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CFTC REPORT ENTITLED "A NEW REGULATORY FRAMEWORK"

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE SUBCOMMITTEE ON RESEARCH, NUTRITION AND GENERAL LEGISLATION

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

ON

CFTC REPORT ENTITLED "A NEW REGULATORY FRAMEWORK"

MARCH 20, 2000

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MONDAY, MARCH 20, 2000

U.S. SENATE,
SUBCOMMITTEE ON RESEARCH, NUTRITION, AND GENERAL
LEGISLATION, OF THE COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:05 a.m., in room 2525, Dirksen Federal Building, 219 South Dearborn Street, Chicago, Illinois, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee,) presiding.

Present or submitting a statement: Senator Fitzgerald.

OPENING STATEMENT OF HON. PETER G. FITZGERALD, A. U.S. SENATOR FROM ILLINOIS, CHAIRMAN, SUBCOMMITTEE ON RESEARCH, NUTRITION, AND GENERAL LEGISLATION, OF THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

The CHAIRMAN. This hearing will come to order. This is a hearing on the Subcommittee on Research, Nutrition and General Legislation of the U.S. Senate Committee on Agriculture, Nutrition and Forestry.

The purpose of the hearing is to examine proposed regulations that may be coming forth from the Commodity Futures Trading Commission. CFTC has suggested that it is willing to grant broad regulatory relief to futures exchanges and create a new regulatory—framework.

I've asked each panelist, instead of reading the prepared remarks, to instead summarize their remarks as best they can. I'm going to set a good example by sparing you the reading of my opening statement which I am now going to ask myself for permission to submit for the record.

And with that, Mr. Paul, welcome to Chicago and please, why don't you begin.

[The prepared statement of Senator Fitzgerald can be found in the appendix on page 42.]

STATEMENT OF C. ROBERT PAUL, GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC., ACCOMPANIED BY PAUL ARCHITZEL, DIVISION OF ECONOMIC ANALYSIS

Mr. PAUL. Thank you Mr. Chairman. I'm pleased to be here to testify before you on behalf of Chairman Rainer and appreciate the opportunity to discuss recent efforts at regulatory reform.

I also want to introduce you to my left, Paul Architzel from our Division of Economic Analysis who headed up the task force that prepared this regulatory framework that we are discussing today.

I will try to summarize my written remarks as briefly as possible but I am sure, Mr. Chairman, that you can feel free to interrupt me as I go through this with any questions you may have and I'll leave time at the end to answer any questions you might have.

Chairman Rainer has identified three public policy goals on which the CFTC should focus in regulating derivatives markets: first, creating a comfortable climate for competition in all sectors of the industry; second, removing any regulatory barriers that hamper these markets from fully exploiting innovations in technology; and third, decreasing the level of systemic risk in domestic and international derivatives trading. To achieve these goals it is imperative to modernize the way we regulate futures markets.

Accordingly, a staff task force of the Commission has developed a new regulatory framework that would change the regulatory structure for derivatives. The proposed framework is intended to promote innovation, maintain U.S. competitiveness, reduce systemic risk, and protect derivatives customers.

The new frame work is a work in progress; it is a staff document on which there has been no Commission action to date. The CFTC intends to hold at least one public hearing on this proposal to get as much input as possible from the markets and participants. We want to find solutions that serve the public interest. But we also recognize that time is not our ally. In spite of the difficulty of developing answers to questions of regulatory architecture, we must work together to expeditiously reach conclusions suitable for these markets and the public interest.

Technology offers us tangible benefits that are either immediate or imminent, including faster and better execution; significantly lower transaction costs; cross-market clearing, netting and offsetting systems; and increased liquidity. The U.S. futures industry must embrace technology without reservation to build stronger markets if it expects to remain competitive.

Flexibility is the hallmark of the new framework. The staff's proposal recommends that the Commission replace the current one-size-fits-all regulation for futures markets with a structure that would instead apply broad, flexible "core principles," which are tailored to match the degree and manner of regulation to a variety of market structures and participants. Under this proposal, multilateral trade execution facilities will operate in one of three categories, taking into account the nature of the underlying commodities and the sophistication of the customers. While the framework invites changes, it does not impose it on established futures exchanges. Existing exchanges operating as contract markets may reorganize under the terms of the framework, but they are not compelled to do so.

The framework offers the following three basic categories of exchanges or trading facilities correlating to a spectrum of regulation: recognized futures exchanges, recognized derivative transaction facilities and exempt multilateral trading facilities. And I want to compliment the Chairman on getting those rather accurately in his introduction.

The category recognized futures exchange [RFE], or an RFE, would include multilateral transaction execution facilities that permit access to any type of customer, institutional or retail, and that trade any type of contract, including those that are based on commodities that have finite deliverable supplies or cash markets with limited liquidity. Because these markets trade markets that may have a greater susceptibility to price manipulation and because the presence of non-institutional traders participating here raise deeper concerns for customer protection, RFEs would be subject to a higher level of Commission oversight than market in either of the other two categories.

Nonetheless, the proposed RFE offers significant regulatory relief compared to the current requirements applicable to designated contract markets. Detailed prescriptive rules would be replaced with 15 broad "core principles." These include principles relating to market surveillance, position reporting, transparency, fair trading and customer protection. Any board of trade, facility, or entity that is currently required to be designated as a contract market would be eligible to qualify as an RFE.

The second category, the derivatives transaction facility [DTF], would be subject to a lesser degree of Commission oversight. A facility would be eligible to become a DTF if: (i) the contracts traded on the facility are for commodities that have nearly inexhaustible supplies or for which there is no underlying cash markets (e.g., weather derivatives); (ii) the Commission determines on a case-by-case basis that the contract would be appropriate for this level of regulation; or (iii) the facility limits access to commercial traders only.

A DTF would be required to adhere to only seven core principles, including those relating to market oversight, transparency, and recordkeeping. Because a DTF either would be limited to commodities that are not susceptible to manipulation or would limit access to institutional or commercial participants, a DTF would not be required to adhere to certain other core principles applicable to an RFE such as those relating to position monitoring, customer protection or dispute resolution.

Finally, the third category, the exempt multilateral transaction execution facility [MTEF], or exempt MTEF, would operate on an unregulated basis. This would be a self-effectuating exemption for transactions among institutional traders in commodities that are unlikely to be susceptible to manipulation.

These markets would be exempt from all requirements of the Commodity Exchange Act and Commission regulations, except for anti-fraud and anti-manipulation. Moreover, if a designated contract market elects to trade an eligible contract that serves as a sort of price discovery on an exempt MTEF, the MTEF would be required to continue to provide pricing information to the public. Exempt MTEFs would not, however, be permitted to hold themselves out to the public as being regulated by the Commission.

That is a brief overview of the staff's regulatory proposal, and I would be happy to answer any questions. Thank you again for the opportunity to testify before you today.

[The prepared statement of Mr. Paul can be found in the appendix on page 46.]

The CHAIRMAN. Mr. Paul, thank you, and I think you gave a very good, concise explanation of the three different categories that would be available.

Let me ask you the threshold question. I believe in the CFTC's report to Congress about these proposals that you suggested that you have the ability to implement it through your own regulatory powers without any help from Congress. Does the CFTC believe that this proposal should or should not be codified by Congress?

Mr. PAUL. Well, although we believe that we have proper statutory authority under Section 4(c) to adopt these regulations without legislation, we do see a benefit in working with your Subcommittee and Chairman Lugar's Parent Committee in codifying some of the structure. We think that it would perhaps enhance the ability to get meaningful legislation adopted that would greater legal certainty to the markets.

The CHAIRMAN. If Congress decides to, as we rewrite the CEA, codifying the core principles and having three different layers?

Mr. PAUL. I am not sure that we would go as far as codifying, suggesting that you codify the core principles, only because that might detract from the kind of flexibility that we hope to achieve through this regulatory framework. But I think what we had discussed internally, and I think already discussing with Congressional staff, is codifying the categories and maybe some of the overarching concepts without necessarily delving into the kind of detail that you would find at the 15 core principles for the RFE, or the seven core principles for the DTF.

The CHAIRMAN. This proposal would really not depend on what type of physical exchange you are, whether you are a pit based exchange or an electronic exchange. It would go beyond those areas and an electronic exchange could try to qualify theoretically to be a recognized futures exchange, I suppose. In addition a pit based exchange could at least try to be a recognized derivatives transaction facility. And possibly, if they are just institutional traders trading commodities with inexhaustible supplies and no underlying cash market, a traditional pit based exchange could try to become an exempt multilateral transaction facility.

Mr. PAUL. I could not have said it any better myself. That is the beauty of this proposal. I think the staff, working with Mr. Architzel, had their different approaches including those that might be based on what the medium is, but we think that kind of flexibility that we put into this proposal is of greater benefit to the markets. We let the markets choose which medium it would like to trade in, and by gearing the regulation, calibrating it according to what products and who the participants are, we think we can achieve regulatory goals without unduly hampering the innovation on the technology side.

The CHAIRMAN. Now, both of the main futures exchanges in Chicago, the Chicago Board of Trade and the Chicago Mercantile Exchange, are now considering proposals to reorganize themselves internally. The Chicago Board of Trade is considering creating two separate companies, one that would be an on-line company and the other that would be the traditional pit based exchange.

Would a change in these regulations affect the way those exchanges might want to be organized? If they decided that they wanted to have an RFE, a DTF and an exempt MTEF, would they have to have three separate subsidiaries? How would this work? Would each have to have a separate legal identity?

Mr. PAUL. The framework currently would call for separate entities for different type of structures, but we are discussing that, because our interest is making sure that the participants know exactly what level of regulation that they are engaging in. So therefore, I think the original inclination was to have separate entities. But I think that we are considering whether or not we want to provide the kind of flexibility that may be able to allow a single entity to offer different types of markets, as long as it is clear to the participants, to the customers, which entity they are trading and therefore, what level of protection that they might be protected by.

Mr. ARCHITZEL. Just to clarify. Recognized markets can be traded under the same legal entity. It is only the exempt MTEF that is required to be traded through a separate legal entity, because that level is not regulated. So the exchanges would have the ability to operate both the RFE and the DTF under the same legal entity.

The CHAIRMAN. OK. So that one legal entity could have the RFE and the DTF, but if you wanted to have the exempt MTEF you would have to have a separate subsidiary or a separate company.

Mr. ARCHITZEL. Exactly.

The CHAIRMAN. OK. That clarifies. That is important.

Now, to be a recognized derivatives transaction facility, a recognized DTF, you say that there would be two main requirements: First, only commodities with, nearly inexhaustible deliverable supplies, no underlying cash market, or contracts that the CFTC allows on an individual case-by-case basis could be traded. Secondly, commercial traders would be allowed to trade. What do you mean by commercial traders?

Mr. PAUL. I'll try to clarify that. That is either/or, Mr. Chairman.

The CHAIRMAN. OK. That is right. So in other words, retail customers and that would not be a problem. If they are dealing with commodities, such as Euro dollars or foreign currencies, commodities a nearly inexhaustible deliverable supply?

Mr. ARCHITZEL. That is correct. Retail customers are permitted with special enhanced protection. This DTF is intended to be a market mainly for institutional customers. But if the market qualifies as a DTF on the basis of the nature of the commodity, then it is possible for retail customers to access the market if certain conditions are met. Those conditions are that the customers trade through a registered FCM, that the FCM be a clearing member of at least one RFE and that the FCM meet a higher minimum net capital standard.

The second group of markets that can be a DTF are markets which are open only to commercial traders. This type of DTEF, which is essentially B–2–B, is only commercial traders is open for any commodity. So these are two very distinct types of markets.

The CHAIRMAN. OK. So you could envision an agricultural commodity being traded in a DTF provided that only institutional participants are involved?

Mr. ARCHITZEL. At this point we have not limited the types of commodities that can trade on a DTEF, although the staff report recommends that the Commission seek comment on whether agricultural commodities in particular should be qualified to belong in this category. So that is something that we recommend that the Commission seek comment on. Agricultural commodities have somewhat different characteristics and in the past were sometimes treated differently under the regulations. But certainly any physical commodity could belong in the DTF category and qualify for it, if the market were restricted to commercial traders.

The CHAIRMAN. Now, let me just talk about commodities with a nearly inexhaustible deliverable supply. Do you fit United States Treasury Bonds in that category?

Mr. ARCHITZEL. That is a "moving target" right now.

The CHAIRMAN. Because the supply is going down. I mean it is 3.5 trillion outstanding right now, but it is scheduled to go down to zero by 2015.

Mr. ARCHITZEL. I think that is something that needs to be addressed further. We should have guidelines saying what commodities fit into this category. And as markets change, as commodities change, we could review and revise the guidelines.

The CHAIRMAN. Now, on the exempt multilateral transaction facilities, would I be correct to surmise that no retail customers could, under any circumstances, be allowed in that?

Mr. ARCHITZEL. That's correct.

The CHAIRMAN. That would be totally institutional. Right now the current sections of the CEA that provide the principle regulatory framework for the CFTC are Section 5 and 6 of the CEA.

How would the new regulatory framework impact those sections?

Mr. ARCHITZEL. The core principles summarize and digest most of the provisions in Section 5 and 5a, and would serve as a replacement by and large for those individual sections of the Act. In other words, sections 5 and 5a of the Act, talk about the manipulability of commodities, and there is a core principle that relates to that. So the core principle would serve as an alternative to that provision of the Act.

The CHAIRMAN. The report recommends, as you have talked about, that the current CFTC regulatory framework be replaced with the derived four principles that are intended to encompass all technology and business organizations. However, the report does not address in detail how these principles are to be implemented or provide guidelines for industry participants to follow.

Who will determine how industry participants will apply these principles and how they will be accomplished?

Mr. ARCHITZEL. The report envisions that the core principles will be accompanied by statements of acceptable practices or best practices, and those would be interpretive statements by the Commission, giving guidance to the industry on compliance with the core principles. We also envision that the interpretive statements would be written in cooperation with the industry and envision that the National Futures Association will be providing input to us on those as well.

I think it is important to note, though, because those would be acceptable practices, they would not be exclusive of other ways that facilities could come to us and demonstrate that they are in compliance with the core principles. That is what we are trying to achieve from this framework, as opposed to giving the specific prescription as to how they should achieve these goals, but leave it open to them. But we give them the convenience of knowing if they do things in a certain way that creates a safe harbor.

The CHAIRMAN. OK. According to your report, non-institutional customers require greater market protection than institutional or commercial customers. Non-institutional customers may be permitted access on both an RFE, a recognized futures exchange, and DTF facility, recognized derivatives transaction facility, although the core principles for an RFE contain provisions for customer protection and dispute resolution for non-institutional customers. The DTF core principles do not contain such provisions.

Could you explain the absence of the customer protection and dispute resolution provisions in the DTF core principles?

Mr. PAUL. Well, I will start and Paul can supplement it. We feel that we can achieve customer protection for the non-institutional customers trading on DTF by regulating the intermediary. And this is frankly a concept that we learned by soliciting comments from the industry. And we think that as long as we have an intermediary that is a registrant of the CFTC, and therefore, is obligated to follow the CFTC rules with respect to risk disclosure, segregation of assets, making sure that they get the information they need on the markets, that we can protect the customer at that level as opposed to doing it at the exchange level.

Mr. ARCHITZEL. I think the additional thing to note is that although there is not the dispute resolution provision, there would be the availability of the CTFC reparation procedures which is like a small claims court for customers who feel they have been injured by a violation of the Act or regulations. And those would remain available to retail customers, because they would be trading through registrants.

The CHAIRMAN. You have a lot in your report about the segregation of customer funds. If I read it correctly, institutional customers would be able to opt out of requiring that their funds be segregated; was that how you set this up?

Mr. ARCHITZEL. That is only if the DTF has rules providing for that. And in doing so, in providing those rules, they would also have to provide for financial disclosure and other types of disclosures to market participants on what the effects would be by having the opt out allowance.

The CHAIRMAN. If those funds are not segregated and there is a problem, it really gets hard to trace, does it not? How do you determine whose money was taken, misappropriated or misapplied?

Mr. PAUL. Well, I guess we believe that, that is a risk that we would allow certain customers to take as long as they are fully informed of what the risks are. And that is also why we are not recommending that, that be permitted at the recognized futures exchange level. And just parenthetically, when the task force originally put together this proposal, they had another category between the RFE and DTF known as a recognized institutional futures exchange, which would be somewhere in between the regulatory framework on the spectrum of regulation, and that would be created so that institutional customers could opt out of seg. We found that there was not a real appetite for that in the market. So we thought we would simplify it with just the three big markets we have now.

The CHAIRMAN. You figured that the big boys who are participating in the markets can take care of themselves. That they would probably demand their funds be segregated or have those kind of protections that they could handle, is that correct? Whereas, a retail customer might not think of that issue, is that correct?

Mr. ARCHITZEL. This issue has come up over the years. There are foreign exchanges that operate without segregation of customer funds, and generally that is available for larger customers as an option. Over the years our exchanges have said that they would be able to compete more effectively with foreign markets if they were able to make adjustments to. So that is something that we are comfortable with for large institutional customers only, provided that appropriate disclosures are made at the market level.

Mr. PAUL. One of the reasons, just to finish this thought, one of the reasons why there did not seem to be a keen appetite for the RFE is because the proposal also recommends that we broaden the permissible investment of segregated funds. And that is really why not only customers, but also the intermediaries were reluctant to extend segregated funds any further than they had to because they would get low return on those funds that were segregated, to the extent that we have made it a little broader possibilities as to what they could invest it in and provide better return, the need to opt out of seg is not as acute.

The CHAIRMAN. OK. Now, the first page of the report recommends that the Commission propose a quote, "new regulatory framework to apply to multilateral execution facilities that trade derivatives."

How does the CFTC define, quote, "transaction execution facility," and what is the CFTC's position on the meaning of multilateral? What is the CFTC's position on the meaning of this term in the context of the current swaps exemption?

Mr. PAUL. Well, that is actually one of the thorniest concepts that we are wrestling with right now, Mr. Chairman. And we are engaged in ongoing discussions both internally and with various representatives of the industry, to come up with a definition that we will include in our proposed rule making, that will better define what a multilateral transaction execution facility is.

Beyond that, I think at this point it is such an inchoate issue that I think that we probably cannot give you much further guidance at this time.

The CHAIRMAN. So that is a work in progress?

Mr. PAUL. That is where the rubber meets the road on the current proposal.

The CHAIRMAN. OK. We are going to have to come up with all the details to actually get these regulations or statutory things enacted.

The report states that the registration process should be "streamlined," quote, unquote, for futures commission merchants and introducing brokers; however, it does not state in any detail how this is to be done.

Would you explain what the report means by streamlining the registration process?

Mr. ARCHITZEL. The streamlining envisioned there is accepting various types of accounting reports at various stages during the year, rather than requiring a certified audit at the time of actual filing for registration. That is the nature of streamlining envisioned.

The CHAIRMAN. OK. The report provides for an exempt multilateral transaction facility in which a facility could choose to operate a market exempt from commission regulations except for the antifraud and anti-manipulation provisions. This facility would only be available to institutional traders who trade commodities with inexhaustible deliverable supplies, or supplies that are otherwise sufficiently large to render a contract traded unlikely to be susceptible of manipulation.

Does not this exemption operate to deny retail customers access to the most liquid markets?

Mr. PAUL. Well, Mr. Chairman, the retail customer currently does not have access to all markets. We do not think that we are denying access by virtue of our proposal. In fact, we actually think that we are providing them with access to certain markets they might not currently have through some of the flexibility we have built into the DTF category.

So to the extent that retail customers currently trade in designated contract markets, they will be able to continue to do so through the recognized futures exchanges. We think they will probably get access to broader markets through the DTF category, but the exempt MTEF category is really designed to provide a regulatory framework that the over the counter market that currently exists completely outside of our regulation to operate under.

The CHAIRMAN. They do not have access to that now; namely, the over the counter market involving private contracts. I notice that you suggest that you suspect that many over the counter type markets now might want to become DTFs so that they could have that imprimatur of CFTC regulation. Would you explain your thinking on that a little bit more? Do you see some positive advantages in saying that you are regulated. Do you believe people might have more faith in the integrity of the markets if they know that you have that regulatory check?

Mr. PAUL. Absolutely. And we believe that there is interest amongst certain types of markets and certain market participants to trade in a regulatory environment. All regulation is not bad. Many market participants seek the U.S. markets because of its high regulatory integrity, because of the sense that the markets and the participants are being looked after. So for those types of markets we certainly don't want to deny them a home if they are looking for some place that they can provide greater comfort to their participants and for their products.

Mr. ARCHITZEL. It is also noteworthy that the recognition that the Commission bestows on markets, either the RFE or the recognized DTF, corresponds to those minimum regulatory standards that other regulators internationally subscribe to, so that recognition as a DTF carries with it an acknowledgement that, that market meets the minimum international standards. It may therefore make it easier for a market which intends to do business globally to get approved by regulators in foreign countries as well.

The CHAIRMAN. I see. What would you say are minimum standards internationally, though? What basis is there for saying there are minimum standards internationally?

Mr. ARCHITZEL. The staff spent a lot of time looking at guidance put out by various organizations of international regulators such as IOSCO, which is an international securities regulatory body. Over the years we have cooperated with those groups to harmonize our rules and regulations. So at this point there is a great deal of guidance put out by these international groups that most international regulators subscribe to. And our core principles correspond with that guidance very closely.

The CHAIRMAN. Finally, I want to ask you a couple other questions. This is a little bit off the main subject of our hearing, which is your proposed new regulations. Many of the Chicago participants are interested in allowing futures on individual stocks. I know that, that will probably be the subject of several other separate hearings. But I was interested in how the margins are now set on stock index futures. Reading the CEA, it looks like it is really up to the Federal Reserve, but if the Federal Reserve declines to set up margin requirement, the CFTC steps in and sets a margin requirement.

What is the margin requirement now on stock index futures and who has set that?

Mr. ARCHITZEL. The exchanges in the first instance set the margin requirements, and report to us for approval of those. They are currently set at levels which cover very high confidence numbers above 99-percent for market movements on a daily basis in the market.

The CHAIRMAN. What is the margin requirement? Do you know?

Mr. ARCHITZEL. I would have to provide that data for you for the record in a written statement.

The CHAIRMAN. OK.

Mr. PAUL. And one of the things that we have discussed with the SEC in our negotiations on Shad–Johnson is coming up with some sort of harmonized margin requirement for single stock futures regardless of where they trade. And we have discussed various approaches. The SEC has its own opinion on the subject. I do not want to speak on their behalf, but it seems like I think we are moving toward meeting in the middle on margin requirements that may begin to equity options as being really the closest parallel, but preferably something that is based on——

The CHAIRMAN. Are those margin requirements about 50-percent?

