99-32

FUTURES INDUSTRY ASSOCIATION INC.
2001 Pennsylvania Avenue N.W. • Suite 600 • Washington, D.C. 20006-1807 • (202) 466-5460
Fax: (202) 296-3184

(2)

October 15, 1999

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

Re: Exemption from Registration for Certain Futures Commission Merchants and Introducing Brokers, 64 Fed.Reg. 46618 (August 26, 1999)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments on the proposed amendments to the Commodity Futures Trading Commission's regulations governing foreign futures and foreign options transactions, 17 CFR Part 30. FIA, a not-for-profit corporation, is a principal spokesman for the futures industry. Its members include approximately sixty of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

Proposed rule 30.12 is designed to codify and amend procedures by which certain institutional customers of a FCM may place orders directly with a foreign affiliate that carries the FCM's customer omnibus account ("foreign order transmittal procedures"). These procedures currently are set forth in two advisories that the Commission's Division of Trading and Markets ("Division") issued in 1993 and 1994. Advisory 93-115, [1992-1994 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶25,932 (December 20, 1993), establishes the procedures that a FCM and its affiliate must follow, if the affiliate has qualified for an exemption from registration with the Commission pursuant to Commission rule 30.10. Advisory 95-08, [1994-1996 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶26,300 (December 22, 1994), establishes the procedures for those affiliates that have not qualified for an exemption under rule 30.10.

As the *Federal Register* release accompanying the proposed rule indicates, the Executive Committee of FIA's Law and Compliance Division ("Law and Compliance") has worked closely with the Division staff over a period of several years seeking to develop amended foreign order transmittal procedures. Law and Compliance's efforts culminated in a letter to the Division in February 1999, in which Law and Compliance described the reasons why the current procedures do not provide adequate relief and proposed specific amendments to the foreign order transmittal

procedures in order to reflect more accurately the needs of institutional customers in a global market environment.[1]

In brief, Law and Compliance recommended that the procedures be amended to: (1) permit FCMs that do not have affiliates in particular foreign markets to take advantage of the foreign order transmittal procedures with respect to those markets; (2) permit an institutional customer to place orders for execution with a foreign executing broker to be given up to the FCM's foreign clearing broker; and (3) permit a wider class of institutional customers to take advantage of the procedures. The recommended amendments would also eliminate certain other restrictions set forth in the advisories that Law and Compliance believed were unnecessary to protect either the FCM carrying institutional customer accounts or the customers themselves.

FIA appreciates the Commission's willingness to work with Law and Compliance in attempting to develop amended foreign order transmittal procedures for institutional customers. As Law and Compliance noted in its February 18 letter:

> Given the tremendous growth in volume on, and even the mere increase in the number of, international exchanges over the past few years, the need for regulatory reform with respect to these institutional customers will only increase. Without such reform, we fear these institutional clients will be forced to trade the US futures markets through US FCMs and non-US markets through non-US firms. Such a result will provide no additional benefit for, and in fact will disadvantage, the customer. As important, such a result will adversely affect the ability of the US FCM to monitor the aggregate worldwide risk its institutional customers are assuming. The Commission's ability to monitor such trading will also be impaired, if non-US institutional customers clear their futures business through non-US firms.

FIA understands the Commission's concern in seeking to assure the adequate protection of institutional customers that trade on foreign markets and the financial integrity of the FCMs carrying their accounts. Nonetheless, the modifications and additional conditions set forth in proposed rule 30.12, when compared with Law and Compliance's proposal, significantly limit the rule's intended benefits. The following comments are designed to result in a rule that will be more useful to FCMs and their institutional customers, while preserving the Commission's regulatory concerns.

Authorized Customers

In its February 18 letter, Law and Compliance proposed that the class of "authorized customers" permitted to place orders pursuant to the foreign order transmittal procedures be defined to include essentially the same type of person that is defined as an "eligible swap participant" in Commission rule 35.1(b)(2). In Law and Compliance's view, any person deemed to have the necessary sophistication to engage in swap transactions, including individuals with total assets of

---

[1] See, letter from Ronald H. Filler, President, Futures Industry Association Law and Compliance Division, to I. Michael Greenberger, Director, Division of Trading and Markets, dated February 18, 1999.

