SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

S. 1566

Statement of John M. Damgard, President Futures Industry Association

September 8, 2005

Chairman Shelby, Ranking Member Sarbanes, members of the Committee, I am John Damgard, President of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today. FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures brokerage firms, known as futures commission merchants (FCMs), in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. FIA estimates that its member firms serve as brokers for more than ninety percent of all customer transactions executed on United States futures exchanges.

In the last Reauthorization of the Commodity Futures Trading Commission (CFTC), this Committee played an important role in forging the landmark legislation known as the Commodity Futures Modernization Act of 2000 (CFMA). With the goal of promoting "responsible innovation and fair competition among boards of trade, other markets and market participants," the CFMA amended the Commodity Exchange Act (CEA) to:

- Assure legal certainty for over-the-counter derivatives;

- Remove the 20-year (supposedly temporary) prohibition on futures on individual securities and narrow-based securities index contracts through the joint regulation of these products by the CFTC and the Securities and Exchange Commission (SEC); and
- Provide a more flexible regulatory system for futures and options.

In any legislation of hundreds of pages, some provisions do not work out as expected. The CFMA is no exception. In a handful of areas, the provisions of the CFMA could use some improvement. FIA looks forward to working with this Committee again on that effort.

On the overriding issue of the CFTC's Reauthorization, FIA's position is unequivocal. FIA believes the CFTC is an excellent agency that discharges its statutory obligations efficiently and effectively. We look forward to a continuation of this tradition of excellence under the CFTC's new Chairman, Reuben Jeffrey. The CFTC deserves to be reauthorized.

FIA believes there are four primary areas that should be addressed in order to fulfill the promise of the CFMA: off-exchange retail foreign currency (FX) transactions; security futures; SRO transparency and governance; and competition. Retail FX transactions have been the main focus of attention in the President's Working Group in recent weeks and the CFTC Reauthorization bill reported by the Senate Agriculture Committee, S. 1566, contains specific proposals for dealing with retail FX transactions. Most of my remarks will therefore focus on that issue, followed by a general summary of FIA's positions in the other areas.

RETAIL FX TRANSACTIONS

As the Committee will recall, in 1997 the U.S. Supreme Court dismissed a CFTC fraud prosecution, ruling that the CEA's Treasury Amendment enacted in 1974 provided a "complete exclusion" from the CEA for any off-exchange FX transactions, including FX futures and options transactions with retail customers. *Dunn v. CFTC*, 519 U.S. 465, 476 (1997). Three years later, Congress reconsidered the Treasury Amendment and made certain modest modifications. The CFMA reaffirmed that the CEA does not apply generally to any FX futures or options transactions, with three exceptions: 1) futures contracts traded on an organized exchange; 2) currency options not traded on a securities exchange; and 3) some FX futures that are offered to retail customers, what the statute calls "non-eligible contract participants."[1]

This last category -- retail FX transactions -- has been the focal point of most of the debate in this CFTC Reauthorization. Current law grants the CFTC full jurisdiction over retail FX futures unless the retail customer's counterparty qualifies in one of six different categories: banks, broker-dealers, FCMs, affiliates of broker-dealers or FCMs, insurance companies, financial holding companies or investment bank holding companies. Retail FX futures entered into with five of these six categories of qualifying entities -- including banks, broker-dealers and their affiliates -- continue to enjoy a complete exclusion from the CEA. The only exception is for retail FX futures where a registered FCM or its affiliate is the counterparty; then the transactions are subject to the CFTC's powers to enforce the antifraud and antimanipulation prohibitions of the CEA.

In recent years, some unsavory, sharp operators have been registering shell companies as FCMs, avoiding any real exchange-traded futures business, creating affiliates to enter into retail FX transactions with consumers and engaging in or promoting fraudulent sales practices in connection with retail FX futures contracts. The CFTC has brought many cases to shut down these schemes. Still more firms are engaging in this form of sales fraud.

1 Section 1a(12) of the CEA defines "eligible contract participant" to mean an individual with more than $10 million in total assets or $ 5 million if the individual retains a professional price risk manager.

The CFTC's enforcement efforts in this area have been substantial. The CFTC has won many cases and put many firms out of business. However, last year the CFTC did lose one of these cases when it failed to prove that the firm involved was selling a futures contract. This is the *Zelener* case.[2]

Zelener and the retail FX fraud problem have raised a series of issues that many believe should be addressed in this CFTC Reauthorization. Let me summarize those issues and FIA's positions.