Mr. PAUL. Fifty-percent, Mr. Chairman, is for the actual stock. The equity options, and similar to what the futures exchanges do on index contracts is it is risk based and the span margining system that the Chicago Mercantile Exchange has developed which is probably the best at trying to calibrate, or at least take into account, the volatility of the instrument. And we think that is probably the approach that we should agree on with the SEC on a consistent margin framework for single stock futures, and whether that is done under the auspices of the Fed or done through an memorandum of understanding between the SEC and the CFTC and through the review process of the exchange margins. Those are the kinds of issues that we are trying to hammer out right now.

The CHAIRMAN. OK. My final question is how long did it take you to come up with this new proposal? I saw you had a task force that put this together. How long have they been working on this?

Mr. ARCHITZEL. We started in October.

The CHAIRMAN. And you got it done that rapidly?

Mr. ARCHITZEL. Yes.

The CHAIRMAN. That is very good work. I want to compliment the CFTC on their proposals here. They seem to me, at least at first blush, to make a lot of sense. I have heard a lot of positive comment. I look forward to hearing in more detail what some of the others have to say today. But I want to compliment Chairman Rainer on moving the CFTC in this direction, and with the speed with which you acted. I think you have a pretty solid framework for us to work on. So thank you all very much.

Mr. PAUL. Thank you, Mr. Chairman.

The CHAIRMAN. Now, we can move to the second panel. On the second panel we have James J. McNulty, President and Chief Executive Officer, Chicago Mercantile Exchange; Mr. David P. Brennan, Chairman, Chicago Board of Trade; Mr. Thomas R. Donovan, President and Chief Executive Officer, Chicago Board of Trade; and Mr. Robert K. Wilmouth, President of the National Futures Association.

And again, if I could ask each of you to summarize your thoughts rather than reading the prepared remarks, I would appreciate that. We will submit your prepared remarks for the record. Also, I notice some of you, in your prepared remarks, had a lot about the possibility of futures on individual stocks. That is a little bit beyond the scope of today's hearing. While that is a great topic, I would probably hear from Bill Brodsky over at the CBOT real quick if we get too far down that road. So I want to keep it pretty much on target, on the proposed new regulations that the CFTC has come up with.

I would also like to hear from the two exchanges on how these new proposals might affect your own plans for reorganization, both of which you both have underway already. If these regulations came into effect, would you want to rethink in any way your proposals for reorganizing, so that you could take advantage of these separate possible regulatory schemes.

I do not know if we have a volunteer to go first. Would Mr. Wilmouth like to go first? Thank you for coming here.

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION

Mr. WILMOUTH. Thank you very much, Mr. Chairman. I appreciate the opportunity to present the views of the National Futures

Association on the CFTC's proposed new regulatory framework which we think is one of the most important developments in the futures industry since the creation of the Commission itself. And I will confine my remarks specifically to the CFTC's proposed new regulatory framework.

We all know that we are facing great competition, both from off shore markets and over the counter markets, and the regulation of the industry must be overhauled and streamlined if regulated markets are going to remain competitive and be attractive. In short, we have to find new ways to reduce regulatory burdens without reducing regulatory protections.

One way to achieve that goal is to maximize the use of self-regulation, while returning the Commission to its intended role of overseer of the self-regulatory process rather than as a micro manager. The Commission's proposed framework is dramatic and it is a bold step.

The focus on core principles for both exchanges and intermediaries is exactly the right approach. The Commission should tell those that it regulates what they have to do, not how to do it. The answer to the how question changes with every new development in technology. That is why the role of self-regulation will be even greater in the markets of tomorrow.

Technology is really tearing down the barrier of entry faster than any government policy ever could. From 1977 to 1999 there were no new futures exchanges formed. In the last 6-months, at least six different enterprises have stated their interest in creating new electronic futures exchanges. All of them are dedicated to using effective self-regulation to insure the integrity of the marketplace, and the public's confidence in those markets. But none of these new exchanges that are in the formation stages are really shackled by the past. Every one of them is looking for more efficient ways to perform their self-regulatory functions, and every one of them has contacted NFA to discuss outsourcing that function to us.

My point is simply not that NFA is going to play an even greater role in the years ahead, but that the flourishing number of exchanges and the corresponding changes to the entire industry, including its self-regulatory functions need action now, today. Time is of the essence. And we would urge both the Commission and Congress, Mr. Chairman, to move ahead as aggressively as possible.

We certainly recognize that difficult work lies ahead. The comments of Paul Architzel and Robert Paul earlier indicate that. The proposed framework is just that, it is simply a framework. It does not address the details which will have to be resolved to move the proposal from the paper world to the real world. Some of these details should be readily solvable, but those core principles need to be supplemented with interpretive guidelines on which the entire industry can rely.

But we suggest first of all how that guidance should not be provided. If we revert to having regulators in Washington dictating to the industry how the core principles have to be followed, we will end up right back where we are now. In addition, NFA is currently involved with the Futures Industry Institute on a best practices study on order transmission and entry, a study directed by the

Commission and funded by a portion of the fine that they imposed in a CFTC enforcement action. We are convinced that a best practices approach is an excellent way to supplement the Commission's proposed core principles and provide the guidance that we think is necessary to the industry.

Two basic points. When we talk about best practices, we have to consider the basic question of best practices from whose perspective. Best practices in our mind have to be considered from the perspective of the customer. We spent a good deal of time in our current study talking to end users and customers and what they want from best practices is very clear. They want procedures that insure fair treatment and quick execution at the best price.

Second point. By definition, best practices have to be developed through direct and active involvement through the industry. The Commission should specify that the core principles will be supplemented with best practices guidance, developed through the industry's self-regulatory process, which includes NFA and of course, the exchanges.

Another detail which can be resolved quickly involves the registration process, and you asked a question about that earlier. The Commission's proposal, as you stated, states that the registration process should be streamlined but does not necessarily address how in any great detail. Over the past several years, NFA has made a number of proposals to simplify the registration process, and we have recently updated those suggestions and submitted them to the Commission's staff.

If a firm or an individual has gone through a screening process in the securities industry, conducting another background check for registration in the futures industry is clearly a wasted effort. And we agreed with the Commission's proposal, in effect, to passport those firms and individuals into registration. Those passported firms would still, however, be registered and subject to the same core principles as other firms. And there needs to be some mechanism to monitor their compliance with those principles, even if those firms are dealing with institutional customers.

The answer again is self-regulation subject to Commission oversight. The Commission's proposal would not require those passported firms to be members of a futures industry SRO. We believe that this is an oversight which needs to be corrected.

One of the major questions unanswered also in the current proposal, and you asked this question, is exactly what the Commission means by the term institutional customer. There are at least to my knowledge six different definitions of sophisticated customer in the Commission's rules. NFA proposed a uniform definition of sophisticated customer several years ago that was modeled very closely on the Commission's definition of eligible swaps participant. That definition has served very well for many, many years and should be the basis for the definition of institutional customer in this context. We would recommend that the threshold test for that term be no higher than those currently in place.

Another key under the proposal will be the types of commodities which are not readily susceptible to manipulation, and should therefore be subject to less regulation. The answer must be a practical one, dictated by the realities of the marketplace, rather than theories of the classroom. The end users of the markets for petroleum products, for example, may very well have the best perspective on this issue and their views should be accorded great weight by the Commission.

And finally, Mr. Chairman, let me reiterate our enthusiastic support for the Commission's overall approach, but let me also note that this exercise of the Commission's exemptive authority does not obviate the need for legislative action. We urge the Commission to move as quickly as possible to resolve the remaining issues and to enact its proposal. And we also urge Congress to support that effort and adopt legislation to codify, as you suggested, the Commission's approach. Thank you very much.

[The prepared statement of Mr. Wilmouth can be found in the appendix on page 67.]

The CHAIRMAN. Thank you, Mr. Wilmouth. Mr. Brennan. Thank you.

STATEMENT OF DAVID P. BRENNAN, CHAIRMAN, CHICAGO BOARD OF TRADE, ACCOMPANIED BY THOMAS DONOVAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OF TRADE, CHICAGO, ILLINOIS

Mr. BRENNAN. Good morning, Mr. Chairman. I am David Brennan, Chairman of the Chicago Board of Trade. With me today is Tom Donovan, our CEO and President. We want to thank you for holding this hearing in the City of Chicago, the derivatives capital of the world. Our theme today is that we want Chicago to retain the title as the derivatives capital of the world. To do that, we have to change our way of doing business. And we are. But we also need to change the way Washington looks at our business. To do that we need to modernize the Commodity Exchange Act and tear down the existing barriers to competition.

Mr. Chairman you have been a true leader on these important issues in Congress, and we thank you for your insights and your intellect and your leadership. In quite a short time you have proven that you are knowledgeable about our issues and committed to our mutual goals of fair competition and even-handed government oversight. We thank you for your efforts.

Another new leader in our industry also deserves praise. CFTC Chairman Bill Rainer is fully committed to rationalizing regulation of exchanges and the industry as a whole. He has brought market experience and creativity to the Agency. We applaud the Chairman's efforts and look forward to working with him on the finishing touches to his new regulatory blueprint.

We have submitted a written statement that describes in detail our reaction to the CFTC's New Regulatory Framework. In summary, the Chicago Board of Trade endorses the CFTC's new regulatory approach. We believe the CFTC's proposal will add up to better markets, better competition and better service for the thousands that use our markets.

Restructuring Federal regulation and restructuring our business go hand in hand. The CFTC's plan responds to the same market forces—technology, globalization, innovation, and competition—which have also caused the exchanges to restructure.

The Board of Trade is no exception. Our plan would take our existing pit trading and electronic trading business lines and restructure them into two independent for-profit companies.

Both will try to attract business by providing liquid trading markets. Both will innovate and invest in technology to provide customers the best service. Both will make every effort to provide customers with a market that they can trust, and both markets will compete.

Our plan is designed to give each company and each trading platform a fair chance to succeed. No business could really ask for more than that.

Federal regulation is part of that "fair chance." We believe in open markets and fair competition. To us, similar products, traded in similar circumstances should have similar government oversight. That means privately negotiated transactions may be excluded, but all public execution facilities should be treated the same. That is our "golden rule" of fair competition.

Today that rule is not being met. After almost 80-years, the Commodity Exchange Act has become unworkable. Over-the-counter derivatives, especially in the area of equity swaps, are plagued by legal uncertainty. Exchange markets suffer from extreme regulatory arbitrage, which the CFTC's proposal tries to remedy. For single stock futures, it is even worse. We are barred from competing at all under a law that we were told 18-years-ago would be "temporary," until a regulatory impasse could be resolved.

Mr. Chairman, reform of the Commodity Exchange Act must cover each of these three areas. All we have ever asked for is a fair chance to compete. This year's CFTC Reauthorization offers us a real opportunity to reach that goal. With your leadership, we are more encouraged than ever before that we might finally get a fair chance to compete. Again, thank you for the opportunity to be here, and we appreciate your efforts. Thank you.

[The prepared statement of Mr. Brennan can be found in the appendix on page 60.]

The CHAIRMAN. Thank you very much, Mr. Brennan. Mr. McNulty, would you like to proceed?

STATEMENT OF JAMES J. MCNULTY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CHICAGO MERCANTILE EXCHANGE, CHICAGO, ILLINOIS

Mr. MCNULTY. Yes. Thank you, Mr. Chairman, and committee members, ladies and gentlemen. I am James J. McNulty. I am the President and Chief Executive Officer of the Chicago Mercantile Exchange, and I have held this post since February 7th of the year 2000.

The CHAIRMAN. This is a baptism by fire, your first Congressional hearing. You will have many more over the years.

Mr. MCNULTY. Thank you. Obviously I come to this hearing short of experience in the history of the exchange; however, I have had 25-years of experience in the full range of financial markets. I have traded and supervised trading in all financial futures and options and I am sensitive to the needs and expectations of the over the counter markets, having trading in the bank, investment bank market for the past 25-years.

I also appreciate the impact of technology on the future of the financial services industry and I hope that this testimony reflects that sensitivity.

The CME is exceptionally encouraged by the CFTC staff task force report, A New Regulatory Framework. The Commission has been both responsible and responsive to the concerns of all elements in the financial services industry. We are pleased by the tone of the proposal, which is consistent with the progressive regulatory philosophy that depends on oversight and competition among markets, rather than prescriptive regulation and protected market spaces.

The CFTC staff under Chairman Rainer has demonstrated a deepening understanding of the complex technological and competitive issues facing our markets, and the commitment to providing much needed regulatory relief. I will discuss our view of the details of the report and suggestions for implementing it below.

The task force recommends that the Commission convert its proposal into proposed rule making, subject to a 60-day-comment-period and public hearings to provide a full public airing of the important public policy issues. If those recommendations are followed, final rules implementing the proposal are likely to be adopted sooner than 6-months. Senator Lugar has indicated that the Commission's recommendations may provide a basis for drafting amendments to the CEA. We agree that the time is right to act and that legislation, based on the principles of the report, is better than rule making.

We are less sanguine about reform of the Shad-Johnson Accord. Eighteen-years ago the Shad-Johnson Accord divided jurisdiction between the SEC and the CFTC and included a temporary ban on most equity futures contracts. That temporary ban lasted 18-years, during which the single stock futures have thrived in the OTC market in the form of equity swaps and on options exchanges in the form of synthetic futures. Recently the President's working group and Congressional leaders have called for an end to the ban.

Of course, we are pleased that the agencies have agreed that this is appropriate and that U.S. exchanges would be permitted to compete in world markets and to offer U.S. customers the opportunity to manage their risk by means of equity futures contracts. We are also pleased that they have found a way to accommodate their jurisdictional and regulatory concerns on several important issues. But it is too late in the game to be satisfied with signs of progress. We share Senator Lugar's disappointment that the agencies were unable to resolve all of the jurisdictional concerns within the time frame requested.

Our goal is freedom to give our customers what they want and need. Remember, we created tremendously useful products, equity indices, for example, in the face of overwhelming opposition. The SEC and its client exchanges opposed futures on indices with all of the same arguments that they now raise against futures on individual securities. Nonetheless, equity indices are among the most popular contracts on securities exchanges, as well as on futures exchanges.

Futures trading of equity indices has enhanced customer opportunity with none of the ill consequences predicted by the SEC or securities exchanges. In fact, their business has directly benefitted.

One-year ago the Chicago Mercantile Exchange, with the Chicago Board of Trade and NYMEX, undertook to craft amendments to the Commodity Exchange Act that would enhance competition and customer opportunity. We continue to believe that the joint exchange proposal is the best formation for regulatory relief. However, we are well aware that the legislative and industry consensus in favor of a good plan, trumps our theoretically better plan. We are prepared to join the consensus and to give up our plan in favor of the CFTC staff proposal, if we can assure Shad-Johnson relief and fix some of the minor flaws in the CFTC plan.

Our goal was and remains equivalent regulatory treatment for functionally equivalent execution facilities, clearing houses and intermediaries. If we can get to that goal by the path of the CFTC's proposal, then let us proceed with reasonable haste. Thank you very much for the opportunity to give testimony today.

[The prepared statement of Mr. McNulty can be found in the appendix on page 51.]

The CHAIRMAN. Thank you very much, Mr. McNulty. Mr. Donovan, did you want to add anything?

Mr. DONOVAN. David Brennan presented our testimony. What I would like to do, though, is thank you for having this hearing today, because this is a process that we have been engaged in for a number of years. The clock is ticking, and we have a short year. We know the members of Congress are going to want to get out as early as possible this year, and quite honestly, I am afraid if we do not complete the process this year, that Congress will grow weary of this issue. So I harken to Senator Lugar's admonition at the last hearing, that we had better resolve this and work closely with all segments of the financial services sector to move this along. I do think that there are some things that we have to have from this legislation. Namely, a codification of what the CFTC has put forward, because having lived with the CFTC for the past 20-years and a number of chairmen, commissioners and staff, it is very important for us to put something in place that also provides legal certainty for the futures industry so that we can deal with the future.

The CHAIRMAN. Well, thank you. Let me just pick up on your remarks, Mr. Donovan. Right now, the CEA is being rewritten, we have not come forward with a proposal. We have not even passed a proposal out of the Committee. At the same time, the CFTC is proposing new regulations. Meanwhile every day you have all sorts of new types of competition. You are looking at reorganizing yourselves to better address the future competition and the competition that you have out there now. You are being hurt by the lack of legal uncertainty in that you do not know what the new CEA is going to look like. You do not know what the new regulations are going to look like.

How is this uncertainty impacting the Chicago Board of Trade's plans for reorganizing itself?

Mr. DONOVAN. I think, first of all, we are moving ahead at full speed because we really believe that we have to restructure the exchange. Chairman Brennan has taken on the initiative, and he has done a tremendous job of moving it along under very difficult circumstances. It is difficult to change a membership organization when you are having success. But we realize that the future is moving at Internet speed and we have to make plans for our restructuring as though Congress will address that legislatively and will give us the regulatory framework and flexibility to do what we propose in our plan.

If you saw today's issue of "Crain's".

The CHAIRMAN. I read it, yes.

Mr. DONOVAN. There is a piece in there from Chairman Brennan where he talks about the blueprint that we have. Well, we are moving very quickly to separate two companies. Each of them will have different needs, and each of these companies will have to find a regulatory framework with which to function and one that, once a law is passed, will not be so rigid that the day after the bill is signed that new technology will not dictate that it be changed, because Congress is not going to come back to this again in the near future. So it is our hope that we will have enough flexibility and have a performance standard, rather than a design standard, that we can look to for guidance as the goals that we have to achieve after this legislation is passed.

The CHAIRMAN. When do you hope to accomplish your proposed reorganization? Would you want to address that?

Mr. BRENNAN. Mr. Chairman, for my purposes I wish it was yesterday. But, we are waiting for about two more pieces of the plan before we can go to a membership vote. As soon as I can get those, I am planning on scheduling a special Board meeting, and the vote will be 30-days after that special Board meeting. Right now, I am waiting to hear from an independent allocation committee which is made up of our five individual directors. Their job is to determine the allocation of stock, because we have five different classes of membership. That is pretty much dictated by law.

The CHAIRMAN. Ultimately you would have two separate companies, one which would be the pit based exchanges, and the other which would be the electronic exchange.

Mr. BRENNAN. That is correct.

The CHAIRMAN. Now, just looking at these new regulations, and maybe I am premature in asking this, but would you be trying to become an exempt multilateral transaction facility for the electronic exchange and remain a recognized future exchange for your pit based? Do you have any ideas on this?

Mr. BRENNAN. We have not gotten into that kind of detail yet, but I think we are going to analyze our business by product and we expect to be trading the same products in both places. To the extent that we can reach the flexibility we need with both, we will approach it on a product basis I would expect.

The CHAIRMAN. But these proposed changes, once they occur, could have a huge impact on your reorganization, could they not?

Mr. BRENNAN. Yes.

The CHAIRMAN. Yes. Mr. McNulty, how would these proposed changes affect the Mercantile Exchange's proposed reorganization?

Mr. MCNULTY. Well, Mr. Chairman, having advised some airlines and utilities and banks even in their recent deregulation and changes of technology, one of the things that we found is that you need to be a speedy decision maker and you need to be able to make the right kinds of investment. So the Chicago Mercantile Exchange has filed an S–4 with the SEC in order to demutualize the exchange. And what we hope to gain by that, of course, is the ability to work more flexibly with the capital structure and also the ability to have a corporate governance that is streamlined and allows us to make those speedy decisions.

This change in regulation will cause us to make some legal steps, undoubtedly. So we would imagine, for example, that the recognized futures exchange and the derivatives transaction facility would be essentially in the parent firm, following demutualization. And then we could imagine that the exempt multilateral transaction facility would be a subsidiary of the parent firm.

The CHAIRMAN. As Mr. Paul pointed out, they would envision that the exempt multilateral transaction facility would have to be a separate corporation, a separate legal entity.

Mr. Wilmouth, how do the proposed regulations change or expand the role of the NFA as a self-regulating body for the industry?

Mr. WILMOUTH. It is rather difficult to tell at this stage of the game exactly what role we are going to be taking by intermediaries and the exchanges. We made a basic decision 2-years ago to put ourselves forward as an outsourcing facility for self-regulatory functions that have to be performed by the industry. Over the past 2-years I have made proposals to both Chicago Board of Trade and the Chicago Mercantile Exchange to outsource their self-regulatory responsibilities to us. At the present time they have decided to maintain that in house, but as they come forward and become electronic exchanges, then we certainly are going to revisit that proposition.

The other thing that we have done, we are, as I said in my prepared testimony, talked to six different electronic, seven different electronic exchanges recently who are just coming to the forefront with all different types of new products and wanting to become futures exchanges. We are discussing with them each of the possibility of outsourcing their self-regulatory functions to us. So we think this is a broad step forward for us. We think it has great opportunities for us in the future and we are gearing ourselves toward that line.

The CHAIRMAN. Would the Board of Trade and Mercantile Exchange, care to comment on what you might do in terms of taking advantage of the option of having self-regulatory functions that would obviate the need for greater CFTC supervision. I do not mean to be putting you on the spot. How does all this strike you?

To be a DTF you would have to have a self-regulatory body. I would imagine your internal self-regulation would fit the bill or you could outsource it. How do you see whether it will be internal or whether you will contract it out to the NFA? How do you see the self-regulatory function being changed by the CFTC's proposed regulations?

Mr. DONOVAN. Well, I think that looking to a restructured Chicago Board of Trade, our new ECBOT, so to speak, our electronic company would be looking to find its way into the least regulated areas and require less regulation. Just by virtue of the electronic trading, you have more information electronically and the markets may require a lesser level of regulation. As far as the CBOT, the open outcry portion of that, we feel that right now our self-regulatory front line function is far and away the best anyway. We think that the CFTC strictly should be an oversight agency, one that provides the flexibility for us to use our self-the regulatory structure as a marketing tool, for people to want to come and trade at the Chicago Board of Trade.

I have a great deal of respect for Bob Wilmouth and NFA. I served on the Board from the very beginning, but I really feel that the regulation that an exchange provides is a front line regulation and serves as a marketing tool, something that you can do better than anyone else, that people feel comfortable trading in your exchange.

Mr. MCNULTY. I can only echo Mr. Donovan's comments. We have spent years building a highly disciplined self-regulatory body in the CME, and we think that is one of the reasons people come to work on our exchange.

The CHAIRMAN. OK. Let me shift gears just a little bit and ask the Chicago Board of Trade a question specifically. Although the basis for eligibility as a DTF applies to all commodities, the report states that domestic agricultural commodities may constitute a unique category because the current futures markets tend to be the primary, if not the only, centralized source of price basing for those commodities.

In your submitted testimony, you recommend that trading in physical commodities, including agricultural futures, qualify for DTF treatment. Would you please comment further on the reasons for your recommendations here?