$10 million or more, should be deemed to have the necessary sophistication to place orders using the foreign order transmittal procedures.[2] The definition of "authorized customers" set forth in proposed rule 30.12(a), however, is narrower than the definition of an "eligible swap participant." Indeed, it is narrower than the definition currently set forth in the advisories.

The Division published its first advisory nearly six years ago. Since that time, FIA member firms are not aware that any customer that has taken advantage of the order transmittal procedures has suffered losses as a result of placing orders directly with a foreign broker. In the absence of any empirical data to suggest that the class of "authorized customers" contained in the advisories is too broad, FIA does not understand why the Commission would now propose a less inclusive definition. Similarly, FIA does not understand why the Commission would propose a definition that is narrower than the definition of an "eligible swap participant." We fail to see why the Commission would adopt a rule that would result in making it more attractive for certain institutional customers to enter into an over the counter transaction involving a foreign product than to execute a comparable transaction on an organized exchange. Our comments with respect to particular aspects of the definition follow.

First, consistent with the definition of an "eligible swap participant" and the definition of an "authorized customer" under the advisories, Law and Compliance had proposed that "authorized customers" include employee benefit plans that are subject to the Employee Retirement Income Security Act of 1994 and have total assets exceeding $5,000,000. In lieu of meeting the asset test, a plan would also qualify, if the investment decisions of the plan were made by a bank, trust company, insurance company or a registered investment adviser or trading advisor.[3] Similarly, Law and Compliance had proposed to include within the definition state governments and their political subdivisions. Proposed rule 30.12, however, would exclude both classes of customer.

---

[2] Law and Compliance's recommendation was also consistent with FIA's position that, as a matter of policy, the Commission should adopt a uniform definition of an "institutional customer." The myriad definitions that are now interspersed among the Commission's rules lead to considerable confusion.

[3] In the *Federal Register* release accompanying the proposed rule, the Commission suggests that accounts, including employee benefit plans, managed by such institutions would be eligible to take advantage of the foreign order transmittal procedures. Specifically, the Commission states that the proposed rule "would focus on the sophistication of the person managing" an account, adding:

> The Commission believes that financial institutions have the sophistication to manage and appreciate the risks of such transactions. These institutions include banks, savings associations, credit unions, insurance companies, investment companies [ ], broker-dealers [ ], and FCMs.

64 *Fed.Reg.* at 46622. As drafted, however, proposed rule 30.12 would permit these institutions to enter into transactions under these procedures only as principals for their own accounts and not in their fiduciary capacities. FIA respectfully suggests that the Commission revise the proposed rule to reflect more accurately the Commission's apparent intent.

In support of these exclusions, the Commission states that, although employee benefit plans and state governments "may be well-versed in the risks of trading on US futures exchanges, [they] are not required to be experts in trading foreign futures and options."[4] FIA respectfully submits that this explanation misses the point. The foreign order transmittal procedures are not intended to address any minor differences that may exist between trading on US exchanges and trading on foreign exchanges; they deal only with the manner in which a customer's order is placed. In this regard, the special risk disclosure statement prepared by Law and Compliance and proposed (with minor modifications) by the Commission effectively advises customers of the particular risks that they will assume under the foreign order transmittal procedures.

The proposed rule also excludes individuals, regardless of the aggregate value of their assets. In addition, all corporations would be required to have assets of $10 million. Law and Compliance had suggested that, consistent with the provisions of Commission rule 35.1(b)(2), corporations with $1 million net worth could place orders "to manage the risk of an asset or liability owned or incurred in the conduct of business."

Law and Compliance had also proposed to include within the definition: (1) any person whose investment decisions with respect to foreign futures and foreign options transactions are made by a commodity trading advisor subject to regulation under the Act, including any investment adviser registered as such with the Securities and Exchange Commission that is exempt from regulation as such under the Act or Commission regulations, (or a foreign person performing a similar role or function subject as such to foreign regulation) with total assets under management exceeding $50,000,000; and (2) a commodity pool that is not formed solely for the specific purpose of constituting an authorized customer and that has total assets exceeding $5,000,000. Under these latter exemptions, the net worth of the underlying customer or the aggregate value of the customer's assets would be irrelevant. Because the advisor or pool operator is a fiduciary to the customer, Law and Compliance believed it is more appropriate to look only to the sophistication of the advisor.