1. <u>Broad Fix (all commodities) or Narrow Fix (FX only)?</u>

Some believe that the *Zelener* decision, even though it arose in the context of a single retail FX fraud case, could lead to broader enforcement issues for the CFTC in areas beyond FX. They would argue that the *Zelener* decision shrank the legal definition of a futures contract and thereby shrank the CFTC's enforcement jurisdiction generally, allowing con artists in the agricultural, energy or precious metals area to defraud customers and avoid CFTC policing by proving that their offerings were not futures contracts under the *Zelener* precedent.

FIA disagrees with those who seek a broad fix. Since 1922, the CFTC's jurisdiction has been limited wisely to futures and options contracts. In fact, Congress as recently as 1982 pruned back CFTC jurisdiction to avoid any possibility that it could spill over into commodity cash or forward markets that operate throughout our country, and are subject to the jurisdiction of other agencies, including law enforcement at the federal, state and local levels.[3] Expanding

2 CFTC v. Zelener, 373 F. 2d 861 (7th Cir. 2004).

3 In 1982, Congress amended the definition of a commodity trading advisor. Prior to the 1982 Act, a commodity trading advisor was broadly defined to include any person who was engaged in the business of providing advice "as to the value of commodities," including cash and forward market transactions. As amended in 1982 Act, a commodity trading advisor is now defined as any person providing advice "as to the value of or advisability of trading in any contract for futures delivery made on or subject to the rules of any contract market, any commodity option authorized under section 4c, or any leverage contract authorized under section 19 of this
(Footnote Continued)

the CFTC's jurisdiction to apply to any form of non-futures contracts would have profound and, FIA believes, adverse implications for the CFTC's ability to discharge its oversight of futures and options exchange-trading, especially given the agency's structure and limited resources. Congress granted the CFTC exclusive jurisdiction over the futures and related options markets in order to make certain the CFTC would concentrate its efforts on those vital areas of our economy. Nothing should distract the CFTC from its core mission.

Overreacting to *Zelener* would also be particularly inappropriate since the *Zelener* court just applied the evidence before it to the traditional legal guidelines for determining whether a transaction is a futures contract, focusing on whether the parties had the right to and contemplated offset of the transaction, and therefore mimicked the offset properties of exchange-traded futures. The CFTC's inability to prove its case to one court is no reason to transform the agency into a national police force for consumer fraud committed in any transaction with a commodity theme. In this regard, FIA is pleased that the CFTC's legislative package and S. 1566 as reported by the Senate Committee on Agriculture (even if adopted only as a "placeholder") do not support the broader "all commodity" fix.

That does not mean FIA supports a "do nothing" approach to the retail FX issues. Far from it. Certain adjustments to the CFMA's provisions would help the CFTC combat the fraud and abuse we have seen in retail FX transactions in recent years. The CFTC claims it would be easier for it to curb that activity if it did not have to prove that the perpetrators of fraud were offering a futures contract. Yet granting the CFTC powers over non-futures transactions has

(Footnote continued)

Act." That is, a person is required to be registered as a commodity trading advisor only if that person is providing advice with respect to transactions that fall within the Commission's exclusive jurisdiction.

historically had troubling implications. Those two differing views frame the next issue being debated.

2. CFTC's Non-Futures FX Jurisdiction: General or Antifraud Only?

Both the CFTC and the Senate Agricultural Committee have proposed granting the CFTC new general jurisdiction over retail FX **non-futures** transactions. Their proposal would empower the CFTC to develop any regulations it sees fit for retail FX transactions that are leveraged, margined or financed and not for commercial use or where the customer takes immediate ownership and possession of the currency involved. It is not clear why the CFTC needs such sweeping regulatory power over these transactions or what kind of regulatory structure the CFTC would set up for these transactions. But it would be expected that the CFTC would adopt an array of regulations for it to enforce or may even ban these products outright.[4]

Expanding the CFTC's general regulatory jurisdiction to non-futures would not only drain the agency's limited resources, but would lead to unwarranted legal uncertainty of the kind the CFMA stamped out in 2000. Both the CFTC's proposal and S. 1566 introduce jurisdictional concepts that will not promote legal certainty. Statutory trip-wires like "financed on a similar basis" or "immediate ownership and possession" leave room for reasonable differences of interpretation that could lead unsuspecting and legitimate enterprises to run afoul of CFTC regulation. Moreover, the emphasis on ownership or possession of FX suggests that CFTC jurisdiction might turn on some of the same definitional dividing lines that have bedeviled courts