Mr. BRENNAN. I will begin. I think rather simply, Mr. Chairman, we believe markets are markets. And to the extent that you can provide liquid markets, the less regulatory burdens you have, the more market players you will have, and the more people that will come and provide liquidity. Any time you have any kind of barriers to entry or any kind of restrictions, it may keep participants away. That ultimately affects the end users. So very simply, we believe that markets are markets and if you have the right regulatory structure, a concern about, whether it be cornering or those issues, I think that those are handled through the regulatory requirements.

The CHAIRMAN. Let me ask Mr. McNulty about clearing facilities. The report recommends the expansion of clearing facilities in the United States. Do you support this recommendation?

Mr. MCNULTY. Well, I think that clearing facilities, in the case of the CME, would be one of the major assets of the exchange. And we could foresee a time when not only do we have further cooperation than we already have with many of the global clearing houses, but we also could foresee a time where we use this as a new source of revenue, where with many of the new exchanges that are opening up, we could provide them with back office services, clearing services, settlement, even dispute resolution as part of a revenue stream for the exchange.

The CHAIRMAN. Mr. Wilmouth, let us return to the best practices issue. In your testimony, you recommended that the core principles should be supplemented with best practices guidelines developed through the industry self-regulatory process. Would you want to comment further on this recommendation. Specifically, would you imagine some of the best practices would be written up in the regulations that the CFTC promulgates pursuant to whatever changes we make in the statute itself, or would you imagine that the CFTC would just have papers on file that people could ask for their best practices, manuals? How would you envision that would work?

Mr. WILMOUTH. Let me, first of all, say that I look best practices as kind of like a safe harbor, and this is a constantly changing thing. So I am not certain that I would want to codify it specifically by the CFTC, because they would be constantly changing. Let me give you an example of what we are doing right now, if I may.

With the Futures Industry Association, funded by the CFTC, we have initiated a best practices study focusing on order entry and transmission procedures in the futures industry. What we did is we formed, and this is part of the self-regulatory process from gathering all the ideas of the best minds in the industry, we have formed four separate committees to take a look at the best practices in that specific area. We formed an operations committee, a technology committee, a compliance committee and a legal committee, made up of industry practitioners. Together with some outside consultants, we are visiting with all of the exchanges, a significant number of the FCMs. We are even sending some of our consultants abroad to talk to some of the exchanges over there. We hope to come out with a best practices in that specific area, through the cooperation of the entire industry.

I would envision that same practice applying across the board to all the best practices that we would envision coming out of the CFTC regulatory reform measure. We think that makes good sense because it draws on the talent, the wealth of talent that exists in the industry.

The CHAIRMAN. So as these best practices guidelines are developed, and if there is a market participant who is complying with those best practices, you would see that as a safe harbor. If they have been following these types of practices, they would presumably be safe from getting in trouble.

Mr. WILMOUTH. They would be a safe harbor, that is right. And I do not think that we want those specified specifically, because they are going to change over a period of time. They will constantly be changing.

The CHAIRMAN. So we would just maybe refer to a best practices policy which itself could be ever changing.

Finally, I have a question for all the panelists. You all agree that we should codify these regulatory changes? Is there an agreement on that.

With respect to intermediaries, the report recommends relaxed standards as to risk, disclosure, registration, financial requirements and the treatment of customer segregated funds. What do you think of these recommendations?

Mr. DONOVAN. We are supportive of the recommendations. We are supportive of a bill that will allow the flexibility to allow this industry to address the technology, the globalization and innovation of our competitors. And if we are unable to do that when this legislation is passed, the business will not be in the United States.

The CHAIRMAN. OK.

Mr. MCNULTY. I would like to echo Mr. Donovan's comments, and I can tell you, having been in the OTC markets for 25-years, it would normally take us 24-hours to turn around a contract, whether the request came from Hong Kong, Latin America, Europe, we could turn around and launch a contract in Switzerland within 24-hours. We are not close to that yet in the United States, and I think this legislation would lead us to that point. And I think it would also loosen some of the restrictions on the intermediaries which would also allow this market to grow at a faster rate than it has in the past 10-years.

The CHAIRMAN. You really like the idea of being able to come out with a new contract without getting prior approval; that is very important to you.

Let me just sum up here. Do you think that this proposal gives you the type of regulatory relief that you need in the 21st Century, leaving aside the issue of the Shad-Johnson. Which I am going to try and address Shad-Johnson at an upcoming hearing and will certainly be something that we will continue to talk about and be working on.

Mr. DONOVAN. It is a step in the right direction. It will definitely depend on how rigid the rules are applied to core principles. If they take away the flexibility that you need, it will miss its purpose.

The CHAIRMAN. The devil is going to be in the details here, how we actually put this in the law.

Mr. DONOVAN. Right.

The CHAIRMAN. But you agree with the principles, and you think it gives you pretty good flexibility and will help you compete, is that correct?

Mr. DONOVAN. Yes.

The CHAIRMAN. That is good. I am very happy to hear that. I want to thank you all for testifying today. We will later take up the issue of futures on individual stocks and Shad-Johnson. If you read the CEA, and I have it right here, I am struck first by the many pages that deal with this complicated Shad-Johnson agreement. It is one of the first things that is addressed in the CEA. I think we are going to have to work on that. To be fair, we will have to have other hearings and receive input from people who might have a different opinion than yours. We will do that at the time.

I remain committed toward making sure that our Chicago markets, not only survive, but succeed and flourish in the 21st Century, and I look forward to working with you all toward that end. Thank you all very much.

I would now like to take about a 5-minute break before we bring in the final panel of market participants.

[Recess.]

Could we bring this hearing back to order.

On our third panel of market participants and intermediaries we have several distinguished panelists. Mr. Barry Lind, who is from Lind-Waldock & Company, has one of the largest retail customer bases, as I understand it, in the country; Mr. Jan R. Waye, Senior Vice President of Cargill Investor Services; Mr. George Crapple, President of the Managed Funds Association; and also Mr. David Downey, Executive Vice President of Interactive Brokers LLC.

Mr. Peter Lee, who is the Managing Director of Merrill Lynch Futures, has had a family emergency and was supposed to be here today, but could not be here due to that emergency. I am going to ask unanimous consent that his testimony be included in the record. Since there is nobody else here to object, I will give that consent.

[The prepared statement of Mr. Lee can be found in the appendix on page 82.]

We will begin with Mr. Lind, the Chairman of Lind-Waldock & Company. Would you summarize what your company does. And what its role in the market is. As I mentioned, you have a large customer base. Could you first describe the manner in which you participate in the market. If you could stick to the topic of how these new regulations would affect your company in the futures market, and stick to that main issue, we would appreciate it. Thank you.

STATEMENT OF BARRY J. LIND, CHAIRMAN, LIND-WALDOCK & CO., LLC, CHICAGO, ILLINOIS

Mr. LIND. Thank you, Mr. Chairman, and thank you for the opportunity to be here. Lind-Waldock is best known for having the largest retail customer base in the industry. We do a lot of institutional business and commercial business, but our primary focus here is on the retail. We are members of almost all the major exchanges in the U.S. We do a lot of our business on-line. Over half our orders come in on-line, as the industry is changing.

The CHAIRMAN. From retail customers?

Mr. LIND. From retail customers. We are probably as well electronically committed and situated as any firm in the industry. And today I would like to address you in regard to the retail aspect of things, because I knew there would be a lot of other people covering the other aspects.

First, let me say that I am very impressed and very happy that the CFTC and Chairman Rainer are looking to modernize and rationalize the regulatory framework of the futures market. Even though this is a work in progress, I would like to commend him for his good work in harmonizing the interests of the industry and the market participants. And I think that the work that he has done has assured us that everybody has gotten a fair hearing. He is certainly very qualified and he is a knowledgeable listener. And that is what has resulted in I think this overall position that we have today of re-engineering the regulation which I agree with.

In general, I agree with the approach. The regulation needs to have flexibility that is based on the type of market that is being regulated, the kind of instruments and the sophistication of the participants. This allows some markets to operate with less regulation, an outcome that I think is a good one. However, there seems to be a consensus that less regulated markets are appropriate for institutional and for qualified investors. There is more hesitation to allow individual investors the advantages that may exist in less regulated areas.

My own position is that individual investors should be allowed access to less regulated markets in order to have the advantages of increased competition that a less regulated market will bring. I believe that with the appropriate framework individuals can enjoy this access with substantially the same protections as the current regulatory environment has.

One of my fundamental convictions is that my customer, in addition to regulatory protection, should be able to have the benefit of the best price available, even if it occurs outside a market that is the most protective of the customer. Any regulatory scheme that has the effect of keeping my customers from less regulated markets will be a costly victory for my customers. They will have all the benefits of protection from fraud and market manipulation but they will be limited to markets where largest liquidity providers may have vanished and it is from this perspective that I offer my comments.

The bedrock of customer protection in current regulations is the requirement that customers' funds be segregated. And I commend the CFTC for keeping this requirement as an important part of the customer protections in any market where an individual investor is permitted to conduct transactions. I fully endorse the report's additional recommendation that non-institutional traders be allowed to access a derivatives transaction facility only through a registered futures broker that is a clearing member of at least one recognized futures exchange, and has a minimum net capital of $20 million.

The benefit of this is twofold. It provides discipline for the carrying firm by requiring that they have capital at risk, and it offers the benefit of regular periodic inspections by an external monitor. And let me say this about the level of capital requirement. I think that this will tend to exclude less responsible parties who may be looking to make a quick buck in these less regulated markets. 20-million will suffice to keep most of these people, if not all of them, out.

I am pleased that the report calls for changing the net capital rules to base them on risk. I have been asking for this for years and years. The current capital rule is an old, old banking rule and makes no sense in derivative markets. Right now, as an example, if I have a customer with $100,000 in cash and no position, I have to put up $7,000 in capital. If, however, he has 100,000-bushels-of-beans on with no money, and therefore, I have substantial risk. Today I have no capital charge for him. So a risk based capital rule would be a move in the direction of rationality.

Most observers, including myself, expect the deregulated environment resulting in increased competition. Even though competition may tighten market spreads in other markets, I think it will take liquidity away from the recognized futures exchanges. If this result occurs, the ability to enter into a transaction in one arena and to offset it in another would benefit all parties, except possibly the market maker. In my written testimony I have termed this the universal transfer mechanism, if you care to look at that.

In a multiple market maker market, I didn't think I would get through that, there will be multiple platforms on which trades can be made. In this kind of environment the challenge is to provide a level of transparency to the price discovery process. We believe in the not too distant future all trades will be conducted on electronic trading platform, where our customers will receive the best bid and offer from the recognized futures exchanges and the counter parties with whom we are dealing with. In this environment our customers will simply point and click on the best market available. However, we are not there yet.

In the interim we propose that brokers who allow retail customers to deal in less regulated markets be obligated to display multiple bids, offers and last sales. These would come from the market makers with whom the retail customer's broker is dealing, along with appropriate recognized futures exchanges. The customer would then simply choose what he believes to be the best priced market. These multiple prices should be recorded along with the customer's transaction.

The one thing that the customer's futures broker cannot totally control is the price. But if the customer can see all the prices that we have available we have put him in the best position that he can possibly be in.

I endorse the report's provision for streamlining the registration of FCM's introducing brokers. I agree that the mandatory disclosures for non-institutional customers should be streamlined and make use of a single signature format including the freedom to accept electronic signatures. All commission requirements including documentation and record keeping should be flexible enough to embrace changes in technology without requiring amendment. In these matters the adoption of core principles that state the goal of the regulation, rather than prescribe exactly how the goal should be met, will go a long way in achieving flexibility in dealing with technical innovation and make us a lot more competitive.

I favor broadening the range of instruments in which segregated funds can be invested, and removing barriers respecting the secured amount requirements for the funds of customers trading non–U.S. markets. I am very encouraged by this report. It is a document that recognizes the dual objectives of regulation, fair markets and suitable customer protection. It reflects careful thought and sensitivity to the needs, both of the industry and the market participants. It moves away from the traditional inflexible regulatory models. It breaks new ground with its philosophy of core principles and offers a shining example of both the process that should be involved in producing regulations and the results that can be achieved by following this process.

This is a working document that provides a framework to be fleshed out. Along with everyone affected by this regulation, I am waiting to see if the final version fulfills the promise of its beginnings. However, this report does make an excellent beginning. Thank you.

[The prepared statement of Mr. Lind can be found in the appendix on page 95.]

The CHAIRMAN. Thank you very much, Mr. Lind. May we now hear from Mr. Waye from Cargill Investor Services. Thank you for being here.

STATEMENT OF JAY R. WAYE, SENIOR VICE PRESIDENT, CARGILL INVESTOR SERVICES, INC., CHICAGO, ILLINOIS

Mr. WAYE. Thank you, Mr. Chairman. Good morning. Cargill Investor Services is A global futures commission merchant operating in all major futures markets around the world. Our client base can be broadly categorized between fund clients of which we are going to hear more of later, large commodity institutions, And large financial institutions. Representing those clients and speaking on behalf of, in addition to Mr. Lind, from the FCM community, I would say we broadly support the recommendations put forward in the staff recommendation to the Commission. We believe this is a step in the right direction, to move from a rules based environment to one guided by broad principles with specific recommendations for best practices.

I would, however, like to make four comments and just briefly summarize on my written remarks which were supplied earlier. First, and before going into the specific recommendations, one of the goals of the report was to provide and continue to provide legal certainty for over the counter derivative contracts. The report said that is imperative and we agree. But we would take it a step further on behalf of our clients and say that we not only need certainty for OTC financial contracts. We also need legal certainty for OTC commodity contracts. And by commodity contracts I am including everything, whether we are talking about corn or crude oil or cotton or electricity. We have seen significant volatility in commodity prices in these contracts, often more so than we have seen in financial markets in the last several years.

Let me explain why this is important. We believe commercial parties should be able to enter into over the counter contracts on commodities without one of the parties later on saying: “No, I am going to walk away from that contract, because I entered into an illegal off exchange futures transaction which was an invalid contract to begin with. We were not allowed to do it.” We believe that legal certainty is essential to prohibit that from happening. We have seen the volatility that can occur in the electricity markets. We have seen the volatility that can occur in agricultural markets. Commercial participants simply need the right to enter into bilateral transactions off exchange and get the same legal certainty that exists in financial over the counter transactions.

There has been a lot of innovation that has brought to bear in financial OTC markets. There has been a significant benefit to consumers in terms of risk management. We believe all those same arguments that have been made for financial OTC certainty, equally apply to commodity OTC certainty.

The CHAIRMAN. Could I stop you for a moment, right now? To what extent are you able to enter into a private contract right now with some institutional customer who wants to have a tailor made contract that will pay his or her institution on the basis of what happens to the price of an agricultural commodity such as corn? Can you do that now?

Mr. WAYE. You can do it, Mr. Chairman, but you run the risk without the legal certainty of the CFTC or the SEC or some other agency bringing an enforcement action against you later on, that,

that was really an off exchange futures contract, even though it was bilaterally negotiated.

The CHAIRMAN. How much of that are you doing right now? How much business are you doing that involves private OTC type contracts dealing with underlying agricultural commodity?

Mr. WAYE. Including both agriculture and energy, and this is a rapidly expanding area. Electricity OTC contracts, we saw the problems a couple of years ago, when electricity prices spiked to record highs during the summer. And then we also saw a record number of defaults. A few years ago we saw a case in Brent crude oil that's called the Transinor case, where one of the parties argued they could walk away from the transaction because it was an off exchange futures contract. So there is a need to eliminate the uncertainty, to encourage the innovation rather than to have this cloud hanging over commodity markets.

The CHAIRMAN. It is good you bring up this point, because we only hear of this legal uncertainty problem in the context of financial over the counter derivatives. That is an area that is growing rapidly and most of that is really interest rates swaps.

Mr. WAYE. Yes, absolutely. And the final comment I would make is, whether we like it or not, people that get involved in commodity markets, tend to be more litigious than institutions trading in financial markets. They tend to walk away from contracts more frequently. The volatility sometimes is much greater. So I guarantee you that going forward we will continue to see these kind of actions pop up.

I would like to go to my second point, and that is one already covered somewhat earlier by the comments you made yourself on the DTF, the derivatives transaction facility, and how do we determine what commodity contracts can be traded on a DTF. But we talked about products with inexhaustible supply, and Mr. Chairman, you pointed out that with Treasury securities that is already a present problem, number one. Number two, one of the few examples of price manipulation did take place with Treasury securities futures on Treasury bond futures. We support the staff report that certain markets do need to be held to higher level transparency and regulation, and we think that is the case, because they perform an important price discovery function. So our comment here is not so much to disagree with the staff report, but just to recommend an alternative definition that contracts were be excluded from the DTF be those contracts that there is no real price discovery function taking place.

I think a lot of financial market participants today would say the price discovery for Treasury bonds probably does not take place anymore in the Chicago Board of Trade, but probably does for corn. So where the market has a true price discovery function taking place, that market needs to be held to a higher degree of oversight and regulation and concern because it is in the public interest. Not because it is in any particular members' interests or participant here this morning, but it is in the public interest. We are trying to discover a true price. Participants in those markets and markets themselves need to be held to a higher degree of regulation.

Third, you said not to go here, but I have to, because I made a comment on stock index products. I will not repeat what was said earlier on Shad-Johnson. But I would say as a global futures commission merchant that our clients outside the U.S. do have access to a much broader range of equity based products that trade on financial futures exchanges than they do in the U.S.

The CHAIRMAN. Do you trade those stock futures?

Mr. WAYE. On behalf of clients.

The CHAIRMAN. What countries do you do that in? Would you know off the top of your head?

Mr. WAYE. Absolutely. In fact, I will just combine this with my last point to save time, because in a lot of these countries we have seen the equities markets and the futures markets merged into one. In the cases of Singapore, Sydney, Frankfort and Paris, we have recently seen a merging, a coming together of the equities exchanges and the futures exchanges under a common platform, a common clearing house and a common regulator. So our clients in those markets are clients of our firm, Cargill Investor Services, are able to trade stock index products, a wide variety of stock index products or stock index derivatives that trade on the futures exchange because in those countries it is all one exchange. It is moving towards one platform and it is one clearing house.

The CHAIRMAN. Do you have American customers who are using Cargill to trade futures on individual stocks in foreign countries? Do you have that at this point?

Mr. WAYE. Yes, but only if those contracts have been approved by the SEC. If the contracts have not yet been approved by the SEC, it would be illegal for us to offer them to U.S. domiciled clients.

The CHAIRMAN. OK.

Mr. WAYE. But non-U.S. domiciled clients can have access to those contracts. I appreciate it is a murky area, but just coming from a customer side, our non–U.S. clients have access to a much broader array of stock in equity based futures contracts than those same customers in the U.S.

Finally, a note on competition. I am glad to see, and the comment was made earlier in the past panel, about the number of new exchanges that are being proposed in the U.S. Our only concern here is that the CFTC be prompt and fair in evaluating these new exchanges and approving them for operation, if they deem so appropriate. I note they did this a couple of weeks ago with a new exchange in Texas which had been under review I believe for 2- or 3-years. There are six or seven new exchanges in the pipeline. And we believe that the role of the CFTC is to encourage competition between exchanges, just as we have significant competition between FCMs and competition exists in other areas of the market, and we are pleased to see the CFTC take steps and acknowledge that these new markets are going to be developed, just as we have seen new markets expand significantly both in equities and in fixed income securities.

Mr. Chairman, that pretty much summarizes the comments that I made in our written submission, and I would be very happy to answer any further questions or be of any further assistance. Thank you.

[The prepared statement of Mr. Waye can be found in the appendix on page 74.]

The CHAIRMAN. Thank you very much, Mr. Waye, for your testimony. And now Mr. Crapple, President of the Managed Funds Association, we appreciate your being here. If you could tell us a little bit at the start what the Managed Funds Association is and does, we would appreciate that.

STATEMENT OF GEORGE E. CRAPPLE, CHAIRMAN, MANAGED FUNDS ASSOCIATION, NEW YORK, NEW YORK

Mr. CRAPPLE. Certainly. A small correction, I am appearing as Chairman of the Managed Funds Association. Our President Jack Gaine overcame great transportation obstacles to get here, and he is also here. But I have the seat at the table.

MFA is a national trade association representing more than 700 participants in the hedge fund and managed funds industry. I should say I am also the co-Chairman and co-Chief executive of Millburn Ridgefield which has managed money in the currency and futures markets since 1971, and also sponsors funds of funds and equity hedge funds.

MFA appreciates the opportunity to testify before the Subcommittee concerning the CFTC's New Regulatory Framework Report and issues relating to the reauthorization of the CFTC. Our association commends the CFTC for its commitment to reinventing the regulatory program in fundamental ways, an approach designed to attract seemingly intractable regulatory issues that have been with us for many years, as well as issues that may be critical in permitting our markets to remain global leaders in the 21st Century.

Members of the MFA in the aggregate manage the vast majority of the over $40 billion invested in managed futures and a significant portion of the nearly $400 billion invested in hedge funds. Our members are active participants in all derivative markets, on and off exchanges, foreign and domestic. Accordingly, a regulatory framework that promotes competition and innovation which results in liquid, efficient markets is of enormous significance to us. We believe the CFTC's report and the previously issued President's Working Group report on over the counter derivatives identify a number of important issues deserving priority and attention.

We believe in general that the CFTC's overall purpose and its suggested approach are highly constructive. The report significantly advances the debate over the optimal regulatory structure in the U.S. futures markets and we applaud the development. I would like to first speak briefly on the new regulatory framework report.

The highly competitive markets in which MFA's members and other market participants operate require prompt and creative responses to new market conditions, new technologies, new products and new trading and clearing mechanisms. The CFTC is to be commended for developing approach to exchange regulation that is designed to expand the ability of U.S. futures exchanges to meet these challenges through a regulatory framework that affords the maximum latitude, subject only to constraints reasonably designed to assure basic customer and market protections.

As we understand it, the report contemplates a regulatory approach under which futures exchanges and the over the counter derivatives trading facilities would operate on an even playing field, one in which appropriate circumstances would be subject to minimal regulatory burdens. We support this concept of a new highly flexible, largely unregulated marketplace. Now, I think I could echo really some of the comments that Barry Lind made. We are concerned about the role of our constituents in the new less or non-regulated marketplaces.

Commodity pool operators and commodity trading advisors and qualified registered professionals acting for pools, hedge funds, and individual accounts should be able to access all futures markets, just as today they have access to swaps, over the counter derivatives and foreign futures and options, markets that are not subject to the highest level of regulation. For CTAs, CPOs and their clients, special conditions or risks in these newly developed markets should be addressed as they are generally today in the case of foreign futures markets by the use of a standardize risk disclosure statement.