The proposed rule, however, defines "authorized customers" to include commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") with $50 million in funds under management. As indicated earlier, the *Federal Register* release accompanying the proposed rule implies that the intent of these provisions is to permit a qualified CTA to place orders for its customers, including a commodity pool, without regard to the sophistication of the underlying customer (or pool participant).[5] Nonetheless, as written, the proposed rule appears to exempt a qualified CTA or CPO only when it is effecting trades for its own account. Proposed rule 30.12(a)(v) and (x). FIA respectfully suggests that the Commission revise the proposed rule to make it clear that a qualified commodity pool is an "authorized customer," without regard to the identity of the pool participants, and that a qualified CTA may place orders for its customers,

---

[4] 64 *Fed.Reg.* at 46622. This same analysis supports the Commission's decision to exclude floor traders and floor brokers from the class of "authorized customers." For the reasons discussed above, FIA does not believe that these individuals should be excluded from this class.

[5] Fn. 2, *supra*.

without regard to the sophistication of the underlying customer or pool participant. FIA also supports Law and Compliance's proposal to include commodity pools with assets exceeding $5 million within the class of "authorized customers." notwithstanding the identity of the pool participants.

FIA's comments in this regard reflect FIA's view that the Commission should adopt a single definition of an "authorized customer" or "institutional customer" for all purposes under the Act. In this regard, FIA notes that the definition of an "eligible swap participant" is essentially the same as the definition of an "enumerated person" that the National Futures Association ("NFA") submitted to the Commission for approval in 1998. FIA respectfully requests the Commission to proceed with its consideration of NFA's proposed definition.[6]

Finally, FIA notes that the advisories include within the class of authorized customers certain foreign persons that perform functions similar to US registrants and are subject to foreign regulation. FIA assumes that foreign persons are not included in the definition of "authorized customers" because foreign persons are not "foreign futures or foreign options customers," as defined in Commission rule 30.1(c). Therefore, FCMs may permit such customers to place orders directly with a foreign broker even in the absence of the proposed relief. FIA requests that, in connection with the promulgation of any final rules in this regard, the Commission confirm that FIA's understanding is correct.

Automated Order Routing Systems

FIA is extremely troubled that proposed rule 30.12 would not permit an authorized customer to place orders with a foreign broker using an automated order routing system ("AORS"). The Commission fails to explain why it has adopted this position. However, the recent Supplemental Order that the Commission issued authorizing members of the Singapore International Monetary Exchange to solicit and accept orders from US customers for execution on Eurex Deutschland,[7] read in conjunction with the no-action letters that the Division has issued to the London International Financial Futures and Options Exchange, Eurex Deutschland, the Sydney Futures Exchange, the New Zealand Futures and Options Exchange and Parisbourse, leads us to conclude that the Commission is continuing to draw no distinction between an AORS and a direct execution system, as those terms were defined in the proposed rules relating to direct access to automated boards of trade. 64 *Fed.Reg.* 14159 (March 24, 1999).

---

[6] In this connection, however, and consistent with the views expressed above, FIA believes that the definition of an "enumerated person" should be expanded to include any person whose investment decisions with respect to futures and options transactions (whether domestic or foreign) are made by a commodity trading advisor subject to regulation under the Act, including any investment adviser registered as such with the Securities and Exchange Commission that is exempt from regulation as such under the Act or Commission regulations, (or a foreign person performing a similar role or function subject as such to foreign regulation) with total assets under management exceeding $50,000,000.

[7] 64 *Fed.Reg.* 50248 (September 16, 1999).

When the Commission issued its order withdrawing those proposed rules, the Commission stated that "further consensus among the various parties must be sought before rules or guidelines may be finalized in this area." 64 *Fed.Reg.* 32829, 32830 (June 18, 1999). Notwithstanding this clear statement to the contrary, proposed rule 30.12 suggests that the Commission has determined that FCMs may not make AORS available to their customers for foreign transactions, except in connection with transactions executed on electronic exchanges that have received permission to place their terminals in the US.

