COMMODITY FUTURES TRADING COMMISSION

PUBLIC HEARING

ON

THE CFTC STUDY OF POTENTIAL CHANGES IN THE REGULATION OF INTERMEDIARIES

Thursday, June 6, 2002

Hearing Room 1000
1155 21st Street, N.W.
Washington, D.C.

The hearing was convened, pursuant to notice, at 10:08 a.m.

BEFORE:

JAMES E. NEWSOME, Chairman

BARBARA PEDERSEN HOLUM, Commissioner

THOMAS J. ERICKSON, Commissioner

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C O N T E N T S

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P R O C E E D I N G S

CHAIRMAN NEWSOME: Okay, now I think we can get started. First of all, I would like to say thanks for everyone who has taken time today to be here with us to share your thoughts and ideas with us, as we move forward to look at potentially modernizing rules for intermediaries.

As many of you know, the Commission has discussed this for a couple of years. Certainly, personally, it's been a priority of mine that we look in this area, and that we take a close look, as we did with transaction facilities now almost two years ago.

Certainly, through changes in technology, changes in industry, I think it's very responsible from the regulatory standpoint to continue to look at needed changes in the regulatory structure based upon changes in technology and changes in the business world. And we're committed to doing that.

Obviously, as a step today, Congress, through the Commodity Futures Modernization Act, required the Commission to do a study. And we appreciate the countless time that staff has put into accomplishing this feat. I know that there have been many hours spent by staff discussing it. There was a very lengthy interview process, which many of you participated in. And now today we look forward to hearing your comments through this hearing, so that we can finalize that report to Congress.

I would say that I’m viewing this report to Congress as a first step in this process to identify areas that the Commission needs to look at. And then after this report is submitted within the next few weeks, the Commission will turn to discussing and looking at ways that we can modernize rules for intermediaries.

So before we ask the first panel to start, I'd like to turn to my colleagues to see if they have any comments this morning. Commissioner Holum?

COMMISSIONER HOLUM: Thank you, Mr. Chairman. Just to join you in welcoming everybody. And thank you all for coming and spending time. And I look forward to all of your remarks. Thank you.

CHAIRMAN NEWSOME: Thank you very much.

Commissioner Erickson?

COMMISSIONER ERICKSON: Likewise, I would just like to extend my thanks to you and your office for putting together a public forum where members of the industry can come to provide us with their remarks in person and give us the opportunity to develop a public record.

And welcome to you all. I look forward to it. Thank you.

CHAIRMAN NEWSOME: Thank you very much, sir.

We have a very distinguished first panel to start, representing organizations that are very widespread and very respected in this industry. And we will start with John Damgard, President of the Futures Industry Association.

And John, we'll turn it over to you for your comments.

STATEMENT OF JOHN M. DAMGARD

PRESIDENT, FUTURES INDUSTRY ASSOCIATION

MR. DAMGARD: Thank you very much, Mr. Chairman. We have certainly been looking forward to this. Thank you, Commissioner Erickson and Commissioner Holum, for your interest in our remarks.

I should say at the outset that Bob Wilmouth has agreed to cede a significant portion of his time, so if I run a little bit over my--

[Laughter]

MR. DAMGARD: Mr. Chairman, members of the Commission, on behalf of the Futures Industry Association, it is a pleasure for me to be here today to discuss our recommendations for reform of the Commission's regulations governing intermediaries. My statement this morning is intended to supplement the views and recommendations contained in our detailed comment letter filed with the Commission on April 5. The recommendations contained in that letter are important to our membership, and I commend that letter to you.

I last had the privilege of appearing before the Commission nearly two years ago, on June 28th, 2000, to address the Commission's proposed New Regulatory Framework. FIA strongly supported the Commission's regulatory reform proposals then, as well as the enactment of the Commodity Futures Modernization Act of 2000 later that year. Our endorsement of these reform proposals was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established insurmountable barriers to entry, would be the best regulator.

The proposed deregulation of the markets promised to facilitate the development of new exchanges and clearing organizations that would vie for business by offering more efficient, cost-effective markets. To counter this competition, existing markets and clearing organizations in turn would be required to forsake their parochialism and focus more strongly on the needs of the FCMs and the customers that they serve.

Since the enactment of the CFMA, the U.S. futures exchanges have launched a number of new products, at times in direct competition with each other. Unfortunately, we cannot say the same for existing products. With the exception of BrokerTec, we have seen remarkably little competition at either the exchange or clearing organization level.