As is the case with foreign futures, this risk disclosure statement should be simple and distinct, clearly highlighting the special risks associated with the particular kind of market, thereby permitting the customer to make an informed choice whether to assume these risks. The approach would facilitate the broadest access for CTA advised futures customers in commodity funds to the greatest possible array of innovative U.S. derivative markets, resulting in the deepest, most liquid and hence, efficient derivative market, a goal that we all share.

This approach is far superior to limiting eligibility to access a particular market, to defined group of customers, such as limiting access to only the institutional clients of a CTA. This would create significant problems. As the CFTC knows from its recent efforts, the use of this approach to implement a post trade, order allocation procedure rendered the rule unworkable. The reporting and record keeping nightmare is great. In the current case, for example, if the CTA had 50 clients in a program and only 30 of them qualified for access to the larger more efficient market, the CTA would be forced to trade the 30 accounts in one market and the other 20 accounts in another. As a result, most importantly, the CTA's performance results for the 30 accounts could differ substantially from those with the 20 accounts. Most likely, better results would be gotten for the 30 supposedly large customers. The fragmentation of liquidity would also adversely affect the efficiency of both markets.

So in summary on this point, MFA strongly suggests that CTAs, CPOs and all of their clients and investors have access to all futures and derivative markets. I would next like to very briefly address the issue of regulatory relief for commodity pool operators and commodity trading advisors which is not part of the new regulatory framework report, but is contemplated to be forthcoming.

The CFTC is operating with the MFA, that they will be reviewing the regulatory framework for CPOs and CTAs with the same objectives, enhancing efficiency and competitiveness, which have guided its review of exchange regulation. The CFTC staff in cooperation with the MFA is developing draft core principles for CPOs and CTAs, designed to supplement the report's recommendations concerning other aspects of regulation. We strongly support this effort and have so far assisted and stand ready to assist the

CFTC and the MFA in any way they consider appropriate. There are many inefficiencies to be remedied, including for example, putting public and private offerings of pool interests on a level playing field with public and private offerings of securities and for example, public offerings of mutual funds. We are under a much more restrictive offering regime for which there is no apparent public interest necessity.

Lastly, I would like to mention legal certainty of OTC derivatives. The CFTC report is not principally designed to address the issue but the report builds upon and is consistent with the President's Working Group recommendations for enhanced legal certainty for OTC derivatives, in particular by reinforcing and augmenting the Part 35 swaps exemption, and by providing new exemptions for innovative trading and clearing structures for OTC derivatives.

MFA strongly supports the objective of enhancing legal certainty for OTC derivatives including the President's Working Group recommendations for legislation to exceed OTC financial derivatives from the CEA, as well as the report's recommendation for actions by the CFTC to enhance legal certainty. I would say having listened to Mr. Waye's remarks, that we would certainly endorse additional legal certainty for OTC commodity contracts as well.

We believe that in defining the statutory exclusion for OTC derivatives and other measures to enhance the legal status of swaps, the existing criteria defined in eligible swaps participants should not be further restricted. In fact, they should be expanded to include all clients of CTAs and all commodity pools. The President's Working Group suggestion that consideration be given to increasing financial threshold for natural persons engaging in swaps to $25 million in discretionary investments, in our view, is not warranted by experience or public policy. MFA opposes the creation of additional restrictions upon access to swaps and other derivatives transactions. In fact, the real limitation on participation to these markets is finding a swaps or derivative dealer who has confidence in accepting the business of a particular customer. And we think this is the real check on preventing unqualified people from participating in these markets.

In conclusion, MFA fully supports the efforts of this Subcommittee and of the CFTC under Chairman Rainer to make U.S. futures regulation as innovative as the industry overseas. We look forward to providing our full assistance and cooperation. Once again, thank you for the opportunity to present MFA's views on this important topic.

[The prepared statement of Mr. Crapple can be found in the appendix on page 77.]

The CHAIRMAN. Thank you very much, Mr. Crapple. We appreciate that. Mr. Downey from Interactive Brokers, LLC, thank you for being here. I would appreciate if you could describe for the panel a little bit about what your company does, and then go on to describe your views on the proposed new regulations.

STATEMENT OF DAVID G. DOWNEY, EXECUTIVE VICE PRESIDENT, INTERACTIVE BROKERS LLC, CHICAGO, ILLINOIS

Mr. DOWNEY. Mr. Chairman, thank you very much for inviting me to participate. It is an honor and a privilege.

Interactive Brokers is an organization that provides electronic access to the world's markets, to a variety of customers ranging from large broker/dealer and FCM trading desks down through some of Mr. Crapple's constituents of professional fund managers to individual investors trading out of their kitchens via the use of the Internet. Our platform provides all of these participants with the exact same level of access into the marketplace at the exact same price levels. So they all participate on a level playing field.

We use a network that is connected to over 30 exchanges around the world. We allow our customers to connect to all 30 of them. Retail, that is our small customers who deserve the highest level of protection, we only allow them into the electronic marketplaces where they are protected. They are not allowed into the open outcry markets because of the inefficiencies that occur.

The CHAIRMAN. Is that by your own choice or is that CFTC regulations?

Mr. DOWNEY. No. I have the technology to bring them into the open outcry using my own people. But I have come to the conclusion recently, within the last 4-months, that there is nothing I can do to control the risk present in these customers entering the open outcry. And we are going to develop only from what we believe will eventually succeed. No one has been able to put forth an argument that the open outcry will ever overcome the inefficiencies and cost structures associated with it. They cannot compete on a cheaper, faster basis with electronic markets.

With that said, Mr. Chairman, I have to join everybody here. I think this is a tremendous start with what the CFTC has put out, and it is based on leadership. We are at a moment where we need absolutely to show, and that includes from Congress. Very briefly, on the document itself, I have two main topics. One is I do not believe that any customer should be denied access to any facility as long as they are intermediated and protected. I think that if you start splitting them up where you have large players creating prices that are somehow reflected in the retail trading arena, the retail should have access to both markets. I think that can be achieved through the intermediaries' role.

In the absence of that price transparency, if they are trading like products on different platforms for different people, all prices should be known to all market participants, whether they are allowed to trade there or not, as long as they have a correlated market elsewhere. They can be influenced by prices being established.

The second issue besides the pricing is that it was very clear about the codes of conduct for the RFE, the DTF and the intermediary. On the first two, the issue of audit trails and making sure that there are time stamps that are very clearly spelled out, protecting the customer's access to the markets on a who knows what when basis, because that is market manipulation. But there is no such call on the intermediary's code of conduct, and that is exactly where they need it the most. There are three pieces to the interaction between customers and the market.

There is a collection piece, ruled by the member firms. There is a distribution piece, ruled by the member firms. And an execution piece, ruled by the exchanges today. The danger of time stamping the orders and frontrunning and market manipulation are just as prevalent upstream as they are at the matching edges. So if I could make that statement, that the codes of conduct for intermediaries simply include high resolution audit trails, at least as high as the exchanges themselves, to make the audit trails meaningful.

With that said, I generally agree with the document. I believe it is a tremendous start for us, and details need to be worked out. But the details that need to be worked out are going to be influenced exactly from the leadership from Congress on two very important issues. The first is competition.

Competition is going to be technology based. The exchanges are rushing towards ownership and they are going to be self-regulated, and it raises serious questions, are they going to be partisan in deciding whether a certain technology will or will not succeed. This is no longer an abstraction. We have some exchanges on the securities side who have been faced with issues, should we allow customers to access our markets with the given technology, and they have taken affirmative steps not to allow customers access, and to cripple the technology. That simply has to be protected against.

My concerns with the current framework, with the framework that is being proposed is that the exchange can stop a piece of technology being given to a customer and I need to know who do I plead to.

The CHAIRMAN. Can you give some examples of what you have in mind there?

Mr. DOWNEY. Sure. On the options exchanges, the SEC has come out and said that the member firms have a duty to provide best execution; that is, deliver their customer orders to the highest bid or the lowest offer. The broker/dealers have provided this technology that allows a customer in a kitchen in Iowa from observing the prices on all competing exchanges and pointing and clicking and sending an order to the appropriate exchange. Last Wednesday the CBOE effectively terminated the customer's rights to do the arbitrage if there was a market dislocation between two exchanges or three exchanges. The customer did not have the right to take advantage of that, given the available technology and they stopped automatic execution on that exchange with the blessing of the SEC, a complete contradiction to Congress' bias toward giving technology and the SEC's own statement on broker/dealer's best execution responsibility.

We have had the experience that while the regulators, acting on the intent of Congress, have pushed technology and competition. When push comes to shove, the exchanges step up to the plate and beg for mercy and the regulators simply back down. The NASD, for instance, Mr. Chairman, had a recent proposal on order handling. They received 71 industry comment letters, 59 of them negative in some regard to its new proposal. The SEC let it stand without comment, no changes. That has to be a Congressional issue.

We demand the regulators, you are to act in the fall on technology, innovation and competition, and you have to make it very clear as to the burden of denying technology which will foster competition. That is the first part, leadership.

The second issue is on the clearing house. Competition in the marketplace in the futures, when I hear that people are going to create exchanges, I think that is a great idea. Where are they going to clear it? Where are they going to clear this stuff? If they do not have a facility to clear, that they have a matching engine means nothing to me as a participant.

In the futures market today there is no national clearing mechanism. There is no way for an individual with a matching engine idea to come up and step up and find a place to clear it. They have to go back. Interesting, Mr. McNulty pointed out that he intends to make his clearing operation a revenue stream. That means he is going to use it as a corporate asset, to keep competitors out and raise the prices. If you really want competitive markets in the futures, by the way, where is the competition between products and the futures market? There is none. Where is it in the securities market? Every exchange. Options market? Every exchange. Futures market? They are all based on each other's exchanges. And that is because of clearing.

Clearing in the futures market was instituted by Congress in the 1920's as a result of a default of the Chicago Board of Trade in the 1900's, early 1900's. Market participants were unable at that time to come to an agreement on clearing and Congress had to step in. In my mind they had a flaw in it. They stepped in and said if you want to be a contract market, you got to have a clearing house. But they did not describe how open that clearing house had to be. They left it to the markets to describe it. The Chicago Board of Trade has a separate entity. The Chicago Mercantile Exchange has a division. But they are both exclusive to anyone else, and you cannot get in. When the member firms say we want to compete, they really want to compete on the clearing house. They want people to allow them to clear. And only Congress is going to allow that to happen. CFTC cannot push it. This document is not going to help.

We need leadership from Congress. We want competition, and in order to get competition you need clearing. Clearing structures should be open to all, along the lines of a national clearing and settlement mechanisms established in the securities market by the Securities and Exchange Act amendments of 1975. Without that, we would not have the SEC on the securities side or the OCC on the options side that allows for competition like the international securities exchange, the all electronic options exchange which has driven the options business to incredible competition, lowering and narrowing of bids and spreads, benefiting the member, benefiting the customer base. That is what competition is all about, and it is about clearing.

Mr. Chairman those two issues, a real vision on how we are going to let technology thrive and the establishment of a national clearing mechanism for futures is something that we need leadership from Congress on. Thank you.

[The prepared statement of Mr. Downey can be found in the appendix on page 87.]

The CHAIRMAN. Thank you very much for that testimony, Mr. Downey.

Would any of the other panelists wish to comment on Mr. Downey's proposal for a national clearing house? Mr. Lind?

Mr. LIND. I do not know how you would get that to work. I can say this, that certainly you could not force the Board of Trade clearing corp. or the Chicago Mercantile Exchange to take on the clearing of another exchange. First off, at the Mercantile Exchange, they have a good to the last drop rule. So any funds that we have up there are one thing, but if there was a big default they could just keep coming after us on a prescribed rotation until all the money was gone. No one is going to guarantee a little cattle exchange or some major exchange that may not know what they are doing. So how you can take that from the level, and certainty you could not force the Chicago Mercantile Exchange to do that. And how you can take that on a national realm where you put everybody there, I do not see how the integrity of that would be able to be set up so that people would be comfortable. Because if you are going to have DTFs and other exchanges that are coming about, there would be a lot of reassurance that would be needed to get people to be willing to guarantee that or put money into that.

The CHAIRMAN. Does anybody else wish to comment? Mr. Waye?

Mr. WAYE. It is difficult to perceive, with all the changes that are going to be coming up, with electronic markets and the new deregulatory framework, how the clearing house issue is going to unfold. But I think as a clearing firm, we would be willing to put our capital at risk, if we are satisfied with the organization, with the rules and the regulations, and if that means new clearing houses where there are solid financial parties and solid rules and regulations. We would be prepared to put our capital at risk to enable our clients to participate on new markets. So I cannot guarantee exactly how it is going to unfold, whether existing clearing houses will start to clear a broader array of underlying physical products, for example. Or we may get futures cleared more broadly among a variety of clearing houses.

The CFTC staff would allow the non–U.S. clearing house, such as the London clearing house, to establish a facility or partnership in the U.S. to clear potentially some of the exempt MTEF trades. And I am sorry staff is not here today, to just ask the question. I believe that is the case. So I think we will see more competition for clearing. I think we will see member firms like ourselves be willing to clear new exchanges, if we are confident of the financial strength of those exchanges. So I agree with Mr. Downey, clearing is really a very, very core critical issue and it is difficult to predict exactly how it is going to unfold, but I think we will see significant change coming up in the next year or two.

The CHAIRMAN. Mr. Crapple?

Mr. CRAPPLE. I think it would be highly desirable and it is necessary for effective competition by new exchanges that there be a clearing mechanism available. I do not really think that a major, a new exchange is going to have much of a chance getting started unless it has got the backing of major securities and futures firms that are clearing members of other exchanges. So I see it more as a voluntary rather than mandated approach. But there is no doubt that if it came about through one means or another, that it would be a great enhancement to competition.

The CHAIRMAN. Mr. Downey, I want to ask you a question about access to exempt multilateral transaction facilities, exempt MTEFs. Would you support access to an exempt MTEF by retail customers as long as they are represented by intermediaries?

Mr. DOWNEY. Yes. I think that the people that you are discussing would be exempt and are going to be people who are professionals who are basically trading a lot of individuals' money. Those individuals are going to have access to it, but they are trusting some person to actually pull the trigger on their behalf. I think I would like to say this. The definition of a sophisticated customer is something that is very difficult to pin down. I know some very sophisticated customers with $100,000 in capital and I know some very unsophisticated customers with 10-million in capital, and I think one would be allowed to trade and the other one would not. I think that it really comes down to do you understand the risks involved here? Do you understand this trade might have some defaulters to it?

And also again, in trading it comes down to one thing in my mind. That is the price. Does everybody know what the price is? Does everybody know what the pressure is going to be? And if you do not allow individuals to trade in these facilities, as long as they are trading a product that does have a correlation to a market that is trading downstream, prices have to be disseminated in a very timely manner and that means no delay. As soon as they know about the price, they disseminate it so everybody else can trade on the knowledge that there is a big transaction that took place and it is going to affect everybody's pricing.

The CHAIRMAN. What do the other panelists think about that issue, whether there should be access to an exempt MTEF by retail customers as long as they are represented by intermediaries?

Mr. CRAPPLE. I will take a stab at that. I think Mr. Lind would probably go a step farther than I feel the need to go, because in his case he is an FCM who would be an intermediary, and in the case of the Managed Funds Association, our clients, our constituents are the CTAs and CPOs. So in the case of a customer of a CTA, an individual, regardless of his means, has signed documentation granting discretionary trading authority to a registered category under the CFTC. So the individual is no longer making his own trading decisions. He has delegated that, and as long as the person that it has been delegated to has been invented by the CFTC and the MFA, we see no good argument for foreclosing that ultimate customer from any category of the new market frameworks.

Now, I think Mr. Lind referred to a concept of FCMs with $20 million in capital. At least in a case like that, if an FCM is forwarding orders to any level of exchange and something has gone wrong, you have got a pocket to go to. The customer is not without recourse. Anyone with capital could actually be an FCM. And it is possible for any fly-by-night organization. You would not, I do not think, want to see a blanket rule that any customer of any FCM could go to any market necessarily. But I have great sympathy for the concept of limiting it to FCMs that achieve the material capital.

The CHAIRMAN. Mr. Lind?

Mr. LIND. It comes down to two basic situations. One situation, the more exotic situation might be as an example, something that was offered to me a year ago, which I should have taken. You, as a customer of mine, on an exempt market, maybe the product that is going to be offered is something like this. You can get a return of 1-percent or a return of what the S&P index does over the course of 2-years. So you put up $100,000 and the worst that you are going to get back is $102,000 or if the S&P index goes up 20-percent a year, you get back $140,000. They should be able to deal in that type of product, and they should be able to deal in that type of product through me. So that is the more exotic type.

But the basic situation that we have is right now a lot of transactions, not anywhere near as many percentage-wise as used to be. The market has grown and volume is still good at the futures exchanges, but when we get these off exchange products, if the exchange market, for example, right now is two, three, an off exchange you get the inside market is now two and a half, three, but if the liquidity goes off exchange, like I would suspect a lot of it is going to happen, then the market might be something more like one, four on the exchange.

So I want my customer to be able to get at least the two, three, if not the two and a half, three market. I certainly do not want him to have to pay four or sell at one, because then, no matter how much you protect him, then he has been hurt by this. So wherever the market is, that is what I would like to get for my customer.

The danger that you have in that is if you have some people, because it does not take much to become an introducing broker, and my fear is that he will go down to this off exchange operation down the street with his buddy and instead of having a market of two, three, he will have a market of even to 40 or even to 60. And we have seen that in the past. And that is why I propose the protection, that the firm has got to be a clearing member, has got to have enough money at risk so that he is not going to do something wrong. No member of an exchange that is any kind of substantial member at all is going to mess around like that. So I think that the protections are there. And if the protections are there, then I think that we certainly have to be able to give the best price to the customer, wherever it exists, whether it exists at the exchange, or at an exchange or any of the other categories that have been provided.

The CHAIRMAN. Thank you. You do not have anything to add, Mr. Waye?

Mr. WAYE. I would just go back and support Mr. Crapple's comment, that I believe individual investors who are having their funds managed by a third party, and that third party is registered with the CFTC and the MFA, that third party then should have the ability to transact in the exempt MTEF market on behalf of its clients, whether those clients are retail or institutional or commercial. So I would support Mr. Crapple's comments in that regard.

The CHAIRMAN. So the retail customers get into that MTEF that way.

Mr. WAYE. Yes.

The CHAIRMAN. Mr. Lind, in your opening statement you talked a lot about access to markets. You did not use the word, but I think you were really talking about the bifurcation of the market between retail and institutional customers and you were concerned that retail customers could be denied access to the market with the greatest liquidity. Do others of you share that concern under this proposed regulatory scheme? Business could really migrate from the RFEs. Liquidity could migrate from the RFEs to the less regulated DTFs and exempt MTEFs. If the retail customers do not have a way of getting in those markets, they are really going to be locked out of the most liquid markets. That is a real problem, is it not?

Mr. LIND. That is my problem.

Mr. CRAPPLE. I think that is a good point. I think inevitably there will be some tendency in that direction. An analogy that was made by someone used to be if you could trade the same contracts, certain grain contracts at the Chicago Board of Trade or if you were a small fry, at the Mid-American Commodity Exchange and you had to set the positions limits, so actually the big traders used them all. And they would send orders to the Mid–American Commodity Exchange, and they have a bank of people that the changer phones and they would just immediately lay this off on the big liquid Board of Trade markets. The problem with that is the toll charge on it. It was more expensive. I think that we probably would be faced with something, you would get more customer protection in one sense, but there would be some cost.

The CHAIRMAN. Mr. Downey?

Mr. DOWNEY. Technology today, I think I have demonstrated it to you in the past, the small retail customers know exactly what they are getting, as long as they can see the price and watch the price move and they can see the buy and sell fluctuations by themselves and they can make an informed decision. I do not see the growth of the market being dominated by the institutions. I see the growth of this market being dominated by individual investors who have taken their own decisions into their own hands. And to deny them access to the liquidity of a marketplace simply because they are deemed unsophisticated, I think that is unfair. If they can be delivered, using the technology of a member to protect them and to make sure that they have all requisite information that they need for protection, they deserve to be able to participate.

The CHAIRMAN. The problem here is that, in an attempt to help protect the retail investor, we could in fact deny them the best prices and thereby hurt them. Far from protecting them, we could be hurting them. We have got to be very careful here.

To summarize, am I correct in saying that you feel that if the retail customers would have access to the exempt MTEFs through other intermediaries, but not directly, they would be protected?

Mr. DOWNEY. I do.

The CHAIRMAN. OK. They would still have access to those most liquid markets, is that correct?

Mr. DOWNEY. You must remember that the only reason why it is not clearing houses is because of contract market status. These would not be contract market status, these entities, these MTEFs, so they would not need a clearing house. Retail customers should not be exposed to non-clearing house cleared products. I am trying, again, to lobby you to create a clearing house.

The CHAIRMAN. Right, right. I hear you. I hear you

Mr. LIND. Wait a minute. Mr. Chairman, may I comment on that?

The CHAIRMAN. Yes.

Mr. LIND. The opposite party in this type of transaction, I am acting as the intermediary for my customer, and maybe the opposite party is Goldman Sachs. Now, in my proposal, all my customers' funds have to be segregated to begin with. But the responsibility of making that trade good on one side is Goldman Sachs. Now, if Goldman Sachs defaults, my customers' monies are still protected because it is all segregated funds.

Now, if we do not have an arrangement, where we settle every day and he defaults to me, then my in my opinion that obligation is mine. The customer gave me the order. I deal with Goldman Sachs, Goldman Sachs goes out of business, I have to make my customer good. I may have his money in segregated funds, but I may not have the profit that he had on a position, I have to make that good myself. But the customer will be totally protected in that regard, whether there is a clearing house with a DTF or not.

The CHAIRMAN. What do you think about the suggestion for the relaxed standards as to the segregated funds? Does anybody want to comment any more on that?

Mr. WAYE. Mr. Chairman, I think the recommendations by staff to allow a somewhat greater degree of flexibility in how segregated funds are invested and managed by the FCM, as Mr. Lind said, we would support that.

The CHAIRMAN. What are you allowed to invest them in now?

Mr. WAYE. U.S. Treasury securities.

The CHAIRMAN. And that is pretty much it? What would the proposal be that you can invest them in?

Mr. WAYE. I have not seen it exactly. But I have heard CFTC staff say you might be able to invest them in similar securities to what a clearing house accepts today. Or I am not quite sure if their thought is to lower it like double A or single A or A–1 plus P–1 commercial paper. I am not sure. Just that they would broaden it beyond treasuries only, which is the current requirement.

The CHAIRMAN. I think they had in mind municipal bonds and the like. I should not comment on that. I will leave that to the CFTC.

What do you think about the other suggestions for relaxed standards as to risk disclosure, registration, financial requirements and the like? What do you all think of these recommendations for the intermediaries?