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[4] FIA is concerned that granting the CFTC general non-futures authority also will lead to considerable legal confusion. One part of the CFTC's proposal states, for example, that the CEA antifraud provisions apply to retail FX futures offered by certain FCMs and their affiliates, but not FCMs that also operate as broker-dealers. Another part of the CFTC's proposal would apply those same antifraud provisions to any retail FX transaction even if not futures and even if offered by FCMs that are also broker-dealers. This inconsistency illustrates the difficulty of trying to superimpose non-futures onto the futures regulatory provisions.

and even the agency itself for many years in the area of distinguishing futures from forward contracts. Compounding the unintended collateral implications of these ambiguities is that the CFTC-S.1566 proposal apparently would allow the CFTC to render "per se" illegal FX-related financing activities of legitimate financial institutions or others.

For many months, FIA has proposed a different approach. We believe the CFTC's enforcement arsenal should be enhanced so that the agency could pursue retail FX fraud cases against bucket shops and boiler rooms without having to prove that the applicable FX transaction was a futures contract. This proposal would be a targeted response to the real problem -- retail FX sales abuses -- without expanding the CFTC's general regulatory jurisdiction and mission beyond futures. Removing the shield of the "futures contract defense" from those who prey on unsuspecting FX customers should make the CFTC's already impressive enforcement track record in this area, even more impressive. And by focusing the CFTC's resources on bringing fraud cases for retail FX, rather than adopting regulations, the retail public can expect better protection and better sales practices.

FIA recognizes that allowing the CFTC to pursue non-futures, off-exchange fraud cases would be a significant departure from the CEA's regulatory scheme. We know that many have criticized us for not simply taking the position that sales fraud in connection with transactions that are not futures contracts should be of no more concern to the CFTC than sales fraud in connection with non-securities transactions is to the SEC. But, in our view, the CEA recognized that FX was a special commodity which Congress had treated with special provisions for many years. Moreover, the special non-futures retail FX antifraud provision would not apply to any transactions where the counterparty was one of the six types of qualifying entities Congress recognized in 2000.[5] Thus, granting the CFTC special, limited and targeted non-futures antifraud authority over certain retail FX transactions that operate outside existing regulatory systems seemed like an appropriate compromise.

FIA also believes that certain important enhancements should be enacted for the retail FX futures transactions Congress permitted in the CFMA. Experience has shown that some of the CFMA's provisions in this area need tightening. A discussion of these issues follows.

3. Should Solicitors of Retail FX Futures be CFTC-Registered?

The CFMA has been interpreted by the CFTC to preclude the registration of many of those who solicit retail FX futures contracts. Since the problem with retail FX transactions has been sales fraud, it makes sense to ensure that any person who solicits retail customer business meet traditional CFTC fitness standards.

FIA proposes that any person who participates in the solicitation or recommendation of any retail FX futures contract where an FCM or its affiliate is the counterparty must be both CFTC registered and a member of National Futures Association. That would mean that any employee of an FCM or its affiliate that solicits retail FX futures business must be CFTC-registered. It also means that independent firms that introduce retail FX futures customers to FCMs or their affiliates must be CFTC-registered. The only exceptions from this requirement would be for the other qualifying entities (including broker-dealers as well as broker-dealers that are also FCMs) and those who are already subject to federal regulatory supervision (like investment advisers). In addition, any person soliciting a customer to buy a retail FX futures contract where the counterparty is not a qualifying entity (including where the counterparty is not

5 Under our proposal, the CFTC would retain its existing authority to pursue antifraud and antimanipulation actions against FCMs and their affiliates (unless the FCM is also a broker-dealer or other qualifying entity) in connection with retail FX futures were the FCM or affiliate is a counterparty.

an FCM or affiliate meeting the conditions set forth below) would be engaging in the illegal offer of an off-exchange futures contract under the CEA. That person would be subject to the full enforcement authority of the CFTC.

Right now, no member of the public can find out who is eligible to solicit retail FX futures business. As a result of this reform, both the CFTC and NFA would have a list of those firms and individuals that are qualified to sell retail FX futures under CFTC jurisdiction. Either the CFTC or NFA, or both, may make this list available to the public through their web-sites or public information efforts. This proposal therefore would provide greater transparency to the investing public.