The regulatory barriers to entry may have been removed, but the vigorous rivalry that we had hoped for has not broken out. As a consequence, we have seen far less progress than we had anticipated in the evolution of exchanges. For example, the boards of directors of the major exchanges remain dominated by representatives of the floor community. As a result, the transition from floor to screen has been halted at the halfway point, requiring FCMs to carry the financial burden of maintaining two trading systems on each exchange.

It may be too soon to state with certainty why competition has failed to develop. However, having spent the greater part of the last year analyzing and commenting on the proposed rules relating to security futures products, we have identified certain characteristics of the securities markets that we believe help enable competition. Two stand out.

The first is fungibility of products across markets. It is no secret that liquidity is essential to the success of any futures contract. Market participants want to know that once they enter into a contract, it can be offset easily and at an efficient cost. A market participant would be understandably hesitant to enter into a contract on a new exchange, therefore, without some expectation that the contract could be offset without difficulty. Fungibility across markets would provide such assurance.

The second characteristic is common clearing. The industry has long recognized the benefits of common clearing in reducing the costs to FCMs and their customers, allowing FCMs and customers alike to make more efficient use of their risk management capital and, no less important, allowing FCMs to better monitor and manage the risks their customers are assuming across markets. Common clearing, therefore, protects customers and serves the public interest by enhancing the financial integrity of the markets.

As you know, achieving this goal has been elusive. Although we have come close several times in Chicago over the years, the self-interests of the exchanges have always surfaced to quash a final agreement.

The structure of clearing is still the primary concern of FIA member firms. Our members strongly believe that the governance of clearing organizations should be independent of the exchanges whose contracts they clear, and should be vested in the clearing organizations' members and shareholders, in proportion to the risks that they assume.

The importance of fungibility and common clearing in the development of truly competitive markets is evidenced by the dramatic changes that have taken place in the equity options markets over recent years. With the prodding of the SEC, the exchanges finally introduced multiple listings, with all trades cleared through the Options Clearing Corp.

The forces of competition were immediately heightened. In less than two years, the International Securities Exchange, an all-electronic options exchange, has become the third-largest options exchange in the U.S., and it continues to gain market share.

It is against this backdrop that relief for intermediaries should be considered.

Intermediary Relief: As you know, FIA was a driving force behind the provisions of the CFMA requiring the Commission to conduct this study of the Act and its rules as they relate to intermediaries. Our motives for requesting this study were simple. As the Commission itself recognized, the derivatives markets are evolving at an increasingly rapid pace. None of us can predict what they will look like only a few years from now. Intermediaries, no less than the markets themselves, must have the ability to respond to this changing environment without being subject to the delays inherent in the rulemaking process.

Moreover, FIA was concerned that the Commission's decision to retain prescriptive regulations for intermediaries would result in shifting an even greater share of the regulatory burden, and its attendant costs, to intermediaries.

Our point is that the myriad rules that govern intermediaries must be reduced to those that are essential to customer protection and financial and market integrity, and must be written in such a manner as to afford intermediaries the flexibility to respond to changing market dynamics. A more flexible regulatory structure, combined with an effective self-regulatory organization audit program, should achieve the Commission's regulatory purpose.

In the time remaining, I would like to highlight a few of the more critical recommendations discussed in our April 5th letter.

Allocation of Bunched Orders: Reform of the Commission's rules with respect to the allocation of bunched orders is essential. FCMs generally have found that existing post-execution allocation procedures, which limit the type of clients that may take advantage of the procedures--essentially, eligible swap participants--and impose additional recordkeeping requirements, are unnecessarily cumbersome. As such, they inhibit the fair and efficient execution of orders, without adding customer protections.

Account managers have also objected to the requirement that they make the disclosures set forth in the rule. As otherwise regulated entities, they believe that the laws and regulations to which they are subject adequately govern their disclosure and other fiduciary obligations to their clients. Their conduct should not be subject to indirect regulation by the Commission through the imposition of recordkeeping requirements on the FCMs that carry the accounts of their clients. We agree.

We encourage the Commission, therefore, to acknowledge that the responsibility for allocation of bunched orders rests with the account manager, the originator of the allocation methodology. The account manager, not the FCM, is the person who knows and must keep records detailing the totality of each of the customers' positions, which may be held at several FCMs.

The increased use of electronic order routing and execution systems, which permit account managers to place orders directly for execution while denying FCMs the ability to monitor such transactions prior to execution and clearing, emphasizes this point, and makes relief in this area all the more urgent.