Mr. DOWNEY. I personally do not find them to be a burden at all. They are deliverable. I know a lot of it is the paper, they would create paper and deliver it and get signed signatures. I think the CFTC has already moved forward on electronic signatures which opens up the door for electronic delivery. I do not provide any of my customers these risk disclosure statements in a paper format. They capture them electronically. They read them. They take a test on them. And they acknowledge that they have gotten them. I do not find them to be a burden. Technology can solve that problem, and I consider it a good policy to understand that our customer understands the risks involved in the business he is about to undertake.

Mr. LIND. First, let me say that the risk disclosure statement for the retail customer today, I am guessing now but I would have to say it is probably over 20-years old. And times have changed. The sophistication of people today, even people who have never traded before, is so much higher than it was back then, that I think that risk disclosure today, I think there should be a risk disclosure. I think it should be for today's times. I do not think that most of my customers read it. Certainly I do not give them a test. What do you do if someone fails the test?

Mr. DOWNEY. Let them take it again.

Mr. LIND. Right. They would check off that they have received it, but I doubt that very many people read it. Now, I think that a more appropriate message about the risks of trading could be enclosed in a short enough form that the people probably would read it. But right now, the whole thing is pretty burdensome, and it is really out of date, but we can live with that. And I think it should be there.

Also, going back to the segregated funds, part of the reason why the relaxation of segregated funds would be, because our competition overseas has a whole relaxed aspect to that. They can invest in many other things. Some of the customers here would like to direct the firm that they are trading with to take the funds and invest it in something else where they are going to get a better return rather than on treasuries. I, myself, for the retail customer believe the funds should stay segregated but only for the retail customer, and that those funds should be invested only in treasuries the way they are today.

The CHAIRMAN. Well, thank you very much. I am going to adjourn this Committee meeting now. I appreciate very much the substantial contribution all of you have made, through your prepared remarks and through your testimony today. Rest assured, I will take this input back to Washington, as we rewrite the Commodities Exchange Act this year. Let us hope that we get it done by September, which we have set as an absolute deadline. Thank you all very much for your help today. Thank you.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

APPENDIX

MARCH 20, 2000

STATEMENT OF SENATOR PETER G. FITZGERALD

Committee on Agriculture, Nutrition, and Forestry
Subcommittee on Research, Nutrition, and General Legislation

Hearing to review the report entitled *A New Regulatory Framework* by the Commodity Futures Trading Commission Staff Task Force

Monday, March 20, 2000

This morning I am pleased to chair this field hearing on the report entitled *A New Regulatory Framework,* which was prepared by the Commodity Futures Trading Commission Staff Task Force. This Report makes recommendations to change the Commodity Exchange Act (CEA) in ways that would significantly impact the nation's financial markets and the commodity futures industry that is so vital to my home state. Thus, I am proud that several of my constituents will be testifying before the Subcommittee today - David Brennan and Tom Donovan from the Chicago Board of Trade, James McNulty from the Chicago Mercantile Exchange, Bob Wilmouth from the National Futures Association, Barry Lind, from Lind-Waldock, Jan Waye from Cargill Investor Services, Inc., and David Downey from Interactive Brokers.

During this year, the Commodity Futures Trading Commission (CFTC) reauthorization process will take center stage in the area of exchange derivatives trading. I look forward to working closely with my colleagues throughout this process to ensure that the United States derivatives markets remain strong, competitive, and viable.

Today's hearing involves one of the major issues that Congress will be examining during the CFTC reauthorization process - regulatory relief for entities covered under the CEA. In the Report, the CFTC proposes a substantial rethinking of its current regulatory approach. Under the proposal, the CFTC would base oversight of futures markets on the types of products they trade and investors they serve. Under the proposed framework, the CFTC envisions three tiers of regulation corresponding to three kinds of trading facilities. This framework uses two criteria to categorize derivatives trading activities: (1) the susceptibility of the market to manipulation and (2) the access to the market by retail or institutional customers. According to the Report, existing futures exchanges would be able to choose which model, or combination of models, best suits their business needs.

In this era of profound change in the world financial markets, United States derivatives markets must be given the regulatory flexibility to compete equally with global markets. In order for the United States to offer the most efficient markets in the world, regulatory relief is a "must do" task.

Unfortunately, federal regulation of the derivatives markets has not kept pace with this change and today serves more as a restriction on modernization and competitiveness. Thus, there is an urgent need to reduce the inefficiencies of the CEA, remove the constraints on innovation and competitiveness, and transform the CFTC into an oversight agency with less front-line regulatory functions. The failure to do so can only result in a loss of our national competitiveness in a rapidly changing global marketplace.

I am encouraged by the proposed broad-oversight regulatory framework recommended by the Report and I commend the efforts by Chairman Rainer and his staff in moving the CFTC to a position of an oversight agency. The Report appears to be very responsive to the concerns of the Chicago futures industry and seems to provide flexibility for various business models to embrace rapidly evolving technological changes. The proposed creation of three kinds of trading facilities with varying levels of regulation appears to provide more flexibility to both traditional exchanges and electronic trading systems.

I also realize that the proposed recommendations present a difficult adjustment for organized futures exchanges. As the Report makes clear, it is a proposed framework that is still very much a work in progress. It contains broad statements of regulatory policy that have not yet been reduced to specific regulatory language. In that regard, it is difficult at this time to assess how the "core principles," which form the regulatory backbone of the Report, will be implemented in a way that will result in a truly oversight role for the CFTC. As a result, I look forward to the issuance of the CFTC's regulatory proposal which will give the futures industry and other interested parties an opportunity to participate in the final process.

As the CFTC moves forward to implement its proposal administratively, I look forward to working with Chairman Lugar on legislation to codify these regulatory intentions. The removal of regulatory barriers to fair competition, while providing appropriate investor protection, must be a top priority of CFTC reauthorization. It is imperative that the United States futures markets be given broad flexibility to respond to the rapid changes in technology and product innovation occurring in the world derivatives markets. I look to guidance from the panelists on this important issue.

Testimony of

C. Robert Paul
General Counsel
Commodity Futures Trading Commission

Before the United States Senate

Committee on Agriculture, Nutrition & Forestry

Subcommittee on Research,
Nutrition, and General Legislation

March 20, 2000
Chicago, Illinois

Thank you, Chairman Fitzgerald. I am pleased to be here to testify before you on behalf of Chairman Rainer and appreciate the opportunity to discuss recent efforts at regulatory reform.

Chairman Rainer has identified three public policy goals that the CFTC should focus on in regulating derivatives markets: first, creating a comfortable climate for competition in all sectors of the industry; second, removing any regulatory barriers that hamper these markets from fully exploiting innovations in technology; and third, decreasing the level of systemic risk in domestic and international derivatives trading. To achieve these goals, it is imperative to modernize the way we regulate futures markets.

Accordingly, a staff task force of the Commission has developed a new regulatory framework that would change the regulatory structure for derivatives. The proposed framework is intended to promote innovation, maintain U.S. competitiveness, reduce systemic risk, and protect derivatives customers. Any proposal ultimately adopted will not be tailored to the desires of any special interest or driven by jurisdictional concerns. We want to find solutions that serve the public interest.

The new framework is a work in progress; it is a staff document on which there has been no Commission action. The CFTC will hold at least one public hearing on this proposal in order to get as much input as possible from markets and participants. But we also recognize that time is *not* our ally. In spite of the difficulty of developing answers to questions of regulatory architecture, we must work together expeditiously to reach conclusions suitable for these markets and the public interest. Technology offers us tangible benefits that are either immediate or imminent: faster and better execution; significantly lower transaction costs; cross-market clearing, netting and offsetting systems; and increased liquidity. The U.S. futures industry must embrace technology without reservation to build stronger markets if they expect to remain competitive.

Flexibility is the hallmark of the new framework. The staff's proposal recommends that the Commission replace the current one-size-fits-all regulation for futures markets with a structure that would instead apply broad, flexible "core principles," which are tailored to match the degree and manner of regulation to a variety of market structures. Under this proposal, multilateral trade execution facilities would operate in one of three categories, taking into account the nature of the underlying commodities and the sophistication of customers. While the framework invites change, it does not impose it on established futures exchanges. Existing exchanges operating as contract markets *may* reorganize under the terms of the framework, but they are not compelled to do so.

The framework offers three basic categories of exchanges or trading facilities correlating to a spectrum of regulation: recognized futures exchanges, recognized derivative transaction facilities and exempt multilateral trading facilities.

The category of recognized futures exchange ("RFE") would include multilateral transaction execution facilities that permit access to any type of customer, institutional or retail, and that trade any type of contract, including those that are based on commodities that have finite deliverable supplies or cash markets with limited liquidity. So these markets would include the current futures markets trading contracts on physical commodities. Because these markets trade products that may have a greater susceptibility to price manipulation and because the presence of non-institutional traders participating here raise deeper concerns for customer protection, RFEs would be subject to a higher level of Commission oversight than markets in either of the other two categories.

Nonetheless, the proposed RFE offers significant regulatory relief compared to the current requirements applicable to designated contract markets. Restrictive or prescriptive rules would be replaced with 15 broad "core principles" governing the RFE, including principles relating to market surveillance, position reporting, transparency, fair trading standards, and customer protection. Any board of trade, facility, or entity that is otherwise required to be designated as a contract market would be eligible to qualify as an RFE.

The second category, the derivatives transaction facility ("DTF"), would be subject to a lesser degree of Commission oversight. A facility is eligible to become a DTF if: (i) the contracts traded on the facility are for underlying commodities that have nearly inexhaustible deliverable supplies or for which there is no underlying cash market (e.g., weather derivatives); (ii) the contracts are determined by the Commission on a case-by-case basis to be appropriate for inclusion in this category; or (iii) only commercial traders are permitted to trade on the facility, regardless of the nature of the underlying commodity. A DTF could permit access by non-institutional traders only if those trades were intermediated by a CFTC registrant, or the DTF could choose to limit access only to institutional participants.

A DTF would be required to adhere to seven core principles, including principles relating to market oversight, transparency, and recordkeeping. Because DTFs will either trade commodities that do not raise concerns about manipulation or because they will be limited to institutional or commercial participants, DTFs are not required to adhere to core principles that apply when those conditions are not met. Consequently, the DTFs are not required to comply with core principles relating to position monitoring, customer protection or dispute resolution, among others, that apply to RFEs.

Finally, the third category, the exempt multilateral transaction execution facility ("Exempt MTEF"), would operate on an unregulated basis. This is a self-effectuating exemption for transactions among institutional traders in commodities with virtually inexhaustible deliverable supplies or supplies that are otherwise sufficiently large and deep to render a contract traded on them unlikely to be susceptible to manipulation.

These markets would be exempt from all requirements of the Act and Commission regulations except for anti-fraud and anti-manipulation. Moreover, if a designated contract market has an eligible contract and chooses to trade it on an exempt-MTEF, the MTEF would have to continue to provide pricing information to the public. The terms of the exemption would also provide that transactions consummated in reliance upon the exemption are not void as a matter of law if the exemption's provisions are violated. Exempt MTEFs would not be permitted to hold themselves out to the public as being regulated by the Commission.

Thank you again for the opportunity to testify before you today.

TESTIMONY OF
JAMES J. MCNULTY
PRESIDENT AND CEO
CHICAGO MERCANTILE EXCHANGE

BEFORE THE
SUBCOMMITTEE ON RESEARCH, NUTRITION
AND GENERAL LEGISLATION

SENATE COMMITTEE ON AGRICULTURE,
NUTRITION AND FORESTRY

March 20, 2000

Testimony of James J. McNulty

On behalf of the

Chicago Mercantile Exchange

Introduction

Chairman Fitzgerald, committee members, ladies and gentlemen, I am James J. McNulty, president and chief executive officer of the Chicago Mercantile Exchange since February 7, 2000. Obviously, I come to this hearing with a very short history at the Exchange. However, I have had 25 years of experience in the full range of financial markets. I have traded or supervised trading in all financial futures and options; I am sensitive to the needs and expectations of over-the-counter markets; I appreciate the impact of technology on the future of the financial services industry. I hope my testimony reflects that sensitivity.

The CME is exceptionally encouraged by the CFTC Staff Task Force Report, *A New Regulatory Framework.* The Commission has been both responsible and responsive to the concerns of all elements in the financial services industry. We are pleased by the tone of the proposal, which is consistent with a progressive regulatory philosophy that depends on oversight and competition among markets rather than prescriptive regulation of protected market spaces. The CFTC staff, under Chairman Rainer, has demonstrated a deepening understanding of the complex technological and competitive issues facing our markets and a commitment to providing much needed regulatory relief. I will discuss our view of the details of the report and suggestions for implementing it below.

We are less sanguine about reform of the Shad/Johnson Accord. Eighteen years ago the Shad/Johnson Accord divided jurisdiction between the SEC and CFTC and included a temporary ban on most equity futures contracts. That temporary ban lasted 18 years during which time single stock futures have thrived in the OTC market in the form of equity swaps and on option exchanges in the form of synthetic futures. Recently the President's Working Group and congressional leaders called for an end to the ban.

On December 17, 1999, Chairman Lugar (Senate Agriculture Committee) and Chairman Gramm (Senate Banking Committee) asked Chairmen Rainer and Levitt for a "detailed report addressing the desirability of lifting the current prohibition on single stock futures together with any legislative proposals . . . no later than February 21, 2000. On January 20, 2000, Chairmen Combest, Ewing and Bliley asked the SEC and CFTC to create a "joint legislative plan for repealing the current prohibition on single stock futures . . . no later than February 21, 2000." On March 2d, Chairmen Levitt and Rainer responded by presenting "the current views" of the agencies.

Of course, we are pleased that the agencies have agreed that it is appropriate that U.S. exchanges be permitted to compete in world markets and offer U.S. customers the opportunity to manage risks by means of equity futures contracts. We are also pleased that they have found a way to accommodate their jurisdictional and regulatory concerns on several important issues. But it is far too late in the game to be satisfied with signs of progress. We share Senator Lugar's "disappointment" that the agencies were unable to resolve all of their jurisdictional concerns within the time frame requested.

The agencies have not committed to submitting the requested comprehensive legislative proposal in time to include it in the regulatory reform bill that will be considered during this session. If that bill permits the over-the-counter market free reign in equity swaps and permits OTC dealers to set up electronic markets to trade single stock equity futures as has been proposed, we will be placed at an even greater disadvantage than we suffered in the past. We favor legal certainty for the OTC market, but it is essential that regulatory parity and complementary relief be given to the futures exchanges contemporaneously with the relief granted to our direct competitors. We agree with Senator Lugar's assessment that, "delaying the resolution of this issue until October puts into serious doubt whether Congress can enact legislation this year to re-authorize the Commodity Exchange Act and to implement the President's Working Group findings on over-the-counter derivatives."

I would like to put my conclusions in context by briefly reviewing legislative and regulatory history, discussing business conditions and trends, discussing our reaction to some key points of the report, and giving you a clear statement of our overall position. Bottom line, I urge that the Report be the basis for a legislative overhaul of the CEA and that elimination of the Shad/Johnson prohibition against single stock futures be an integral part of that legislative package.

Legislative and regulatory framework

The history of the Commodity Exchange Act is often misconstrued to support arguments that derivative contracts traded by banks, broker - dealers, or unregulated OTC dealers are beyond the jurisdiction of the Commission. In fact the CEA's purpose was to force all derivative agricultural contract to be executed subject to the rules of a designated contract market. When the CEA was amended to create the CFTC, its scope was broadened by amending the definition of a commodity to include "all other goods and articles, except onions . . ., and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." This change brought all derivative contracts under the aegis of the Commission.

In retrospect, it is clear that Congress did not foresee development of an immense off-exchange market for individually tailored and negotiated, "contracts for future delivery" among sophisticated counter-parties, *i.e.*, "swaps." While such contracts are literally governed by the CEA, they were not candidates for exchange trading nor was there good reason to ban them. In 1989, the Commission declared that it would not enforce the CEA against swaps transactions between qualified parties. The Commission was unable to exempt such contracts from the exchange trading requirement of the CEA before the 1992 addition of section 4(c) to the CEA. The Commission hastily granted unambiguous regulatory relief to the swap market after the amendment.

The current regulatory structure places U.S. regulated futures exchanges at a significant disadvantage to off-shore competitors and the domestic OTC market. Overly detailed regulation of futures exchanges increases direct costs and time to market of innovative products. Our business space is constricted by the artificial constraints imposed by Shad/Johnson. OTC competitors are converging with futures markets in all respects other than regulatory burdens. Although the CFTC exemption that permits the OTC market to do swaps business precludes mimicking futures exchanges, we see auction markets for standardized futures contracts cloaking themselves in the mantle of the OTC market and avoiding any regulatory response.

Business Conditions and Trends

Regulatory policy in the futures industry was crafted on the presumption that the business was not portable. Recent massive business shifts have demonstrated the fallacy of that presumption. The dominance of U.S. futures exchanges has eroded. Their ability to compete with the over-the-counter market and foreign exchanges has been hampered by U.S. regulatory policy. Some governments have quickly and accurately balanced legitimate business needs against customer and market protection. London's exchanges have been freed from the pre-approval process. Singapore's regulator expedites approvals when international competition is at stake. U.S. exchanges have been kept waiting for regulatory relief. In contrast to the treatment of exchanges, the CFTC speedily exempted most of the OTC derivatives market from oversight and regulation immediately after authorizing legislation in 1992. Growth in the OTC market has been staggering compared to growth of exchange traded derivatives. Foreign exchanges have caught and surpassed U.S. markets.

Advances in communications and information management have changed the face of the industry and outrun the policy that had been used by the CFTC to shape the regulatory landscape for financial products. A number of jurisdictions recognized this change and crafted their tax and regulatory policies to capture business. Because of the importance of international financial transactions to London, it adopted a regulatory system that facilitates the operation of futures markets. In London, recognition of the realities of international business flows combined with a "...benign political attitude permits an accommodating tax and regulatory framework and a relatively predictable and sensible legal system." London profited from the restrictive policies in the USA, which reinforced London's comparative advantage as a benign location.

Twenty- five years ago, New York State, New York City and the New York Stock Exchange learned this lesson in a less technological environment. Each acted as if the local monopoly on securities trading was secure. Market users found a remarkably simple solution. They boarded the subway, traveled under the river to New Jersey and completed their transactions on the station platform less than a mile away. Burdensome transfer taxes and restrictions on certain block trading practices were avoided. Eventually the New York Stock Exchange and its overseers recognized market realities and removed these restrictions.

International networks have replaced the subway. Encrypted communications and secure fund transfers coupled with international depositories and clearing organizations have written finis to local market monopolies. Not even the almighty dollar anchors business transactions to this jurisdiction. The vast store of capital on deposit in Europe has eliminated the local advantage. Investment capital moves based on the London inter-bank offered rate, not U.S. interest rates.

The U.S. futures industry operates in a global economy where the primary competitors are unregulated, like the over-the-counter market, or regulated by governments and agencies intent on promoting domestic financial markets, like London, Singapore, Brazil, and now France. We must follow those examples or watch further erosion of market share.

CFTC Task Force Report

On February 22, 2000, Chairman Rainer sent the report of the CFTC Staff Task Force, titled *A New Regulatory Framework* to Senator Richard G. Lugar, Chairman of the Senate Committee on Agriculture Nutrition and Forestry and Representative Larry Combest, Chairman of the House

Committee on Agriculture. The report reflected comments from exchanges, agricultural groups, FCMs and participants in the OTC market.

The report suggests use of the Commission's exemptive power to create a regulatory environment that will permit the industry to accommodate itself to real world conditions. The goal was to move the agency toward an oversight standard and to limit regulation to the extent necessary to accomplish legitimate regulatory goals. The degree of regulation will be directly related to the characteristics of the product (whether it is manipulation proof) and the type of customer that has direct or indirect access to the market (markets with retail customers must endure more regulation). The Commission will not discriminate against open out-cry markets in favor of electronic systems.

The staff proposes a self-executing exemption from everything other than fraud and manipulation prohibitions for exchanges that trade manipulation proof products, like the Bonds and the Eurodollar, and that limit access to institutional traders (MTEF). This will permit the CBT or the CME to set up an unregulated subsidiary without any CFTC approval or regulatory oversight. That subsidiary will be protected from other regulators and state lawmakers by the Commission's exclusive jurisdiction and the preemption provision of the CEA. This proposal offers the regulated exchanges a fighting chance to respond to exchanges, like Blackbird, that are now operating outside the CEA with the tacit consent of the Commission.

Any exchange that meets the requirements for an MTEF exemption could become a Derivative Transaction Facility (DTF) and subject itself to slight CFTC regulation. The CFTC believes that there are significant benefits, such as eased access into foreign countries and greater appeal to certain customers, of being "recognized" and lightly regulated by a federal agency. In addition, a DTF is open to retail customers that are intermediated by an FCM.

The staff also recommends that an exchange operated for commercial users of the traded products may qualify for DTF treatment even if the underlying products are not free from the risks of manipulation. This exemption is tailored to the burgeoning internet trading systems for electricity, pulp, etc commercial products that are used by businesses. Many of these exchanges are now focussed on spot transactions, but expect to transition to forwards and futures in the near future. The facilitation of growth of these niche markets as unintermediated, stand-alone operations increases competition.

All designated contract markets qualify as Recognized Futures Exchanges (RFEs). An RFE will be subject to oversight regulation requiring performance in accordance with 15 core principles rather than the prescriptive regulation that now characterizes the Commission's approach.

Clearing

The staff proposes that clearinghouses "that clear transactions executed on an RFE or DTF be authorized by the Commission." This proposal appears to give CFTC regulated clearinghouses the exclusive right to clear such exchanges. However, staff recommends that the Commission find a way to "authorize" without regulating DTF clearinghouses authorized by the SEC, Federal banking regulators, or an approved foreign authority.

Staff proposes to permit bank regulators, the SEC, or approved foreign regulators to govern clearinghouses that clear exempt products or exchanges, like Blackbird. A clearinghouse that clears agriculture derivatives or an exchange with direct or indirect retail customers must be regulated by the CFTC. This feature of the proposal raises significant competitive concerns.

The proposal permits exempt futures exchanges (MTEFs) to clear their futures contracts through SEC, bank, or foreign regulated clearinghouses. The staff has recommended that the Commission extend this leeway to institutional futures exchanges (DTFs). We will be concerned if SEC and bank regulated clearinghouses are able to clear cash, securities and futures under one roof while that privilege is denied to our clearinghouse.

Intermediaries

The CFTC staff responded positively to our call to permit broker-dealers and banks to send institutional business to designated contract markets without subjecting themselves to duplicative CFTC registration. Unfortunately, staff proposes to limit this relief to the DTF category of futures exchange. It is not clear that retail customers would be subject to increased risk of any sort if institutional customers could more easily participate in the same market. We would argue that retail customers will benefit from a broadening of the market and the increased liquidity and transparency that usually follow.