4. <u>Should Shell FCMs Be Qualifying Entities?</u>

No. The CFMA has been interpreted by the CFTC to allow firms to register as FCMs even if the firm does not intend to engage in the business of being an FCM, brokering or clearing exchange-traded futures contracts for others. Those firms (or their affiliates) can then become the counterparties to retail FX futures contracts and enjoy the benefits of an exemption that Congress wrote for FCMs that would be engaged in the exchange-traded futures business.

FIA believes that when Congress granted this exemption for registered FCMs, Congress intended those FCMs would be real futures brokers, not shells. To achieve that objective, FIA has proposed that any FCM qualifying for the exemption to serve as a counterparty for retail FX futures must be "substantially and primarily" engaged in the exchange-traded futures business. The CFTC will have discretion to define "substantially and primarily" in this context. Through this requirement, the shell FCM loophole should be ended. S. 1566 does not contain a similar limitation on registered FCMs acting as counterparties for retail FX transactions.

This new "substantially and primarily" requirement also should contribute materially to reducing many of the sales practice abuses experienced in recent years. Substantial FCMs who deal with the retail public everyday will not want to see their reputations tarnished by sales practice abuses committed in connection with retail FX futures to which those FCMs (or their affiliates) are the counterparties.

5. Should FCM Affiliates Be Allowed to Continue to be Qualifying Entities?

Yes. The CFMA treats affiliates of broker-dealers and FCMs equally. Both are allowed to serve as qualifying entities that may be counterparties to retail FX futures under Section 2(c)(2)(B) of the CEA. FIA understands that the CFTC may now be proposing to allow broker-dealer affiliates to continue to act as counterparties to retail FX transactions but would bar FCM affiliates from continuing to do so. FIA believes both broker-dealer affiliates and FCM affiliates should continue to be able to serve as qualifying entities under Section 2(c)(2)(B) of the CEA. No basis exists to treat affiliates of broker-dealers more favorably in this regard than the affiliates of FCMs, especially once the shell FCM loophole is plugged as we have recommended.

FIA also believes the FCM affiliate provisions in Section 2(c)(2)(B) should be improved in two important respects. First, FIA recommends that only affiliates of FCMs with at least $20 million in net capital (or higher if the CFTC believes it to be appropriate) should be eligible to be qualifying entities. This will ensure as a practical matter that if an affiliate of an FCM faces financial difficulty in performing its counterparty role, its FCM will have the capacity to step in and cover those obligations in order to avoid the harm to its reputation from a default. Second, FIA recommends that in order for any FCM affiliate to qualify under Section 2(c)(2)(B), the FCM must undertake to comply with the CFTC regulatory requirements (record keeping and reporting) for material associated persons or the affiliate must be a material associated person

(MAP) of the FCM. By this requirement, the CFTC will retain an important measure of oversight for the FCM affiliate serving as the counterparty to the retail FX transaction.[6]

In 2000, the CFMA authorized FCM affiliates to qualify as counterparties for retail FX transactions. Based on that authorization, some affiliates have engaged in this business without customer complaints for years. Congress should not over-react to the sales problems others have caused by insisting now that those affiliates must cease operations.

6. <u>Should the CEA Prohibit Principal to Principal Fraud?</u>

Section 2(c)(2(C) of the CEA makes the general antifraud provision in Section 4b applicable to all retail FX futures where an FCM (that is not also a broker-dealer) or its affiliate is the counterparty. Section 4b, however, was enacted in 1936 in the context of FCMs acting as brokers for customers on futures exchanges and prohibited defrauding any one the FCM was acting "for or on behalf of" as an agent. Section 4b did not, however, cover fraud in connection with transactions where the FCM or its affiliate would act as a principal or counterparty to the transaction. Since the retail FX futures transactions authorized by the CFMA contemplate that FCMs would act as principals to those transactions, questions were raised whether the CFTC's antifraud jurisdiction actually applied to those retail FX futures.

