FSA regime to be a 'comparable' regime for the purposes of these proposed rules.

However, there is scope for different approaches to determine what constitutes a "comparable" regime. One approach is to focus on the inputs, in other words the various elements of the regulatory process. Thus, if the elements of the regulatory process are the same in the home and host country, the home country can be deemed comparable. The alternative approach is to look at the outputs, namely what the regulatory regime is designed to achieve and whether it does so. The first approach is more straightforward, but risks overlooking national factors (such as legislation, history, institutional structure) which make

a like-for-like comparison impractical. The second is potentially more time-consuming initially but - in our view – ultimately delivers a more efficient outcome.

To illustrate the possible efficiency gains, we comment on four particular examples. First, the proposed approach to the recognition of a comparable regulatory regime. Second, the proposed approach to IT systems. Third, the proposals on AORSs. Fourth, the potential for a DES to be required by the CFTC to become a U.S. designated market.

1. In effect, the CFTC need only make one assessment of the comparability of an overseas regulatory regime, to coincide with the first application by an exchange from that country. We hope that it is possible to amend the proposed rules to reflect this, or for you to find a way of indicating that this is how the CFTC will approach the matter in practice. The FSA stands ready to provide the CFTC with all relevant information concerning the regulatory structure under which UK exchanges operate, although I trust that you have all that you need already. We can pass information directly to the CFTC. This will remove the need for several UK RIEs to provide the same information in their initial application.

2. In respect of the proposed approach to IT systems, the CFTC should be able to rely on the home regulator's regulatory assessment of systems and could dispense with the various relevant requirements in the proposed rules. This would recognise that – in some cases – the supervisory output can still be the same.

   As you know the FSA (SIB at the time) has endorsed the IOSCO principles for the regulation of screen-based trading. Consequently, the fact that the FSA does not explicitly "certify" that an exchange's systems comply with the principles should not pose you any practical difficulties.

3. In respect of the proposed rules on AORSs, we are concerned that the proposed approach leaves little room for recognition that the overall regulatory framework in the home state of a non-U.S. AORS may be such as to deliver sufficient protection to U.S. investors. Is it not possible for the CFTC to look to the nature of (comparable) regulation in another jurisdiction on this matter?

   More specifically, further clarification of the U.S. regulatory position under the proposed rules, for foreign brokers and exchanges providing order routing systems for U.S. clients would be helpful. It appears that Rule 30.10 firms could be subject to an extra layer of regulation under proposed Rule 1.71(a).

   In addition, the consistency of the decision to exclude telephoned orders to an employee of an FCM or Rule 30.10 firm from the definition of an AORS is not clear, particularly in the absence of a requirement for the nature of the human intervention to be substantial (which would be consistent with the terminology used in the definition of an AORS). It would be useful to have an understanding of your thoughts on this and some clarification on questions such as whether an e-mailed order to an employee of a FCM or Rule 30.10 firm would be treated differently to a telephoned order.

4. Finally, the proposals for the CFTC to maintain a capacity to require a DES to become a U.S. designated market seem to call into question the cornerstone of the CFTC's proposed approach, namely the recognition of comparable regulation. It seems to us that once the CFTC has judged that an overseas exchange is properly regulated in its home

jurisdiction and can therefore place terminals in the U.S., there is no reason to question that judgement in response to either an increase in business volume or physical presence.

We press this point due to the potential uncertainty created in the proposed rules for exchanges, including the UK RIEs. It is possible, due to the total size and volume traded in many markets in the U.S., that the U.S. reported volume of overseas exchanges' business could become the significant proportion of their business over time. Moreover, it is reasonable that an exchange with a DES may wish to retain some form of marketing capacity in the U.S., particularly when developing new business.