Swaps

The exemption for OTC dealers engaged in bilateral transactions with "appropriate persons" is retained. However, OTC dealers engaged in bilateral transactions under Part 35 would be permitted to clear the contracts without losing the exemption. The Part 35 swap exemption is superseded with respect to products like the bonds and the Euro. To the extent that the underlying commodity is manipulation proof, OTC dealers need not rely on Part 35. They will be permitted to set up the equivalent of an exempt exchange and trade fungible products through the facilities of an MTEF.

Treasury Amendment

The CFTC proposal should end all arguments in favor of expanding the scope of the Treasury Amendment. The proposal will permit anyone to set up an institutional futures market involving non-manipulable products and completely escape CFTC regulatory jurisdiction. Brokers will be able to operate electronic systems to deal with their institutional customers. Groups of brokers can set up futures exchange look alikes and escape regulatory jurisdiction. In essence, the CFTC offers the OTC market complete legal certainty for exchange trading and clearing of all manipulation proof products except equity swaps. This is as far as Congress should be prepared to go. Proposals to permit exempt retail futures exchanges in Treasury Amendment products are contrary to the intent and purpose of the CEA. We support the CFTC proposal as an alternative to the PWG proposal to amend the Treasury Amendment.

Timing and Content

The Task Force recommends that the Commission convert its proposal into a proposed rulemaking subject to a 60 day comment period and public hearings to "provide a full public airing of the important public policy issues . . . ." If those recommendations are followed, final rules implementing the proposal are unlikely to be adopted sooner than six months. Senator Lugar has indicated that the Commission's recommendations may provide a basis for drafting amendments to the CEA. We agree that the time is right to act and that legislation based on the principles of the report is better than rulemaking.

The Report is limited to matters fully within the Commission's exemptive powers. It does not consider Shad/Johnson reform. We believe, however, that any legislation that incorporates legal certainty for the OTC market should simultaneously deal with Shad/Johnson relief for organized markets. The President's Working Group has proposed to override Shad/Johnson restrictions that now limit OTC transactions. The PWG proposes to exclude swap agreements that "reference non-exempt securities" from the CEA. We are confounded by the irreconcilable contradiction between the Working Group's conclusion that over-the-counter swaps, including equity swaps, should be excluded from the CEA while refusing to endorse revisions to the Shad/Johnson Accord for regulated markets. There is no principled reason to support unregulated, over-the-counter trading in a product while refusing to permit identical products to trade in the well regulated, price-transparent and liquid environment provided by the CME.

Resolution of Shad/Johnson Issues

Eighteen years ago, the Shad-Johnson Accord resolved a jurisdictional conflict between the SEC and the CFTC. It was not intended as a permanent barrier to innovation and growth. Stock index futures have matured into vital financial management tools that enable pension funds, investment companies and others to manage their risk of adverse stock price movements. The options markets and swaps dealers offer customers risk management tools and investment alternatives involving both sector indexes and single stock derivatives. Futures exchanges have been frozen out.

The reasons advanced against reform of Shad-Johnson disguise competitive and/or political concerns. Today, Shad-Johnson is being used as a weapon against competition. The SEC, through statutory misinterpretation and, what a court has found to be at best "arbitrary and capricious," and at worst "suspect," application of its powers, has denied futures exchanges the right to trade futures on stock indexes that reflect price movements in substantial market sectors. The SEC has taken the position that futures could not be traded on the Dow Jones Utilities and Transportation Averages because they did not "reflect" the utilities and transportation sectors, respectively. While a recent court decision has overturned and vacated that SEC decision, Board of Trade v. Securities and Exchange Commission, No. 98-2923 (7th Cir., August 10, 1999). The court of appeals found: "The stock exchanges prefer less competition; but if competition breaks out they prefer to trade the instruments themselves . . . . The Securities and Exchange Commission, which regulates stock markets, has sided with its clients." Slip Op. at 4.

Congress intended the Shad-Johnson ban on single stock futures to be temporary. The court of appeals found that the ban "was a political compromise; no one has suggested an economic rationale for the distinction." Slip Op. at 4. In the absence of such a rationale, Congress should lift the single stock futures ban and allow the marketplace to decide whether these instruments would be useful new risk management tools. Many exchanges around the world trade single stock futures; no reason exists to deny U.S. customers and markets the same opportunity.

An appropriate division of responsibility between the SEC and CFTC for futures trading of contracts currently prohibited by the Shad/Johnson Accord may be directly derived by determining how a futures contract can be used to avoid prescriptions of the Securities Acts. In all such cases, it is reasonable to amend the Securities Acts to treat a futures contract as if it were an option on a security for enforcement purposes. We agree that the integrity of the Securities Acts require that futures contracts should not be used to avoid the following prescriptions of the Securities Acts:

- Federal Reserve margin setting authority and oversight;
- Insider trading;
- Short swing trading;
- Front running (a program is already in place);
- Manipulation of securities prices;
- Protection of pricing and integrity of tender offers (Section 14);
- Protection of pricing and integrity of public offerings;
- Avoidance of the economic risk of compelled holding of a security, e.g., lockups (although the OTC market regularly permits persons who are locked into a security position to eliminate the risk of that position);
- Trading during a regulatory market halt;
- Circuit breakers;
- Trading suspensions or halts;
- Emergency declarations;
- Any similar prescription to be identified.

The CME's goal is freedom to list and trade futures contracts now forbidden by the Shad/Johnson Accord without being subjected to multiple regulators and without changing the fashion in which we have conducted our business for more than 100 years. Remember, we created a tremendously useful product, equity indexes, in the face of overwhelming opposition. The SEC and its client exchanges opposed futures on indexes with all of the same arguments that they now raise against futures on individual securities. Nonetheless, equity indexes are among the most popular contracts on securities exchanges as well as futures exchanges. Futures trading of equity indexes has enhanced customer opportunity with none of the ill consequences predicted by the SEC or securities exchanges. In fact, their business has directly benefited.

This division of responsibility between the SEC and CFTC, which I have proposed, will eliminate competitive barriers that injure public customers. It will not protect futures exchanges or securities exchanges against any legitimate competitive advantages of the other. We are prepared, however to deviate somewhat from the strict logic behind this principle in order to resolve the most contentious objections. For example, it is clear that the option exchanges now have sufficient power and authority to employ a risk based margining system. Competitive concerns have stopped them from acting prudently and in the best interests of their customers. However, because equivalent margin is a "deal-breaker," we are prepared to accept margin equivalence between a short option traded on an option exchange and a futures contract on the same stock traded on a futures exchange. Moreover, we are prepared to limit futures contracts on individual securities to those that meet option listing standards.

Conclusion

One year ago, the Chicago Mercantile Exchange, with the Chicago Board of Trade, undertook to craft amendments to the Commodity Exchange Act that would enhance competition and customer opportunity. We proposed five principles and a long list of detailed proposals. With much work we were able to find a way to rationalize the CEA to restore internal consistency in concert with sound public policy. Within our framework, each segment of the industry, other than security exchanges, which seek protection from legitimate competition, got exactly what it had been publicly seeking. Our proposal went farther than the OTC request for codification of the swaps exemption. We proposed that swaps could be cleared without losing their exemption. We were diligently following advice of congressional leaders that we needed to gain sufficient support from the derivatives industry to insure passage of much needed reform legislation. We proposed a five-part plan:

- Convert the CFTC to an oversight agency;
- Reform Shad/Johnson constraints;
- Expand access to futures markets;
- Provide legal certainty to OTC markets; and
- Level the regulatory playing field.

We continue to believe that the joint exchange proposal is the best formulation for regulatory relief. However, we are well aware that legislative and industry consensus in favor of a good plan trumps our theoretically better plan. We are prepared to join the consensus and give up our plan in favor of the CFTC staff proposal if we can secure Shad-Johnson relief and fix some of the minor flaws of the CFTC plan, noted above. We believe that the CFTC Staff Report can be the basis for legislation that will be fair and even-handed. Our goal was and remains equivalent regulatory treatment for functionally equivalent execution facilities, clearinghouses and intermediaries. If we can get to that goal by the path of the CFTC's proposal, then let us proceed with all haste.

CBOT

Testimony of David P. Brennan
Chairman of the Chicago Board of Trade
Before the Subcommittee on Research, Nutrition, and General Legislation
of the Senate Agriculture Committee

March 20, 2000

Testimony of David P. Brennan

Chairman of the Board of Directors

Board of Trade of the City of Chicago

Before the Subcommittee on Research, Nutrition, and General Legislation
of the Senate Agriculture Committee

March 20, 2000

Mr. Chairman, I am David Brennan, Chairman of the Board of Trade of the City of Chicago. Accompanying me today is Tom Donovan, our President and CEO. We thank you for holding this hearing in the derivatives capital of the world, the City of Chicago. We also thank you for the leadership you have shown in this Congress on the vital issues relating to legislation to reform the Commodity Exchange Act.

For many years, the Board of Trade has argued that the Commodity Exchange Act has needed a comprehensive overhaul. Provisions enacted for markets in the 1920's and 1930's must be modernized to reflect the markets of the 21st century. The combined forces of innovation, technology, globalization and new competition have called into question the stability of many elements of our current regulatory architecture. Wholesale remodeling is warranted.

In that effort, the Board of Trade has urged Congress to be guided by a simple, yet elusive, concept. Fairness. In our view, similar derivative products traded in a similar way should be subject to similar regulation. That promotes fair competition. Where regulatory differences do exist, they should be rational and tied to identifiable public policy goals. Regulation for regulation's sake should be discarded. Regulatory arbitrage should be minimized.

The Report of the President's Working Group last November set out the three key ingredients of a comprehensive reform package. First, the US futures exchanges need regulatory relief. By transforming, the Commodity Futures Trading Commission's regulation mission to one of flexible oversight, not rigid mandates, the competitive forces of the exchanges can be unleashed in a fair competitive fight. Second, the over-the-counter market should be granted legal certainty. Privately-negotiated transactions among sophisticated counter-parties do not need federal regulation. Third, the statutory restrictions on securities-based derivatives, known as the Shad-Johnson Accord, should be lifted so that futures exchanges and OTC markets may offer those innovative products just as they are all over the world. The current ban was enacted 18 years ago as a "temporary foreclosure" while the agencies studied the issues. Eighteen years is "temporary" enough. Congress must open this area to full competition as well.

Each of these three elements must be addressed in legislation if reform is to be comprehensive and meaningful. Each of these three areas deals with the competitive future of futures. Each of these three areas presents challenging, but not impossible, issues for people of good will to resolve.

The CFTC's Staff Task Force Report on a New Regulatory Framework typifies the kind of creative thinking that answers some of these challenging questions. CFTC Chairman Bill Rainer directed his staff to consider ways to reshape and modernize their regulatory approach. His leadership and his vision must be commended. The CFTC Report is compelling and comprehensive. It sets out a framework that, with some modest fine-tuning, should allow the futures industry to compete effectively in the global derivatives market place. It gives the futures industry the freedom to make choices of different oversight regimes, to find the best fit for the business. That emphasis on market choice to facilitate competition is one of the bedrock, and most appealing, principles of the CFTC's New Framework. Allowing business to shed the current "one size fits all" brand of regulation will be of immense benefit to exchanges and other derivatives market innovators.

The CFTC Report recognizes three general categories of regulatory interest – execution facilities, clearing organizations and intermediaries. In each area, the CFTC Report sets out new regulatory approaches that attempt to tailor government oversight to the real regulatory issues. I will focus my remarks on execution facilities.

In this effort, the Board of Trade's principal concern was whether exchanges would be afforded the same type of flexible treatment that is now enjoyed by the over-the-counter derivatives markets and overseas exchanges. Since 1993, when the CFTC adopted its swaps exemption, the Board of Trade has made numerous filings urging the CFTC to allow exchanges the same treatment as OTC swaps dealers. Our argument was: the same instruments traded among the same participants should have the same regulation.

After seven years, the CFTC has agreed. Now, under the category of an Exempt Multilateral Transaction Execution Facility (Exempt MTEFs), an exchange could offer a derivatives market with roughly the same regulatory freedom as a swaps dealer. In short, interest rate futures and interest rate swaps would have the same regulation. Only institutional participants could trade on Exempt MTEFs. The only regulations that would apply would be antifraud, antimanipulation and, potentially, some form of market data transparency. If a futures exchange wanted to trade an eligible futures product in an Exempt MTEF, it could do so and still be subject to the CFTC's exclusive jurisdiction. This feature provides maximum regulatory flexibility. Any exchange using the Exempt MTEF approach would be required to conduct that business in a separate affiliate and would not be considered to be a CFTC-regulated exchange.

The CFTC's new framework offers an exchange two other choices if it wants to be considered to be a CFTC-regulated exchange, a status of some value in the global marketplace. Basically, the CFTC would allow futures contracts that are "highly unlikely to be susceptible to manipulation" to trade in exchange markets regulated as Derivatives Transaction Facilities (DTFs). It is contemplated that the Board of Trade's Treasury security complex, at a minimum, would qualify to be traded on a DTF. Significantly, DTFs could be open to all market participants, whether institutional customers or retail market participants. Any retail market participant may place DTF orders only through a CFTC-registered intermediary that is a member of the National Futures Association. In addition to those sources of intermediation, institutional market participants could place orders through banks or broker-dealers in good standing with their regulators. This flexibility should allow institutional market participants to use the same intermediaries and brokers for their futures, swaps, and securities business thereby promoting efficiency and lower costs.

Futures exchanges that are already CFTC-registered would need to comply with seven core principles on an ongoing basis as CFTC-recognized DTFs. These principles are: 1) rule enforcement; 2) market oversight; 3) disclosure of operational information; 4) transparency of data; 5) fitness; 6) recordkeeping and 7) fair competition. Each of these areas touches upon a good business practice that any sensible exchange must adopt to be successful. No exchange wants its market integrity tarnished. No exchange wants to give its competitors an opening by running a market that has operational flaws or that favors one set of market participants over another. The CFTC's approach reflects those competitive realities and a greater sensitivity to the competitive incentives that compel exchanges to operate their markets in a way that responds to customer needs and avoids any potential problems with market manipulation or other abusive trading practices.

Significantly, the CFTC is not telling the DTF how to satisfy those core principles. The design and methods of compliance are left to the DTF itself to develop. The CFTC will oversee, not dictate, the DTF's successful implementation of those core business practices.

Generally, for futures contracts on physical commodities, the CFTC allows already approved exchanges to become Recognized Futures Exchanges (RFEs). The CFTC's thinking is that markets involving physical commodities may need somewhat more detailed mechanisms to prevent price manipulation. To that end, the CFTC would require an RFE to meet 15 core principles. Those principles would replace technical rules, like the CFTC's audit trail and conflict of interest rules, with flexible objectives that an RFE must design a way to meet. But the design would be of the RFE's own making, not the government's. By shifting from their current contract market status to an RFE, exchanges could utilize that flexibility and shift in regulatory emphasis.

The CFTC's framework follows years of debate and study on these issues going back to 1993. Past efforts by the Commission to address the competitive disparities exchanges face due to OTC and overseas competition have fallen far short of the mark. This proposal better reflects the market realities exchanges face and offers tailored oversight of the critical clearing function while streamlining the regulatory burdens of futures commission merchants acting as intermediaries.

It is a sound proposal. It should be incorporated in any legislation Congress considers to reauthorize the CFTC.

In that connection, the Board of Trade offers three constructive suggestions to the CFTC framework. First, the choices should be expanded to allow trading in physical commodities to qualify for DTF treatment. An exchange's principal mission is to provide a trading environment free from manipulation, defaults and other market abuses. That is true whether the underlying commodity being traded is Treasury securities or corn. Working with the CFTC, exchanges have developed surveillance techniques that cut across all markets. Those mechanisms are just as effective in agricultural futures as they are in financial futures. While at some level the surveillance issues facing each type of futures contract are unique to that futures market and its participants, the method of collecting data and monitoring trading activity is the same. Giving exchanges the added flexibility to trade more of their contracts under the DTF construct would enhance exchange competitiveness without sacrificing market integrity.

Second, the Board of Trade heartily endorses the concept of replacing inflexible, micromanageing, government mandates with core principles. The CFTC is right that exchanges and others are best able to design systems to achieve the desired and shared objectives of market integrity, financial integrity and preventing abuses. But what happens if the CFTC decides that the system designed by an exchange is not adequate? The CFTC's framework does not provide any mechanism for enforcing the core principles it sets out. We would recommend that in codifying the CFTC's proposal Congress should add a procedure for resolving disputes between exchanges and the CFTC through balanced negotiations and, if all else fails, special forms of administrative process. Hopefully, this enforcement mechanism would be rarely needed but no one should expect that the CFTC and each exchange would always see eye-to-eye. A fair process should be adopted to anticipate how best to resolve these disputes.

Third, the CFTC's proposed framework does not specify what types of entities must become either contract markets (under current law) or Registered Futures Exchange or Derivatives Transactions Facilities (under the CFTC proposal). Nor does the CFTC define what entities are eligible for exemption as Multi-Lateral Transaction Execution Facilities. With the ongoing explosion in electronic trading systems, many new forms of marketplaces are being created. Market observers have criticized the current statutory definition of "board of trade" as too broad and outdated. If that is true, the CFTC and Congress will need to consider how to distinguish those derivative transaction execution facilities that must be CFTC-regulated from those that are either excluded from CFTC jurisdiction or subject to it as an Exempt Multi-Lateral Transaction Execution Facility.

In effect, harmonization of the CFTC's proposal with the recommendations of the President's Working Group is required. One example illustrates this point. The Working Group would exclude from the Act any centralized electronic trading facility in standardized financial derivatives traded among institutional parties as principals. The CFTC's proposal would seemingly sort that same facility into either the DTF or Exempt MTEF box. Logically, no execution facility can be both <u>excluded</u> from a statute and exempt from most, but not all, regulation under that statute. If the facility is statutorily excluded, it is out; no exemption is needed or could apply to the facility.

As this example shows, lines will need to be drawn to distinguish what is excluded from the Act from what is subject to regulation or exemption from the Act. Otherwise the quest for legal certainty will result in legal confusion that will not serve the marketplace. The Board of Trade has endorsed the goal of legal certainty for the OTC markets. We would be happy to work out a solution to this important conundrum that is fair to all sides.

The final component of meaningful modernization of the Act is Shad-Johnson reform. The ban on single securities futures should be lifted. Free and fair competition should be allowed. That will make the markets stronger and lead to more efficient risk management for securities market participants.

As recent correspondence from the SEC and CFTC suggests, the regulatory issues raised by futures on single securities or more targeted sector-based indexes can be resolved without transforming those futures into securities for all purposes under the federal securities laws and without requiring the futures exchanges to go through the costly and duplicative process of registering with the Securities and Exchange Commission as national securities exchanges. A more targeted approach aimed at specific areas of regulatory concern will be more than adequate to harmonize regulation.

The best illustration is the area of insider trading and margin. For many years, those two issues were the principal stated areas of concern of the securities exchanges. Fears were expressed that futures on stocks would become a haven for insider traders. Unlike securities, the futures markets have no insider trading restrictions since hedgers always trade on material nonpublic information. To address that concern, last year the Chicago futures exchanges agreed that if they were allowed to offer single stock futures then the same insider trading protections applicable to stock options would apply to stock futures. Similarly, in the margin area, the futures exchanges have agreed that initial margin levels for stock futures and stock options should be the same. That will not be hard to achieve statutorily since the Federal Reserve Board would have ultimate jurisdiction to oversee the setting of margins levels for both stock options and stock futures. Thus, in both the areas of insider trading and margin, the futures exchanges have shown the needed flexibility to resolve the stated primary areas of regulatory concern.

Shad-Johnson reform has been a long time coming. Equity swaps, single stock futures, sector-based stock index futures and even futures on corporate debt all should not be withheld from the market place or be forced to trade overseas or under a legal cloud. The time for Congress to act is now.

Senator Fitzgerald, we need legislation now, not regulatory exemptions or studies. Our competition is moving quickly. We need to be just as agile to keep up. Statutory reform in the three areas I have identified will strengthen the U.S derivatives markets by letting the market decide on the winners and losers under rules that are fair to all. Given the pace of technological change and other market realities, no one can predict how long the exchanges really have to change their way of doing business. But we know we must change, and we will. So must the laws that regulate us. We appreciate your support and leadership and look forward to working with you to fashion legislation to modernize regulation of our markets, provide legal certainty for the OTC markets and remove the Shad-Johnson product restrictions.

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON RESEARCH, NUTRITION,
AND GENERAL LEGISLATION

OF THE
UNITED STATES SENATE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTY

MARCH 20, 2000

NATIONAL FUTURES ASSOCIATION

NFA

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE SUBCOMMITTEE ON
RESEARCH, NUTRITION, AND GENERAL LEGISLATION
OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
OF THE UNITED STATES SENATE

March 20, 2000

Senator Fitzgerald, I certainly appreciate the opportunity to present the views of the National Futures Association on the CFTC's proposed New Regulatory Framework, which I consider to be one of the most important regulatory developments in the futures industry since the Commission itself was created. Like many other industry leaders I have testified many times before this Committee in the last few years and each time my message was the same.

The futures industry is facing greater competition than ever before, both from off shore markets and OTC markets, and the regulation of the industry needs to be over-hauled and streamlined if regulated markets are to remain competitively attractive. In short, my message over and over was that Congress and the Commission had to find ways to reduce regulatory burdens without reducing regulatory protections. I also said that the way to achieve that goal was to maximize the use of self-regulation while returning the Commission to its intended role as an overseer of the self-regulatory process rather than a micro-manager of that process. It is truly a pleasure to testify before you today and to state that the Commission's proposed framework is a dramatic and bold step in the right direction.

The focus on core principles for both exchanges and intermediaries is exactly the right approach. The Commission should tell those that it regulates what they have to do—not how they have to do it. The old approach of having detailed regulation specifying exactly how firms should cross their t's and dot their i's was never well grounded, but it is particularly inappropriate today. The answer to the "how" question changes with every new development in technology. That's why the role of self-regulation will be even greater in the markets of tomorrow than it has been in the past.

Technology is tearing down barriers to entry faster than any government policy ever could. The simple fact is that it is easier to create a central market place for buyers and sellers in cyberspace than it is in Chicago or New York. In the twenty-two years from 1977 to 1999 there were a grand total of zero new futures exchanges. In the last six months at least six different enterprises have stated their interest in creating new electronic futures exchanges. All of them are dedicated to using effective self-regulation to ensure the integrity of their markets and the public's confidence in those markets. But these new exchanges are not shackled by the past. They are looking for more efficient ways to perform their self-regulatory functions and each has contacted NFA about outsourcing that function to us. We certainly look forward to working with each of them.