Section 2 of S. 1566 contains an amendment to Section 4b of the CEA that would extend that antifraud prohibition to principal to principal fraud. FIA supports this amendment. It would

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6 Current law contains a perverse anomaly that this proposal will cure. Under current law, the affiliate of a modestly capitalized FCM would qualify as a MAP and be eligible as a qualifying entity. The affiliate of a substantially capitalized FCM might not qualify as a MAP since its operations would not be material to the overall financial picture of the FCM. In FIA's view, if the FCM undertakes in writing to the CFTC that its affiliate will comply with all MAP requirements even if the affiliate is not technically a MAP, that affiliate should be considered to be a qualifying entity so long as the FCM has at least $20 million in net capital.

strengthen the CFTC's enforcement efforts in the retail FX futures area by removing another possible defense to a CFTC fraud prosecution.

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FIA understands that the President's Working Group has focused its deliberations on the retail FX issue and we have accordingly focused our testimony on those issues. In summary, FIA sees no need for either a broad, all-commodity response to *Zelener* or to grant the CFTC general jurisdiction over retail FX non-futures. Instead, FIA recommends that Congress amend the CFMA in the retail FX futures area by 1) prohibiting shell FCMs; 2) registering soliciting retail FX futures firms and individuals; 3) imposing at least a $20 million net capital requirement on FCMs whose affiliates are acting as permissible counterparties; 4) requiring any qualifying affiliates to comply with CFTC MAP regulation; and 5) expanding the CEA to cover principal to principal fraud. In addition, FIA continues to propose that Congress grant the CFTC special new enforcement powers to pursue fraud actions in connection with narrowly-defined retail FX transactions even if not futures contracts. These changes will respond to the customer protection challenges of recent years without compromising the CFTC's overall mission or the CFMA's goal of legal certainty.[7]

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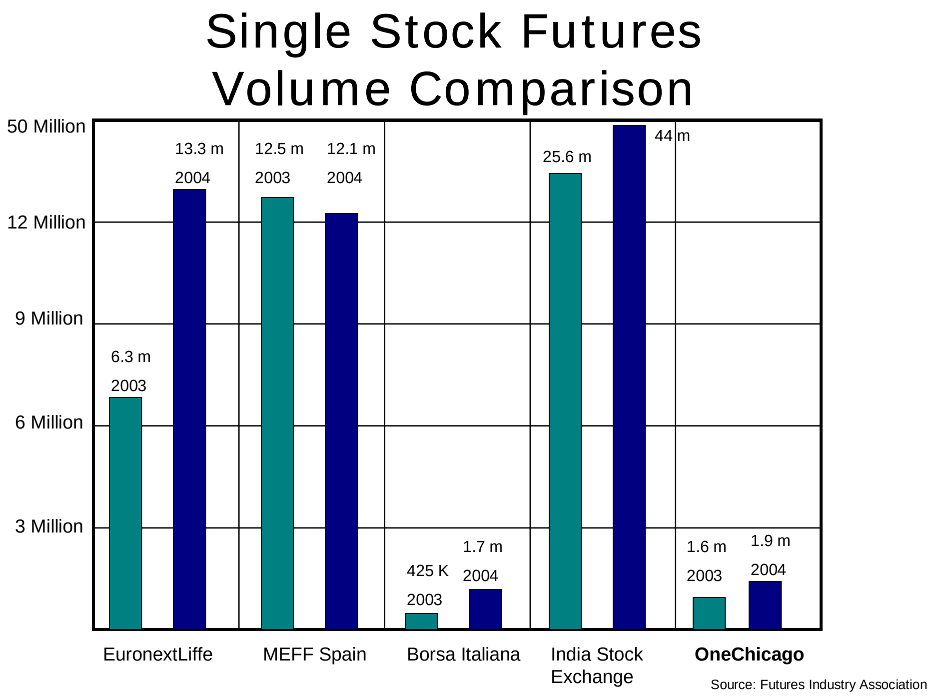
7 The goal of legal certainty is also threatened by Committee Reports that attempt to create legislative history for statutory provisions that do not exist. For example, the Report of the Senate Committee on Agriculture claims to make certain amendments to Section 2(c)(2)(C) of the CEA that are mere clarifications of existing law. S. Rep. No. 109-19, 109th Cong. 1st Sess. 8 (2005). But those "clarifications" create significant new legal obligations and causes of action not contained in the CFMA and not discussed in any Committee hearings or deliberations. In addition, the Committee Report attempts to graft onto provisions that confirm the CFTC's ability to pursue civil enforcement actions for violations of the criminal provisions of the CEA limitations in the CFMA's exclusions and exemptions that contradict the actual language Congress enacted to achieve the goal of legal certainty. Id. at 6. Any expansions or contractions of the CFTC's jurisdiction in this important area should come from provisions Congress actually enacts.