The possibility that all such business development could necessitate designation as a U.S. market, may constrain or slow innovation unnecessarily. Again, we are concerned with the possible loss of efficiency in this outcome. We are aware that the CFTC is aiming to prevent U.S. boards of trade from exploiting the proposed rules to avoid direct CFTC regulation. Consequently, in respect of non-U.S. exchanges, we believe it would be possible for the CFTC, at the point of granting the exemption, to explain the specific factors which the CFTC would take into account when reaching a decision on whether or not to require designation of that individual exchange. On a point of detail, we believe that an overseas exchange should be given the option to confine the calculation of the volume of business emanating from the U.S. to transactions originated in the U.S.. This would exclude any business routed from one country through a terminal in the U.S. on its way to an exchange in a third country.

Information sharing

It is important that the CFTC move swiftly to confirm that the current information sharing arrangements between us are 'satisfactory' for both the DES and AORS regimes. We would be surprised if they were to prove unsatisfactory.

Nevertheless, in the event that the CFTC is not entirely satisfied with the current information sharing arrangements, we will need to negotiate a further agreement. If this is necessary, we would like to avoid the negotiation of a new agreement every time, for example, an RIE wishes to obtain DES status or develop its DES business in any way. Instead, we should plug any information sharing gaps in one ex-ante agreement, that removes the need for further agreements. We would like any such agreement as may be needed to be concluded swiftly, so as to avoid delaying any exemption order. We recognise that such an agreement may ultimately require further amendment, for example as market structures/technologies evolve. But this should not prevent us from concluding a durable agreement now.

Reciprocity

The FSA supports the CFTC's decision not to 'impose a requirement that a particular petitioner's home country jurisdiction extend reciprocity to U.S. exchanges' automated trading systems'. Against a background of straightforward access to the UK for overseas exchanges (that of course has benefited greatly many U.S. exchanges), you will appreciate that the UK had nothing to lose from the imposition of such a requirement. It is our view that investors and market efficiency generally suffer under reciprocity requirements.

Consequently, even though UK markets have not enjoyed similar access to all other, important, overseas jurisdictions, including the U.S., the UK has avoided demanding reciprocity when granting access to its own jurisdiction.

Comparison with UK approach

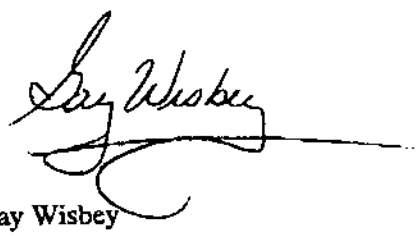
In the discussion that accompanies the proposed rules, the CFTC notes that its proposed approach is broadly equivalent to the UK regime for access to foreign automated exchanges. Although this comparison holds in terms of the basic approaches – which both rely on the regulator in the home jurisdiction - we are not entirely comfortable with this analogy. This is for two reasons. First, although it is cited as being so, the Recognised Overseas Investment Exchange (ROIE) regime is not the only basis for foreign electronic exchange access to the UK. The exemptions for overseas persons could be used by overseas exchanges to provide cross-border electronic trading facilities to UK persons, without necessitating either authorisation or exemption under the Financial Services Act 1986 (FS Act). In general, the regime can only be used if the UK persons using the facilities directly are authorised or exempt under FS Act, or there is no breach of the FS Act marketing restrictions.

Second, despite the similarity of approach between the ROIE regime and proposed DES regime, there are also material differences that do not support a claim of broad equivalence. Specifically, the initial and ongoing (reporting) requirements of a foreign exchange are less onerous under the ROIE framework than they are under proposed Rule 30.11. reflecting the greater reliance the UK places on the home regulator of a foreign exchange. A copy of Her Majesty's Treasury (HMT) guidance for ROIE applicants is attached. In summary, the main differences in reporting requirements in the UK from those proposed by the CFTC include:

- no explicit systems requirements;
- no regular requirements for turnover data;
- annual rather than quarterly reporting of information; and
- no specific trigger for notifications of events such as defaults and systems failures.

There is also a general commitment by HMT to try to process applications within 3 months.

We hope that you will find these comments useful and we would be happy to discuss them further with you.



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