My point is not simply that NFA will play an even greater role in the years ahead than we have already, although I would be happy to discuss that for an hour or two if you have the time. My real point is that the burgeoning number of exchanges and the corresponding changes to the entire industry, including its self-regulatory structure, point out the need for action **now**. As never before, time is of the essence. I applaud the Commission on its efforts to date but would urge both the Commission and Congress to move ahead as aggressively as possible. We simply do not have time to delay.

I certainly recognize that difficult work lies ahead. The proposed framework is just that—a framework. The proposal does not address some of the details which will have to be resolved to move the proposal from paper to the real world. Some of these details should be readily soluble. As I mentioned earlier, the Commission's reliance on core principles, rather than detailed, one size fits all regulations is exactly the right approach. But those core principles need to be supplemented with interpretive guidance which the industry can rely on. The Commission's proposal recognizes this point but does not discuss how that guidance would be provided.

Let me tell you how that guidance should **not** be provided. If we revert to having regulators in Washington dictating to the industry how the core principles have to be followed, we will end up right back where we are, a result which no one wants. NFA is currently involved with the Futures Industry Institute on a Best Practices study on order transmission and entry, a study which was ordered by the Commission and funded from a portion of a fine imposed in a CFTC enforcement action. I am convinced that a Best Practices approach is the best way to supplement the CFTC's proposed core principles and to provide guidance to the industry.

I should explain two basic points, however. Whenever we talk about "best practices," we have to consider the basic question of "best practices from whose perspective." To be effective, best practices have to be considered from the perspective of the customer. We have spent a good deal of time in our current study talking to end users and customers, and what they want from best practices is clear. They want procedures that ensure that they will be treated fairly and procedures that will ensure that their orders are executed as quickly as possible. If customer protection rules prevent the customer from getting the quickest fill at the best price at the lowest cost, then we haven't done the customers any favors at all.

The second point is that, by definition, best practices have to be developed through direct and active involvement of the industry itself. The best way to ensure that involvement is through the self-regulatory process. The Commission should specify that the core principles will be supplemented with best practices guidance developed through the industry's self-regulatory process.

Another detail which can be resolved quickly involves the registration process. The Commission's proposal states that the registration process should be streamlined but doesn't really address how in any detail. Over the past several years NFA has made a number of proposals to simplify the registration process, and we have recently updated those suggestions and submitted them to the Commission staff. If a firm or individual has gone through a screening process in the securities industry, conducting another background check for registration in the futures industry is clearly wasted effort, and we agree with the Commission's proposal to, in effect, "passport" those firms and individuals into registration.

These passported firms, though, would still be registered and still be subject to the same core principles as other firms, and there needs to be some mechanism to monitor their compliance with those principles, even if those firms are dealing with institutional customers. The answer, again, is self-regulation subject to Commission oversight. The Commission's proposal, though, would not require these passported firms to be members of a futures industry SRO. We believe that this is an oversight which needs to be corrected.

One of the major questions unanswered in the current proposal is exactly what the Commission means by the term "institutional customer." There are at least six different definitions of sophisticated customers in the Commission's rules, which is about five more than we need. We should not be adding a seventh. NFA proposed a uniform definition of sophisticated customer several years ago that was modeled very closely on the Commission's definition of eligible swaps participant. The eligible swaps definition has served well for the last seven years and should be the basis for the definition of institutional customer in this context. We would recommend that the threshold tests for that term should be no higher than those currently in place for eligible swaps participants.

Another key under the proposal will be the types of commodities which are not readily susceptible to manipulation, and which should therefore be subject to less regulation. Any issue which involves both lawyers and economists is likely to get complicated real quick. My only recommendation on this question is that the answer has to be a practical one—one which is dictated by the realities of the market place rather than theories of the classroom. The end users of the markets for petroleum products, for example, may well have the best perspective on this issue and their views should be accorded great weight by the Commission as it goes forward.

Finally, Senator, let me reiterate my enthusiastic support for the Commission's overall approach, but let me also remind you that this exercise of the Commission's exemptive authority does not obviate the need for legislative action. The basic regulatory structure for the industry should not hinge on the exercise of exemptive authority. What this Chairman of the CFTC has embraced the next Chairman might reject. Without legislative confirmation of this approach, we will have injected an entirely new dimension into the discussion of legal uncertainty. I urge the Commission to move as quickly as possible to resolve the remaining issues and to enact its proposal, and I urge Congress to support that effort and adopt legislation to codify the Commission's approach.

I again thank you for the opportunity to present my views and look forward to any questions you may have.

CIS CARGILL INVESTOR SERVICES

March 14, 2000

The Hon. Peter G. Fitzgerald
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RE: Commodity Futures Trading Commission ("CFTC") Staff Report: A New Regulatory Framework ("Report")

Dear Senator Fitzgerald:

Cargill Investor Services ("CIS") submits this statement on the CFTC Report in response to your request for comment to the Subcommittee on Research, Nutrition and General Legislation of the Committee on Agriculture, Nutrition and Forestry.

CIS is a global Futures Commission Merchant ("FCM") headquartered in Chicago, IL. We are one of the largest independent FCM's in the futures industry. Our client base is broadly diversified and includes leading financial institutions, commercial commodity firms and managed funds that use futures and options markets globally.

The February 22, 2000 Report forwarded by William J. Rainer, Chairman, CFTC to Senator Richard G. Lugar and Representative Larry Combest represents a positive new approach for regulating U.S. futures and options markets. We support the Report's recommendation to move the CFTC from a front line rule based regulator to an oversight regulator providing core principles supplemented with best practices. These changes are an important step in providing the futures industry broader flexibility in responding to the rapidly changing over-the-counter ("OTC") and electronic environments in which narrowly focused rules can no longer keep pace with product innovation and technological change. We believe our customers will welcome these changes. We also congratulate the CFTC staff who prepared this Report. They solicited input from a cross section of industry participants. Recognition should also be given to Commissioner Barbara P. Holum who formed the CFTC's Global Markets Action Committee ("GMAC") two years ago. Because of her efforts to listen closely to industry concerns about regulatory matters, GMAC provided a valuable forum for this industry.

While we broadly support the Report there has been insufficient time to analyze it in great detail and understand all of its implications. We do, however, have a few constructive suggestions regarding major issues discussed in the Report:

1. Legal Certainty for OTC Derivative Contracts

   One conclusion of the Report is that there should be legal certainty for OTC financial derivative contracts. Market participants concur. That certainty is equally essential for OTC commodity contracts. OTC commodity markets will continue to grow. These markets are highly developed for commodities such as liquid energy and others, such as electricity, are rapidly maturing. Market participants should be just as free to negotiate OTC commodity contracts as they are OTC financial contracts. In either case, legal certainty is needed to ensure that market participants do not run the risk of one side avoiding performance by arguing the contract was an illegal off--exchange futures or options transaction. This has happened in OTC energy contracts. Action should be taken now so those problems do not grow. We need to encourage the same innovation in commodity markets that we now enjoy in financial markets. Innovation helps consumers and producers better manage risk. Commercial counterparties should be able to negotiate private contracts, be they financial or commodity based, on the same set of rules.

2. Recognized Derivatives Transaction Facilities (DTF's)

   A DTF facility as defined in the Report could trade contracts for commodities that have deliverable supplies that are either inexhaustible or sufficiently large to render the contract highly unlikely to be susceptible to manipulation or trade commodities having no underlying cash market.

   This definition raises as many questions as it answers. Many contracts that seem to have a nearly inexhaustible supply, such as U.S. Treasury securities, have been subject to price manipulation. And their supply is far from inexhaustible. But clearly no one feels they should be excluded from trading on a DTF facility.

   A definition that we believe better meets the public interest would be one restricting commodities traded on a DTF facility to those contracts that do not serve a price discovery function. When a contract does serve such a function there is broad public interest in making certain the markets involved operate at the highest possible level of integrity and transparency. We believe this definition would provide greater clarity for the CFTC than one focused on physical supplies.

CIS

3. Stock Index Products

   Our customers want to trade more stock index contracts on foreign exchanges. And they want the opportunity to trade individual stock futures contracts on U.S. exchanges. The Shad-Johnson Accord restricts U.S. customers from accessing some of the most rapidly growing exchange traded contracts globally. U.S. futures exchanges are now disadvantaged because the SEC has been more restrictive in approving stock index futures contracts trading on futures exchanges than index contracts traded on securities exchanges. This puts futures exchanges at a disadvantage. Our customers want broader access to all forms of equity contracts wherever they trade.

4. Competition

   As an FCM, we operate in a highly competitive environment that fosters innovation and change. We would expect to see new electronic futures exchanges being developed just as we have witnessed significant growth in new markets for trading equities and bonds. The CFTC should provide clear guidelines for new exchanges to follow as well as a prompt, fair evaluation of core criteria before such exchanges begin operation.

5. A First Step

   As a global FCM we see a world outside the U.S. that looks significantly different and that provides customers significantly more flexibility than what exists within the U.S. today. Most futures exchanges are teaming with equity exchanges in their domestic market to provide product diversity, common clearing and a common trading platform all under a single regulator. We need a regulatory framework that allows and encourages this product integration in the U.S. as well.

CIS appreciates the opportunity given to comment on the Report and we would be pleased to provide any further input that might you find helpful.

Sincerely,

Jan R. Waye
Senior Vice President

Testimony of George E. Crapple

Chairman

Managed Funds Association

Before the Subcommittee on Research, Nutrition and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry

March 20, 2000

Thank you for the opportunity to testify here today. I appear here as the Chairman of the Managed Funds Association ("MFA"), a national trade association representing more than 700 participants in the hedge fund and managed funds industry. I am also the Co-Chairman and Co-Chief Executive Officer of Millburn Ridgefield Corporation, which has managed money in the currency and futures markets since 1971 and also sponsors funds of funds and equity hedge funds.

MFA appreciates the opportunity to testify before this Subcommittee concerning the Commodity Futures Trading Commission's recently published staff task force report, "A New Regulatory Framework" (the "Report") and issues relating to the reauthorization of the CFTC. MFA commends the CFTC for its evident commitment to reinventing its regulatory program in fundamental ways – an approach designed to address seemingly intractable regulatory issues that have been with us for many years as well as issues that may be critical in permitting our markets to remain global leaders in the twenty-first century. Members of MFA in the aggregate manage the vast majority of the over $40 billion invested in managed futures and a significant portion of the nearly $400 billion invested in hedge funds. Our members are active participants in all derivatives markets, both on and off exchanges, foreign and domestic. Accordingly, a regulatory environment that promotes competition and innovation which results in liquid, efficient markets is of enormous significance to us.

MFA believes that the CFTC's Report and the previously issued President's Working Group Report on Over-the-Counter Derivatives identify a number of important issues deserving priority attention. I will review these issues in greater detail in the balance of my remarks. We believe in general that the CFTC's overall purpose and its suggested approach are highly constructive. The Report significantly advances the debate over the optimal regulatory structure for the U.S. futures markets, and MFA applauds this development.

Redesigning Regulation of U.S. Futures Exchanges

The highly competitive markets in which MFA's members and other market participants operate require prompt and creative responses to new market conditions, new technologies, new products, and new trading and clearing mechanisms. The CFTC is to be commended for developing an approach to exchange regulation that is designed to expand the ability of U.S. futures exchanges to meet these challenges – through a regulatory framework that affords the market maximum latitude, subject only to constraints reasonably designed to assure basic customer and market protections. As we understand it, the Report contemplates a regulatory approach under which futures exchanges and over-the-counter derivatives trading facilities would operate on an even playing field, one which in appropriate circumstances would be subject to minimal regulatory burdens.

MFA supports this concept of a new, highly flexible, largely unregulated marketplace. Commodity pool operators and commodity trading advisors X qualified, registered professionals acting for pools, hedge funds and individual accounts X should be able to access all future markets, just as today they have access to swaps, over-the-counter derivatives and foreign futures and options (markets not subject to the highest level of regulation). For CTAs, CPOs and their clients, special conditions or risks in these newly developed markets should be addressed as they are generally today in the case of foreign futures markets by the use of a standardized risk disclosure statement. As is the case with foreign futures, this risk disclosure statement would be simple and succinct, clearly highlighting the special risks associated with the particular kind of market thereby permitting the customer to make an informed choice whether to assume these risks. This approach would facilitate the broadest access for CTA-advised futures customers and commodity funds to the greatest possible array of innovative U.S. derivatives markets, resulting in the deepest, most liquid, hence, efficient, derivatives markets. A goal that all of us share. This approach is far superior to limiting eligibility to access a particular market to a defined group of customers, such as limiting access to only the institutional clients of a CTA. This creates significant problems. As the CFTC knows from its recent efforts, the use of this approach to implement a post-trade order allocation procedure rendered the rule unworkable. A reporting and record-keeping nightmare is created. For example, if a CTA had 50 clients in one program and only 30 of them "qualified" for access to the larger, more efficient market. The CTA would be forced to trade for the 30 accounts in one market and for the 20 accounts in another. As a result, most importantly, the CTA's performance results for the 30 accounts could differ substantially from those for the 20 accounts. Most likely, better results would be gotten for the 30 (large) customers. The fragmentation of liquidity would also adversely impact the efficiency of both markets.

Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors

The CFTC Report does not specifically address regulatory issues relating to CPOs and CTAs. However, MFA understands that the CFTC will be reviewing its regulatory framework for CPOs and CTAs with the same objectives of enhancing efficiency and competitiveness which have guided its review of exchange regulation. We are aware that CFTC staff, in cooperation with the National Futures Association, is developing draft "core principles" for CPOs and CTAs designed to supplement the Report's recommendations concerning other aspects of CFTC regulation. MFA strongly supports this effort and stands ready to assist the CFTC and NFA in any way they consider appropriate.

Legal Certainty for OTC Derivatives

The CFTC Report is not principally designed to address the issue of legal certainty for OTC derivatives. However, the Report builds upon and is consistent with the President's Working Group's recommendations for enhanced legal certainty for OTC derivatives, in particular by reinforcing and augmenting the existing Part 35 swaps exemption and by providing new exemptions for innovative trading and clearing structures for OTC derivatives. MFA strongly supports the objective of enhancing legal certainty for OTC derivatives, including the President's Working Group's recommendations for legislation to exclude OTC financial derivatives from the Commodity Exchange Act, as well as the Report's recommendations for actions by the CFTC to enhance legal certainty.

MFA believes that in defining a statutory exclusion for OTC derivatives and any other measures to enhance the legal status of swaps, the existing criteria defining eligible swaps participants should not be further restricted. In fact, they should be expanded to include all clients of CTAs and all commodity pools. The President's Working Group's suggestion that consideration be given to increasing the financial threshold for natural persons engaging in swaps to $25 million in discretionary investments is not, in our view, warranted by experience or public policy. MFA opposes the creation of additional restrictions upon access to swaps or other derivative transactions.

Conclusion

I appreciate the opportunity to submit MFA's views to this Subcommittee. MFA fully supports the efforts of this Subcommittee and of the CFTC under Chairman Rainer to make U.S. futures regulation as vigorous and innovative as the industry it oversees. We look forward to providing our full assistance and cooperation in this endeavor. Once again, thank you for the opportunity to present MFA's views on this important topic. I would be pleased to answer any questions you may have.

STATEMENT OF

PETER C. LEE

MERRILL LYNCH & CO., INC.

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

SUBCOMMITTEE ON RESEARCH, NUTRITION,

AND GENERAL LEGISLATION

UNITED STATES SENATE

HEARING ON

THE CFTC REPORT ENTITLED

A NEW REGULATORY FRAMEWORK

MARCH 20, 2000

Good morning, Mr. Chairman and Members of the Subcommittee. My name is Peter Lee and I am responsible for all North American operations for Merrill Lynch Futures, Inc. On behalf of Merrill Lynch, I want to thank you for the opportunity to appear before you today to present our views on the Report of the CFTC Staff Task Force entitled "A New Regulatory Framework".

Overwhelmingly, the message that I would like to communicate to you today is that the CFTC staff, under the leadership of Chairman Rainer, has done an outstanding job of setting forth a viable proposed framework for regulatory reform. The CFTC staff has worked within a somewhat outdated statute to identify important reforms capable of being administratively enacted. We eagerly await the opportunity to work with the Commission and others in the industry to fashion rules that can implement these important initiatives. At the same time, we will continue to work for legislation that will address the issues that, as the CFTC staff acknowledges, cannot be resolved administratively. We will also continue to offer recommendations for additional administrative relief necessary, in our view, to complete the package of reform.

Merrill Lynch is a user of the derivatives markets – listed and OTC – for its own benefit and on behalf of its clients. There are several important challenges the firm faces in these markets, some competitive and some regulatory, but virtually all driven by technology. Improved communications and electronic processing have fostered global access and reduced barriers to entry, all of which have increased competition and improved market efficiency. However, in many important respects, because U.S. law in this area has been too inflexible to accommodate the markets' evolution, it has created artificial competitive boundaries and legal distinctions that have impeded the growth of both the listed futures and the OTC derivatives markets.

The most important issue to Merrill Lynch relating to these markets is legal certainty. The firm and its customers must be confident that they understand the requirements applied to the transactions they enter into, the systems they use, and the counterparties with which they deal. Those requirements must be clear and not subject to change based upon philosophical changes at the regulator. And most importantly, a failure to adhere to a specific regulatory requirement should not, except in extraordinary circumstances, result in the "death penalty" – allowing a counterparty on the losing side of a transaction to walk away from its obligations under the guise of an illegality defense.

The second most important issue to Merrill Lynch in this debate is regulatory flexibility. Technological change, particularly in communications, makes it impossible to have any confidence that the associations we now know will be the associations of the future. We need a structure that allows participants in the OTC and exchange-traded derivatives markets to communicate broadly, across borders and across markets, without the current consequences of being deemed a "board of trade". Similarly, we need a change in regulatory focus – from detailed, specific regulations to flexible oversight. We need the ability to try new concepts and regulate only the issues that arise in the real world, not inhibit the implementation of new ideas by the imposition of a bevy of requirements to prevent theoretical problems.

Overall, Merrill Lynch believes that the Report positively reflects the goals of legal certainty and regulatory flexibility within the framework of the Commodity Exchange Act, although this is clearly an area that will require legislative and further administrative action to fully achieve our objectives. That said, specifically providing that clearing of bilaterally negotiated swap transactions would not transform an otherwise exempt instrument into a futures contract required to be traded on a designated contract market is a significant step forward. In the same vein, the replacement of many prescriptive regulations with core principles, if coupled with the proper oversight approach in practice, should significantly improve our ability to innovate and test new trading products and practices in the marketplace.

As always, "the devil is in the details" and we look forward to working with the Commission and its staff to implement the reforms represented by the Report. We would like to note several important issues that should be addressed in that process.

In the competitive marketplace, the use of our capital and the customer's use of its capital are paramount. They are drivers of where and how the business gets done. We believe that the Commission needs to focus very carefully on these issues in fashioning proposed rules. Specifically, the Commission needs to find alternatives to the current restrictions on investment of segregated funds, customers' inability to opt-out of segregation requirements, and the calculation of amounts necessary to secure foreign futures and options obligations that result, in certain cases, in an inefficient use of capital. The Commission should also give thorough consideration to the use of risk-based capital requirements for intermediaries. Finally, whatever market structure options are ultimately available, an intermediary must be free, at its election (and subject to the specific requirements of each marketplace), to conduct all of its business within a single legal entity in order to capture the benefits of reduced capital requirements, reduced risk, and netting of exposures.

In closing, I would again like to commend the Commission for its leadership and its vision in pushing forward with regulatory reform, and to thank Subcommittee Members for their interest in these issues. The firm pledges its support in working through the issues directly, and through its participation in the FIA, the ad hoc coalition of investment banks, and the other trade associations of which it is a member. I thank you for your time and attention and would be happy to answer any questions you may have.

Written Testimony of
David G. Downey, Executive Vice President
Interactive Brokers LLC

Examination of the CFTC report entitled *A New Regulatory Framework.*

Before the United States Senate
Subcommittee on Research, Nutrition, and General Legislation of the
Committee on Agriculture, Nutrition, and Forestry.

MARCH 20, 2000

INTRODUCTION:

Senator Fitzgerald and members of the Committee: Thank you for inviting me to testify before you today and discuss the CFTC's recently released report , titled *A New Regulatory Framework.*

My name is David Downey, Executive Vice President, Operations Interactive Brokers LLC. (IB), a registered Broker/Dealer and Futures Commission Merchant. IB is a member of the Timber Hill Group of Companies which, along with its affiliated entities, are members of most commodities and securities exchanges in the United States, and several foreign exchanges...in all 30 exchanges in 15 countries on 4 continents. IB provides its customers with electronic order routing and execution of domestic and foreign futures, options, securities and related derivative products through its proprietary screen-based computer and communications technology and the Internet (the IB system).

Background:

The Internet is fundamentally changing the nature of how customers interact with market systems. This applies to almost every industry we can think of, <u>including</u> the financial services industry. The changing nature of this relationship, and the new competitors fostered by the technology revolution, are quickly exposing existing regulations as antiquated and are having a profound impact on the debate of how to regulate in these new times. It is appropriate that regulations are revised such that they do not act as an obstacle for growth while still maintaining a level playing field perspective. Towards that end any regulatory revisions should not weaken the ability to achieve the primary objectives of the CEA: ensuring market and price integrity; protecting against market manipulation; protecting the financial integrity of the markets; and protecting customers from abusive trading and sales practices.

The CFTC's recently released paper is a courageous step in the right direction; thoughtfully crafted and a wonderful launching pad for the discussions. Chairman Rainer and his staff have done a terrific job and should be commended.

I would like to take some time to discuss three particular areas of concern from our perspective: Transparency of prices and the cost borne by the customer; protection against fraud and manipulation through the use of audit trails and the need to open up the clearing house system to the OTC markets.

DISCUSSION

1.Transparency of pricing and real-time access to the data is essential to fair and level playing fields. Enhancement of the price discovery function to the fullest extent that technology permits is clearly in the public interest, and publicly regulated markets which invite participation have an obligation to offer as even a playing field as is possible. This mandates equal access to all, including the size of bids and offers. Imposition of fees that are charged equally to all, but which are practical only for large professional traders to pay is not equal access. This was highlighted at a recent CFTC roundtable where the charges imposed by exchanges for market data were highlighted as a huge problem for futures customers and FCMs who want to give those customers real-time pricing data so that they can fairly compete.