SECURITY FUTURES PRODUCTS

Since the enactment of the CFMA, FIA has worked diligently with the CFTC, the SEC and the exchange community to implement both the spirit and the letter of the provisions authorizing trading in security futures products. Although volume on these markets has not been as robust as we would like, we continue to believe that this is an important product that will grow over time. Last year, the only U.S. market for security futures -- OneChicago -- increased its annual trading volume by 19% from 1.6 million contracts in 2003 to 1.9 million in 2004.

In contrast, security futures are more popular in other countries. As the following chart shows, at the London based Euronext.Liffe exchange, 2004 single stock futures volume was up 114% over 2003 volume, with a total of 13.5 million contracts traded. And at Italy's Borsa Italiana, single stock futures volume rose more than 250% last year as it traded over 1.7 million contracts. At the Stock Exchange of India, 2004 single stock futures volume was up 72% to 44 million contracts. And finally, even at Spain's MEFF exchange, where single stock futures volume was basically flat, they were still able to trade 12.1 million contracts. As you can see, it is clear that at this time the security futures industry in the United States has not caught up with our competitors on foreign exchanges.



FIA supports action in three areas relating to security futures. In each area, legislation would not be needed if the CFTC and SEC adopted administrative solutions as contemplated by the CFMA. But that hasn't happened. Reluctantly, FIA believes Congress should take some action to make certain that the agencies address these three areas.

First, U.S. futures exchange representatives believe that U.S. security futures markets would grow if their portfolio margining systems for futures generally were made available to security futures trading. The U.S. futures exchanges and clearing firms are deservedly proud of their portfolio margining systems. These systems provide financial integrity for the futures markets while allowing for more efficient use of capital by traders and clearing firms. The CFTC and the SEC are empowered to allow portfolio margining systems to apply to U.S. security futures markets. Since those markets are struggling now to catch up with foreign competition, FIA would urge the agencies to allow existing futures clearing portfolio margining systems to be applied to security futures products as soon as practicable.

FIA understands that the options and cash markets in securities also would like to have the SEC approve futures-style portfolio margining for their market users. FIA supports these efforts as well, provided that nothing tips the competitive scales in favor of broker-dealers at the expense of FCMs. Perhaps the fledgling security futures markets can offer a pilot program for this concept while the SEC considers adapting that system to the options and cash markets. Or the new leadership at the SEC and the CFTC can agree to a reasonable and mutually acceptable timetable for implementing portfolio margining. This is not a matter of seeking competitive advantage for security futures; it is a matter of competitive viability for security futures in the U.S.

Second, provisions of the CFMA combined with regulatory intransigence are creating a significant competitive disadvantage for U.S. investors and U.S. firms. The problem stems from the definition of a "narrow-based" securities index in the CFMA, its application to indexes on securities other than U.S. equity securities, and the regulatory consequences for futures trading on any index that falls within the "narrow-based" definition.

Prior to the CFMA, in fact since 1981, futures contracts had been trading on stock indexes which were generally considered to be broad-based. Those stock index futures were traded subject to the CFTC's exclusive jurisdiction. An index was considered to be broad-based if the index could not be used as a surrogate for an individual stock or a small group of stocks or to manipulate the underlying cash market price. Otherwise, the CFTC and the SEC were concerned that insider trading in the stock could take place outside the SEC's purview through trading in the stock index futures contract.

In deciding to lift the ban on single stock futures in the CFMA, Congress chose to set up a special regulatory regime for those new futures products subject to shared CFTC and SEC regulatory authority. At the same time, Congress decided that some existing stock indexes, and surely those to be developed, could not be considered to be broad-based, but could become the subject of futures trading under the same rules as single stock futures. Congress decided therefore to treat and regulate both single stock futures and "narrow-based" stock index futures as "security futures products" subject to CFTC and SEC jurisdiction.

For a stock index, therefore, the issue whether it is "narrow-based" or "broad-based" has important regulatory consequences under the CFMA. Broad-based indexes (those are that not narrow-based) may be traded under the traditional rules for futures trading subject to CFTC jurisdiction. Narrow-based indexes may be traded only as security futures subject to the special rules set out in the CFMA. And, as discussed more fully below, U.S. investors are banned from trading foreign security futures products, including foreign futures on narrow-based indexes.