We respectfully submit that there is no practical, logical or regulatory purpose to be served in limiting the use of AORS in this way. To the contrary, a FCM may have greater control over the transactions effected by its customers through an AORS. As FIA has commented previously:[8]

> In developing its regulatory program, the Commission must be careful not to permit technological developments to obscure the distinction between exchanges and brokers, *i.e.*, between exchange systems pursuant to which transactions are executed and order entry or routing systems that provide enhanced interfaces with exchange trade execution systems. Technology may change the manner in which brokers and customers relate to, and communicate with, each other, but it does not alter the fundamental nature of the relationship, or the respective rights and obligations of the parties.

FIA encourages the Commission to revise the proposed rule to recognize the use of AORS by authorized customers.

Capital Requirements for FCMs

The Commission proposes to impose additional capital requirements on FCMs that wish to authorize their customers to take advantage of the foreign order transmittal procedures. FIA questions the necessity of imposing these additional requirements. The capital that an FCM maintains obviously is a relevant factor that any customer should take into consideration in choosing a FCM, without regard to the location of the exchange on which the transactions are executed. However, it is only one such factor. The breadth of markets the FCM covers, the knowledge of its staff, its back office capabilities and the FCM's overall reputation in the industry are among the other factors that a customer will take into consideration. The institutional and other sophisticated investors that comprise the class of authorized customers that may take advantage of the foreign order transmittal procedures, in particular, may be relied upon to conduct such an analysis in selecting a FCM.[9]

---

[8] Letter from John M. Damgard, President, Futures Industry Association, to the Honorable Richard G. Lugar, United States Senate, dated March 15, 1999.

[9] The Commission's expressed willingness to consider relief for those FCMs that may not meet this additional capital requirement may ameliorate the potential anti-competitive effects of the Commission's proposal. However, the Commission has failed to explain the type a showing a FCM would be required to make in order to obtain such relief. If the Commission determines to retain this additional capital requirement, the Commission must clarify the nature of the showing that a firm seeking relief must make. In addition, FIA

Eligible Foreign Brokers

Under the proposed rule, authorized customers may transmit orders, whether for execution only or for execution and clearing, only to a foreign broker that is either a clearing member of the foreign exchange on which the trade is executed, a majority-owned affiliate of such a clearing member, or an affiliate of the US FCM that is carrying the customer's account. FIA believes that these restrictions are unwarranted. In the *Federal Register* release accompanying the proposed rule, the Commission states that one purpose of the rule is to "permit qualified US investors to select execution and clearing firms based upon their analysis of the respective services that each firm provides." 64 *Fed.Reg.* at 46621. The proposed rule undercuts the Commission's intent in this regard by unnecessarily limiting the class of eligible execution and clearing firms from which authorized customers may choose.

In particular, if a foreign broker is acting only as an executing broker, there appears to be no reason why that broker must be a clearing member of the exchange on which the trade is executed or an affiliate of a clearing member. Moreover, there may be circumstances when a customer will transmit an order to an entity that is not a member of the exchange on which the trade is executed. For example, a customer may call a broker's Hong Kong office to place trades in Singapore and Tokyo. We respectfully request the Commission to remove these restrictions in any final rule that may be adopted.

Indirect Relationships

In its February 18 letter to the Division, Law and Compliance noted that certain FCMs may maintain a customer omnibus account with a single foreign affiliate. The affiliate, in turn, then maintains customer omnibus accounts with clearing brokers at various foreign exchanges. The advisories specifically confirmed that this indirect relationship between the US FCM and the foreign broker would not affect the ability of an authorized customer to take advantage of the foreign order transmittal procedures. FIA believes that rule 30.12 should be revised to provide similar confirmation.

---

believes that, in lieu of no-action relief suggested in the *Federal Register*, the Commission should provide that any FCM adversely affected by the proposed rule may request an exemption from its provisions in accordance with the provisions of Commission rule 30.10.

Conclusion

FIA appreciates the opportunity to comment on proposed rule 30.12. If you have any questions regarding this letter, please contact me at (202) 466-5460 or Ronald H. Filler, President of the Law and Compliance Division, at (212) 526-0236.

Very truly yours,

John M. Damgard
President

cc: Honorable William J. Rainer
Honorable Barbara Pederson Holum
Honorable David D. Spears
Honorable James E. Newsome
Honorable Thomas J. Erickson
C. Robert Paul, General Counsel
John C. Lawton, Acting Director, Division of Trading and Markets
John Mielke, Acting Director, Division of Economic Analysis
Phyllis J. Cela, Acting Director, Division of Enforcement