On the securities side the SEC has recognized the seriousness of this issue and issued a lengthy release in December of last year stating the Commission's intent to limit market data fees charged by exchanges. As the SEC notes in the release:

> "[N]ew technology has greatly expanded the opportunity for retail investors to obtain access to real-time market information through 'on-line' accounts with their broker-dealers...This information could greatly expand the ability of retail investors to monitor and control their own securities transactions, including the quality of execution of their transactions..." 64 Fed. Reg. 70614

Data fees already are far lower in the securities markets than in the commodities markets but as you can see the SEC release leans toward lowering them even more. Cost recovery may be appropriate but it is important to be sure that data fees are not "at a sufficiently high level that a significant number of users are deterred from obtaining the information".

2. The CFTC's release appropriately recognizes the need to protect the financial integrity of the market and to protect against market manipulation. The release appears to address this with calls for rules and Core Principles that would include data capture or audit trails. We submit that the technology is able to produce audit trails at such a high resolution with such a low investment that it should only be encouraged. However, we did notice that while audit trail language is associated with DTEF and the RFE discussions it is noticeably absent from the Core Requirements for

Intermediaries. High resolution audit trails should encompass the life to death cycle of any customer order that is sent to the market. There is much more opportunity for fraud and manipulation up-stream from the transaction facility at the intermediaries processes. We respectfully submit that the CFTC clarify this in any final language to include the responsibility for the intermediaries.

3. Why do we need open access clearinghouses for OTC? First, when examining the soundness of the OTC markets today it is important to understand "Portfolio Risk" in that there is no limit to the amount of risk that may be accumulated in a given participant's portfolio; and, there are no assurances that the parties involved understand the aggregate risk or that the participant can absorb the potential losses. A clearinghouse, serving as the central counter-party, would act to limit portfolio risk with a given participant based on the clearinghouses' own economic self-interest. The clearinghouse would likely achieve this through risk based margins and appropriate standards of financial responsibility (i.e., The owner of a given portfolio would have to have sufficient funds, or free collateral, to post margins to cover anticipated losses under "normal market conditions" and sufficient capital to absorb losses under "abnormal market conditions"). The clearinghouse would use its own independent model based upon prevailing market prices to evaluate the risk of the portfolio.

Second, since positions cannot be netted, no participants, not even intermediaries, can truly hedge their risk positions. In other words, whenever there is a potential default in the system, like LTCM, it is the gross positions that matter not the net. The larger the market becomes, the more participants will have exposure to each other. This necessarily means that almost any large bankruptcy has the potential to have a domino effect through the system, knocking down a lot of players. The time-tested private sector solution to this problem is a clearinghouse. Indeed, it is precisely this role for which clearinghouses were invented (i.e., to assume the position of the opposing side to each and every trade). Accordingly, all parties have exposure to only one counter party...the clearinghouse.

Third, the current OTC structure does not allow for price and open interest transparency which further aggravates matters, for no financially healthy bystander will interject himself without knowing the exact extent to which prices have deviated from the norm and just what magnitude the problem might be. Using a clearinghouse, open interest and marking prices are published by the clearing entity daily. Everyone knows that amount of risk and price dislocations in the system. In addition the clearinghouse has procedures in place for the liquidation of defaulting clearing members. All of these factors act to attract more buyers and sellers to the market which enhances pricing efficiency. There is no practical alternative to the establishment of a clearinghouse.

Conclusion:

The CFTC can only do so much. At certain times it is appropriate for Congress to step up and articulate a vision around which policy will be shaped. We contend that the goal of efficient market places where all market participants compete on a level playing field can be achieved cheaply and easily with available technology. The only thing that has stymied its implementation in the past has been the intentional acts by the economically advantaged groups to cripple the potential of the systems.

We are confident that given the right encouragement by Congress and appropriate regulatory oversight to assure public confidence, the financial markets will embrace new technologies such that the US markets will grow and strengthen. Specifically we need leadership from Congress on a couple of issues.

First we need Congress to set the tone for the regulators and the market on the use of technology and limit attempts to frustrate technology's proliferation. It is our experience that the market centers with rule making and enforcement authority will use it to retard the introduction of technology if it encroaches on the economic advantages of certain participants to the detriment of all users. It is also our experience that the regulators take an accommodating stance with the market centers when these issues arise. Congress needs to make clear to the regulators and the markets that technologies to enhance the workings of the US markets should be allowed absent clear evidence that using the technology will undermine the integrity of the markets. The burden of proof to demonstrate the risks of the technology should be on the market center.

Second, there is clearly systemic risk in the markets for OTC trading since the trades are not processed through a clearing house. History shows that clearing houses proliferated in the futures markets only after they became a requirement for registration as an "approved contract market" under the Commodity Exchange Act. In addition many of the innovations in the nation's securities markets and related clearing mechanisms did not occur until after the 1975 Act Amendments to the Securities Exchange Act.

Only Congress can deal with this tricky issue.

Hearing Testimony Submitted to
The United States Senate Subcommittee
on Research, Nutrition, and General Legislation,
A Subcommittee of the Committee of Agriculture, Nutrition, and Forestry
Chairman: Senator Peter G. Fitzgerald

By Barry J. Lind
Chairman
Lind-Waldock & Co., LLC

March 20, 2000
Dirksen Federal Building
Chicago, Illinois

Introduction

I would like to take this opportunity to thank Senator Fitzgerald for the opportunity to present testimony to this Committee concerning the new report titled *A New Regulatory Framework* issued by the Commodity Futures Trading Commission (CFTC) staff task force in February, 2000. In considering the regulation of any industry, it behooves the regulators to understand the business of the regulated, lest the regulation irreparably damage the industry it oversees.

The current CFTC chairman, the Honorable William Rainer, has sought to rationalize and modernize the regulatory framework of the futures markets. Although I realize that this is a work in progress, I can only commend him in the strongest terms for his good work in harmonizing the interests of the industry and the market participants, while assuring that the customer protections are in place based on the sophistication of the market users. Chairman Rainer has proven to be both a sympathetic and knowledgeable listener, and these two qualities guarantee that all parties to this process receive a full but fair hearing.

Background of the Presenter

I offer the Sub-committee a sketch of my background to assure them that my remarks are based on many years experience as a futures trader and broker, on deep commitment to the industry and its well-being, and most of all, on a history of involvement with and advocacy for the interests of the retail futures trader.

I am chairman of Lind-Waldock & Company, LLC, until very recently a private, independent Chicago-based futures brokerage firm. Last month, February, 2000, Lind-Waldock & Co. was acquired by Refco Group, a world leader in institutional risk management services, and also a provider of institutional asset management.

I began in the futures business in 1962, beginning by acting as a broker on the trading floor of the Chicago Mercantile Exchange for both individuals and commercial users of the futures markets. By 1965, I had developed enough business to open my own firm. I ran a successful futures brokerage business for many years, and realized, as commission rates in the securities business became unfixed, that the impact of the "Big Bang" (as the move to unfix commissions in securities markets was called) would move to the futures business too. I drew up a business plan that could succeed in an environment of lower commissions, and became an early adopter of automation, because it was only by implementing a technology solution that I could make the economics of the discount futures business work. In 1980, Lind-Waldock became the first "discount" futures firm. My firm is now the largest of the discount futures firms, with over 30,000 accounts.

Lind-Waldock was one of the first futures firms to offer its customers online trading. Today, its customers enter about half the orders it receives online.

I have been energetically engaged over the years in the debates and processes that have formed the futures industry. In 1970, I was elected to the first of five terms on the Chicago Mercantile Exchange Board of Governors. I was very involved in the creation of the CME's International Monetary Market (IMM), the division of the exchange formed to trade international currency futures, and served as its vice-chairman. Currency futures were the first futures products to move the industry away from its roots in agricultural and physical commodity markets and into the world of financial products, which now represent the most active part of the business. I have been a member of a number of CME committees, including the Strategic Planning, Financial Instruments, Membership Expansion, and the International Steering Committees. These committees, I am proud to say, have proven very influential in guiding not only the growth of the CME, but eventually have had profound influences on the direction of the whole futures industry.

I am a strong proponent of increasing the use of technology in futures trading, and my firm was among the earliest to automate its order routing system and to offer online trading. In addition, I was a major advocate of the introduction of the "e-mini" S&P 500 futures contract, the first U.S. futures product to be traded electronically during regular business hours, and a product that I believe has pointed the way to the survival and prosperity of the U.S. futures exchanges.

I have also served on the Finance Committee of the National Futures Association, and was a member of that organization's Board of Directors for 12 years. I was a member of the Financial Products Advisory Committee, one of a select number of CFTC advisory committees. I am now a member of the National Futures Association and Futures Industry Institute's Advisory Committee for the Best Practices Study of Order Transmission and Entry Procedures.

Perspective of the Remarks

Even though I have had institutional and commercial clients, throughout my career I have represented what I believe to be the best interests of the retail client, the individual trader who is in the futures markets both for profit opportunity and portfolio protection. The remarks I offer on the CFTC report are made from the perspective of the individual account holder, and the intermediaries who serve this client.

I am in general agreement with the approach of re-engineering regulation with the intention of making it into a flexible structure that is based on the structure of the market being regulated, the kind of instruments traded and the sophistication of the participants. This approach allows some markets to operate with decreased levels of regulation, an outcome I take to be a favorable one. However, while there seems to be a consensus that less-regulated markets are appropriate for institutional and other qualified investors, there is more hesitation to allow individual investors the advantages that may exist in less-regulated arenas.

My own position, one which I have shared with the CFTC and members of the futures industry, is that individual investors should be allowed access to less regulated markets in order to have the advantages of increased competition a less-regulated market will bring. I believe, with the appropriate framework, that individuals can enjoy this access with substantially the same protections as the current regulatory environment.

One of my fundamental convictions is that, in addition to regulatory protections, my customer should be able to have the benefit of the best price available, even if it occurs outside a market that is designed to be the most protective of the consumer. I fear that any regulatory scheme that has the effect of barring my customers from less regulated markets will be a Pyrrhic victory for them: they will have all the benefits of protection from fraud and market manipulation, while being consigned to markets from which the largest liquidity providers may have fled. It is from this perspective that I offer the comments below.

Before discussing the protections that might be proposed, I'd first like to make clear the assumptions I'm making about the new, less-regulated markets.

Assumptions

First, I assume that Derivatives Transaction Facility (DTF) and Exempt Multilateral Transaction Facility (MTEF) participants will either be groups of firms trading with each other, or an individual firm making markets for institutional customers. I'm further assuming that market-makers will not be prepared to make a market for my customers on an individual basis. These market-makers may be willing to make markets for a corporate counter-party like my firm, which will then direct order flow to them from smaller customers. The positions that result from the transactions of my customers with the market-maker will be carried on the market-maker's books on an omnibus basis. While not every market-maker in the DTF or MTEF environment may elect to serve as a counter-party to firms who are handling retail customer orders, I feel comfortable in assuring you that some of the participants will be more than willing to make a market for my order flow of around 20,000 orders a day.

Second, I assume that customers ought to be protected in several respects: the integrity of customer funds on deposit must be assured; the price at which the customer transacts business must be fair; and the atmosphere in which the customer operates must be free of fraud.

Third, I assume trading vehicles (contracts) available to my customers will be relatively the same as those available at Recognized Futures Exchanges (RFEs), except for size.

Fourth, I assume that in the interim period during which the entire trading process is being automated, resting orders will be placed with a RFE.

My job as an intermediary includes seeing that my customer is protected and getting my customer the best price. I believe the CFTC recommendations contained in the staff report provide the outline for a regulatory structure that allows me to accomplish these goals.

Segregated Funds

The bedrock of customer protection in the current regulatory framework is the requirement that customer funds be segregated. I commend the staff for retaining this requirement as an important feature of the safety net of customer protections that are carried forward into any market environment in which an individual investor is permitted to conduct transactions. The report recommends that the Commission consider whether institutional customers should be able to direct intermediaries not to segregate funds when trading on a DTF that so permits. I would go further, and confine the segregated funds requirement to funds held on behalf of individual investors. It should be noted that failure of firms acting as intermediaries will, almost invariably, be brought about through the failure of an institutional customer. Therefore, if the segregation requirement is applied only to the individual investor, segregated funds will be even safer.

Membership in a Regulated Futures Exchange and Capital Requirements

Clearly the segregated funds requirement is a fundamental protection for the customer. However, I fully endorse the report's additional recommendation that non-institutional traders may access a DTF only through a registered FCM that is a clearing member of at least one RFE and that carries minimum net capital of

$20 million. These requirements have a two-fold benefit: they provide discipline for the carrying firm by requiring it to have capital at risk; and they provide the benefit of regular periodic inspections by an external monitor. Moreover, the level of the capital requirement will tend to exclude less responsible parties who may be looking to make a "quick buck" in less-regulated markets.

I'm extremely pleased to find the report calling for the net capital rules to be amended to permit the application of risk-based net capital rules. I have been asking for this change for years. The current capital rules are based on an old banking rule and make no sense for derivatives markets. Right now, if I have a customer with $100,000 and no market position—and hence no risk—I have to put up $7,000 of capital. If I have a customer with 100,000 bushels of soybean futures contracts and no money—and hence lots of risk—I have no capital charge. You can see that a risk-based capital rule is definitely a move in the direction of rationality.

Universal Transfer Mechanism

One of the clear expectations is that a deregulated environment would result in an increase in competition. Even though the competition may tighten market spreads in DTF and MTEF markets, it will clearly take liquidity away from RFEs. The ability to enter into a transaction in one arena and to offset it in another would benefit all parties, except possibly the market-maker.

Competition will most likely come into play as multiple entities enter the fray as "market-makers" for standardized derivative products. If the products are standardized, they will be fungible only if there is a universal transfer mechanism that enables positions to be transferred among parties as customers establish positions with one counter-party and close them with another. The market will work without this mechanism, but its absence would disadvantage both the public and the institutional customer.

Best Price Availability, Transparency, and Audit Trail

In a multiple-market-maker market, there will be multiple platforms on which trades may be effected. In this kind of market, the challenge is to provide a level of transparency to the price discovery process. We believe in the not too distant future, all trades will be conducted on an electronic trading platform where our customers will see the best bid and offer from the RFE and the counterparties with whom we're dealing. In this environment, our customers will simply point and click on the best market available.

However, we're not there yet. And in the interim, we propose that intermediaries who allow retail customers to deal in less regulated markets be obligated to display multiple bids, offers, and last sales; these would come both from the market-makers with whom the FCM intermediary is dealing, along with the appropriate RFEs. The customer would then simply choose what he believes to be the best-priced market. Furthermore, these multiple prices should be recorded along with the customer's transaction price. The one thing that the FCM can't totally control is the price. But if the customer can see all the prices we have available, we've put the customer in the best position he can be in.

At a minimum, the last sale and the bid/offer (if available) from the RFE in which the relevant standardized trading vehicle is available for trading should be captured for comparison to the price at which the transaction with the market-maker has occurred. These records should be retained for some period of time to allow for inspection and audit.

The recommendations I've made contain a fair level of detail about mechanisms to assure that the best interests of the retail customer are served. I concede that the staff report requires in general that markets that serve a price discovery function provide a degree of price transparency, and that the core principles for recognition of a DTF call for providing information regarding prices and other appropriate information to market participants on a fair, equitable, and timely basis, and that there is a five-year recordkeeping requirement pertaining to data entry and trade details. At the risk of being accused of falling back into rigid, one-size-fits-all thinking, I offer my detailed proposals as a template for achieving these goals and adhering to these principles.

Other Issues Affecting Intermediaries

I endorse the report's provision for streamlining the registration process for FCMs and Introducing Brokers (IBs).

I concur with the report's recommendation that the mandatory disclosures for non-institutional customers also be streamlined and make use of a single signature format, including the freedom to accept electronic signatures. All Commission requirements, including documentation and recordkeeping, should be flexible enough to embrace changes in technology without requiring amendment. In these matters too the adoption of the philosophy of "core principles" that state the goal of the regulation rather than prescribe exactly how the goal should be met will go a long way in achieving flexibility in dealing with technical innovation.

I applaud the report's proposal that the range of instruments in which segregated funds can be invested be broadened, and the move toward removing barriers respecting the secured amount requirements for the funds of customers trading on non-U.S. exchanges.

Summary

I am extremely encouraged by the report released by the Commission. It is a document sensitive to the primary mission of regulation: to provide fair markets and suitable customer protection. It reflects careful thought and sensitivity to the needs both of the industry and the market participant. It moves away from the traditional inflexible regulatory models, breaks new ground with its philosophy of "core principles," and, I think, has offered a shining example of both the process that should be involved in producing regulations and the results that can be achieved by following the process.

Of course, the document is a working document that provides a framework to be fleshed out. And, along with everyone affected by this regulation, I am eager to see if the final version fulfills the promise of its beginnings. However, this report makes a very excellent beginning.

DOCUMENTS SUBMITTED FOR THE RECORD

MARCH 20, 2000

A NEW REGULATORY FRAMEWORK

Executive Summary

The Commodity Futures Trading Commission (CFTC or Commission) recently formed a staff task force to recommend changes to the regulatory structure for derivatives. This is the task force's report on its recommendations for modernizing regulation of derivatives. It is not a proposal of the Commission. The report does not include legal definitions for various new categories that it recommends be included in the new framework. Nor does it address comprehensively issues relating to the regulation of commodity pool operators (CPOs) or commodity trading advisors (CTAs). Those issues will be the subject of a further task force study.

By this report, the task force is recommending that the Commission propose a new regulatory framework to apply to multilateral transaction execution facilities that trade derivatives. All of the task force's recommendations can be promulgated by the Commission under its administrative authority. The task force also recommends that the Commission accept its recommendations as the basis for publishing in the Federal Register a notice of proposed rulemaking for a 60-day comment period. The task force further recommends that the Commission hold public hearings on the proposal order to provide a full public airing of the important public policy issues that it raises.

The staff task force believes that this new structure will promote innovation, maintain U.S. competitiveness, reduce systemic risk, and protect derivatives customers. The proposed framework does not require that U.S. futures exchanges change their method of operation in any way. However, the derivatives markets are poised to undergo rapid change as they continue to embrace technological advances and meet the associated competitive challenges. The new framework provides U.S. futures exchanges the flexibility to respond to these challenges by offering a level of regulation tailored to three alternative types of markets.

Specifically, the staff task force recommends that the Commission propose replacing the current one-size-fits-all regulation for futures markets with broad, flexible "Core Principles." The Core Principles are tailored to match the degree and manner of regulation to a variety of market structures, to the varying nature of the commodities traded and to the sophistication of customers. Under the recommended framework, U.S. futures markets, in addition to achieving greater flexibility in their current operations as **recognized futures exchanges (RFEs)**, also could choose to operate subject to a lesser degree of regulation for many of the commodities that they trade. For example, they could choose to operate a market exempt from Commission regulation, an **exempt multilateral transaction facility (exempt MTEF)**, for certain commodities. They could also choose to operate a market geared toward sophisticated, institutional traders that is subject to an intermediate degree of regulation and oversight, a **derivatives transaction facility (DTF)**. Or they could operate a combination of the three. The business choice would be theirs.

The following chart summarizes the proposed framework:

SUMMARY OF REGULATORY FRAMEWORK FOR MULTILATERAL TRADE EXECUTION FACILITIES

MARKET	CHARACTERISTICS	REQUIREMENTS
Recognized Futures Exchange (RFE)	1. Any commodity; 2. Any trader	Fifteen Core Principles
Recognized Derivatives Transaction Facility (DTF)[1]	1. Only commodities with: (a) nearly inexhaustible deliverable supplies; (b) no underlying cash market; or (c) individual contracts on a case-by-case basis; **or** 2. Only commercial traders	Seven Core Principles
Exempt Multilateral Transaction Facility (Exempt MTEF)	1. Only commodities with: (a) nearly inexhaustible deliverable supplies; or (b) no underlying cash market; **and** 2. Only institutional traders	1. Anti-fraud section of the CEA; 2. Anti-manipulation section of the CEA; 3. anti-fraud rule; and 4. may not hold self out as regulated

At the same time, the framework provides the over-the-counter (OTC) markets with greater legal certainty regarding market structures or practices that have evolved or that are likely

[1] As noted below, although DTFs are geared toward sophisticated or institutional traders, the framework would permit a facility eligible to be a DTF based upon the nature of the commodities traded to choose to include non-institutional traders.

to evolve in connection with OTC trading. Specifically, the framework includes an exemption for transactions among institutional traders in commodities with inexhaustible deliverable supplies or supplies that are otherwise sufficiently large and deep to render the contract highly unlikely to be susceptible to the threat of manipulation. These markets (exempt MTEFs) would be exempt from all of the requirements of the Commodity Exchange Act (Act or CEA) and Commission rules, except for anti-fraud and anti-manipulation provisions, a requirement that if performing a price discovery function they provide pricing information to the public and a provision that a violation of the terms of the exemption would not render the transactions void. Finally, these exempt markets could not hold themselves out as being regulated by the Commission. As noted above, existing futures markets also have the opportunity to operate under the terms of this exemption, if they so choose. Nothing in the staff proposal, however, would amend or affect the continued vitality of the Commission's exemption for swaps transactions under Part 35 of its rules, or any of its other existing exemptions, policy statements or interpretations.

The framework also provides for an intermediate level of regulation for derivatives markets, known as "Derivatives Transaction Facilities" (DTFs), that are geared toward institutional or commercial traders. A market that is eligible to be exempt from regulation may voluntarily become a DTF in order to become a "recognized" market. Futures exchanges may, if they choose, also operate as a DTF for those commodities with deliverable supplies sufficiently large to render them eligible for the above exemption. Although DTFs are intended primarily for institutional traders, the framework provides the individual DTF the flexibility to decide whether or not to include non-institutional traders. Access to a DTF by non-institutional traders, however, would be permitted only through intermediaries registered with, and regulated by, the Commission. Those intermediaries would be required to provide their non-institutional customers trading on a DTF with additional price disclosure and other protections. In addition, certain largely commercial markets may operate as DTFs for any commodity. Such commercial traders generally would have both the financial ability and the physical means to deliver tangible commodities.

The staff task force's recommendations also would provide significant regulatory relief for intermediaries. The staff suggests that the Commission streamline its registration procedures, streamline the mandatory risk disclosures provided to non-institutional customers and provide flexibility in how disclosures are made to institutional customers. It also recommends that the Commission propose broadening the range of instruments in which segregated customer funds could be invested, and removing unnecessary operational barriers relating to the secured amount requirements for the funds of customers trading on non-U.S. exchanges. The Commission should also propose relaxing certain registration and associated requirements for account executives who deal only with institutional clients. Finally, the framework clarifies that transactions under the Commission's Part 35 swaps exemption can be cleared, and permits clearing houses or agencies to be separate from an exchange or trading facility.

This new framework changes the structure of derivatives regulation, providing the derivatives markets with the flexibility to decide how they will meet the coming technological and competitive challenges. In doing so, the Commission would retain its oversight authorities to ensure the integrity of the markets and their prices, to deter manipulation, to protect the markets' financial integrity, and to protect customers.

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