In the CFMA, Congress defined through numerical criteria what indexes would be considered to be "narrow-based" -- at least 9 securities, no single security more than 30% of the index value, no five securities more than 60% of the index value, and aggregate capitalization amounts for the lowest quartile of the index. These criteria were authored jointly by the CFTC and SEC. While those criteria were adopted with U.S. equity markets in mind, the CFMA literally applies those criteria to any "security" market -- debt or equity, foreign or domestic. For that reason, the CFMA grants the CFTC and SEC joint power to adopt criteria for defining "narrow based" indexes for these other security markets. To date, that has not happened.

Instead, we understand that the SEC has taken the view that the CFMA's narrow-based criteria apply to all equity markets, not just those in the U.S. That position leads to some unintended and unfathomable results. For example, one foreign stock index comprised of 229 stocks traded in Switzerland is considered "narrow-based" because it would not meet the criterion that no five stocks may comprise 60% of the value of the index. Indexes developed to reflect the value of equity markets in many other countries, including Japan, Greece, Australia, Portugal, Russia, Belgium, Denmark and Norway also do not meet the rigid CFMA narrow-based index criteria.

As a result, no U.S. firm may offer, and no U.S. investors may buy or sell, foreign futures on these indexes since they are foreign security futures products (foreign futures contracts on a narrow-based index). This is the case even though in foreign jurisdictions trading in these stock index futures is treated like any other futures contract.

FIA understands the agencies' rationale for the CFMA's "narrow-based" criteria as applied to U.S. equity markets. But misapplying those criteria to foreign equity markets has disadvantaged U.S. investors and U.S. FCMs in a profoundly anticompetitive manner. Congress should provide the agencies with direct guidance on this issue and make certain that the "narrow-based" criteria no longer operate as a competitive barrier for U.S. exchanges, firms and investors.

Third, as mentioned above, U.S. institutional investors are being discriminated against today because they are barred from trading futures on individual securities and narrow-based security index futures contracts on a non-U.S. exchange. These instruments could be of significant value to customers for various purposes, including risk management and asset allocation. The best way to understand the issue is this. FIA has been told by investment managers of the pension funds for U.S. government employees that the rate of return earned on the U.S. employees' funds is often not as high as the rate of return earned on the pension funds of foreign government employees. The reason is that the investment manager may not use foreign security futures products to manage the U.S. employees' funds, but may use those risk management tools for foreign government employees.

In the CFMA, Congress instructed the SEC and the CFTC "to the extent necessary and appropriate in the public interest, to promote fair competition, and consistent with promotion of market efficiency, innovation and expansion of investment opportunities" to "issue such rules regulations or orders as may be appropriate to permit the offer and sale of a security futures product traded on or subject to the rules of a foreign board of trade to United States persons." Consistent with this explicit congressional direction, FIA had been assured that necessary rules or orders permitting the offer and sale of foreign security futures products to U.S. persons would be adopted contemporaneously with the rules authorizing security futures products on U.S. exchanges. However, the CFTC and SEC did not promulgate such rules.

The investment objectives of pension plans, investment companies, endowments, hedge funds and other large money managers that FIA members serve have been restricted by the agencies' failure to act. Those institutional customers are free to engage in transactions in the international securities markets with few regulatory limitations. These institutions also are authorized to enter into principal-to-principal derivatives transactions that replicate foreign security index contracts, but may be more difficult, and substantially more expensive, to effect than exchange-traded instruments. In these circumstances, no U.S. regulatory purpose is served by preventing U.S. institutional customers, in particular, from using foreign futures on narrow-based indexes or single securities, provided that a U.S. stock exchange is not the primary market for the securities underlying such security futures products.

Unfortunately, S. 1566 does not address this issue. We request that this Committee work with your counterparts on the Agriculture Committee and the new leaders at the CFTC and SEC to determine when action in this area may be forthcoming and to codify that timetable in legislation. If the agencies believe that they need additional statutory authority, they should so advise Congress so that appropriate amendments can be enacted this year.

SRO GOVERNANCE

Like the SEC and the securities markets, SRO governance has been an issue under review at the CFTC for some time. In this regard, FIA supports the important role that the exchanges, clearing organizations and National Futures Association perform as self-regulatory organizations (SROs). Given their strong market knowledge and close proximity to the trading markets, they provide the best vantage point for addressing many of the futures markets' oversight functions. However, to be fully effective, there must be an increased degree of public confidence in the integrity and objectivity of SROs.

The Commission, the SROs and the derivatives industry generally must act to remove the real and perceived conflicts of interest and potential for anti-competitive conduct that are inherent in any self-regulatory structure, particularly when the exchange is operated on a for-profit basis and has issued stock to the public. Specific modifications to the SRO structure should increase its overall efficiency and effectiveness. For example, FIA believes that establishing a meaningful number of truly independent directors on SRO Boards is one of the most important reforms that could be considered. The FIA has filed extensive comments with the CFTC in this area containing many recommendations. We would be pleased to provide our comments to this Committee at your request.

A good illustration of our concern is the recently-adopted U.S. Treasury futures position limits imposed by the Chicago Board of Trade (CBOT). The CBOT imposed these limits through a new procedure made available under the CFMA. It allows futures exchanges to self-certify that their rule changes are in compliance with the CEA and then place the rules into effect without obtaining CFTC approval. On many non-controversial rule changes this kind of administrative efficiency may make sense. In this case, however, the CBOT's rule changes had an impact on trading in futures contracts with open positions and may have caused some to enjoy trading gains and some to suffer trading losses. Many market participants have raised serious questions about the (unstated) purpose of the CBOT's rule change and the ability of the CBOT to enforce its rule as written. Weeks after the CBOT's actions had been implemented, the CBOT offered only a partial explanation for why it took the action it did and how it intended to enforce its rule change.

Whether the CBOT's actions were wise or precipitous is not the main issue for FIA. We believe the fairness and transparency of the exchange rule change and approval process is the issue. We fear some market participants lost confidence in the CBOT by virtue of its decisions both to change the rules of the game during the game and to offer no reason for doing so. FIA does not believe that any contract market should self-certify rules that change the trading terms and conditions for contracts that have already been listed and where traders have already established open positions. But surely no exchange should take such action without telling the public why it took the action and how it reached that decision.

FIA hopes that CFTC Chairman Jeffrey will take a fresh look at this area in the coming months and that no legislation will be needed to address these issues.

FAIR COMPETITION

Promoting fair competition should be the goal of any sound regulatory program. Robust competition facilitates the ability of U.S. futures markets to serve the public interest. Competition leads to reduced costs, higher volumes, narrower spreads and greater innovation.

Our strong support for the CFMA was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established excessively high barriers to entry, would be the best regulator. We fully anticipated that the CFMA's regulatory reforms would encourage new entrants to apply for designation with the Commission as contract markets or clearing organizations. These new self-regulatory organizations would compete among themselves and with the existing exchanges for customer business based on products, quality of execution, and cost.

Unfortunately, since the CFMA was enacted very little direct competition among markets has occurred. Virtually all efforts at direct competition have been unsuccessful thus far. Even the largest derivatives exchange in the world (EUREX) has been unable to penetrate the market share of the Chicago Board of Trade in U.S. Treasury Note and Bond futures. Shortly after EUREX US indicated it was reassessing its operations, the CBOT announced a fee increase for all market participants, an apparent by-product of the absence of competition.

Some believe that unless or until Congress or the CFTC mandate multiple contract listings together with cooperative clearing arrangements the potential benefits of meaningful direct competition will never be realized. (That would mean, for example, that a "long" contract entered into on Exchange #1 could be offset by a mirror-image "short" contract on Exchange #2 through cooperative or common clearing, and vice versa.) As this Committee well knows, it makes sense to give customers the ability to choose their market and obtain the best price available for an offsetting trade, even if the market with the best price is not the market where the original position was established.[8] These are salutary goals we believe everyone should

8 This system also would encourage customers to enter into original positions on a challenger exchange when that exchange offers the customer the better price. The customer then could offset that same position on the dominant exchange.

support in the interest of serving the customer and enhancing competition. Yet, established exchanges are reluctant to surrender their market advantages.

As noted above, the efforts of the challenger markets to date have done little more than chip away at the entrenched markets' dominance. We believe that further study by the CFTC of how to stimulate futures market competition would be appropriate now. With the benefit of that analysis, Congress may wish in the future to consider whether legislation in the direct competition area would help to realize fully the goals of the CFMA.

CONCLUSION

FIA greatly appreciates the opportunity to present its views to the Committee. We look forward to answering any questions you may have and to working with the Committee on this year's CFTC Reauthorization legislation.