To effect this change, FIA recommends that the Commission replace its audit trail rules with a core principle that would require FCMs and introducing brokers to keep such records of transactions as are appropriate to their respective businesses, or as may be required by exchange and other self-regulatory organization rule or regulation. This principle would be consistent with the core principle applicable to recognized futures exchanges.

Number Two, Single Customer Account: Commission rules generally prohibit an FCM from depositing in the customer segregated account cash and other property of such customers that the FCM holds to margin or secure OTC derivatives, equity securities, or cash market positions. This prohibition interferes with the efficient use of the customer's capital in managing the risks associated with trading.

FIA believes that the Commission should modify these rules, both to permit non-futures position margin and other property to be held in the customer segregated account, and to permit futures margin and other property on behalf of eligible contract participants to be held outside of the segregated account.

We appreciate that the Commission has taken some steps in this direction. For example, the Commission and the SEC have previously agreed on an approach by which professional traders have been authorized to carry futures on stock indices and related options on stock indices in a single cross margin account.

More recently, the Commission issued an order authorizing the NYMEX Clearing House and FCMs clearing through that clearing house to hold in the customer segregated account funds used to margin, guarantee, or secure transactions in designated OTC transactions cleared by that clearing house. The Commission also has adopted rules permitting qualified customers trading on derivative transaction facilities to hold their funds in an account outside of segregation.

Expanding the circumstances in which customers could elect either of these alternatives would maximize flexibility and serve market participants' needs to operate through a single account.

We recognize that the practical and regulatory issues that would arise under this proposal may be complex, particularly if securities and futures positions are to be held in a single account. We further recognize that the Commission will be required to revise its regulations relating to commodity broker liquidations to assure appropriate treatment of customer cash and OTC derivatives positions, as well as securities, that the FCM holds. FIA will be pleased to work with the Commission as it sorts through these issues.

Foreign Security Products: As you know, ours is an international business. FIA members serve both U.S. and international customers, all of which trade on markets worldwide. As the Commission and the SEC moved forward on an agreement to permit the trading of security futures products, therefore, we were concerned that our customers would continue to have the ability to trade on those markets that offered the products that they needed, wherever those markets were located. As a consequence, we worked closely with the commissions and Congress to include provisions designed to ensure that customers would be able to trade security futures products listed on non-U.S. exchanges.

We are pleased that the Commission and the SEC have taken an important step in this regard by issuing a joint order permanently grandfathering those broad-based security index futures contracts that were approved for offer and sale to U.S. customers prior to the enactment of the CFMA. This action provides much-needed legal certainty.

Actions on other provisions of the Act remain. By letter dated July 18th, 2001, FIA encouraged the Commission and the SEC to exercise the rulemaking authority that Congress granted specifically to address foreign security index contracts and adopt a regulatory standard defining a broad-based security index that takes into appropriate account "the nature and size of the markets that the securities underlying the security future product reflect." The standard recommended by FIA was set forth in Appendix "A" to that letter. And FIA urges, again, the Commission to adopt that proposal.

FIA further encourages the Commission to continue to work with the SEC to implement the provisions of Section 2(a). One subparagraph of this section is intended to extend the terms of a no-action position adopted by the Commission, after consultation with the SEC, which authorizes U.S. FCMs to carry on behalf of non-U.S. customers foreign stock index contracts that have not been approved for trading by U.S. customers. This subparagraph grants this same right to FCMs carrying foreign security futures products on behalf of their non-U.S. customers. FIA has discussed this matter with the SEC, but to date has been unsuccessful.

Another paragraph simply provides that eligible contract participants may purchase security futures products traded on a non-U.S. exchange to the same extent that such person may be authorized to purchase or carry other securities traded on a foreign exchange or market.

The purpose of this subparagraph is to authorize U.S. institutional customers, which are authorized to buy and sell cash securities on foreign markets, to hedge those transactions through the use of security futures products. These provisions of the Act were adopted after substantial discussion with the Commission and the SEC staff. There is no reason why the Commission should not confirm the right of U.S. FCMs to take advantage of them.

Financial and Segregation Interpretation Number Twelve: As the Commission is aware, FIA, along with other industry representatives, has long opposed certain provisions of Financial and Segregation Interpretation Number 12 governing the deposit of customer funds outside of the United States.

In particular, FIA has objected to the requirement that, number one, an FCM obtain specific written authorization from a customer to maintain funds offshore in that customer's segregated account and, two, before placing a customer's funds overseas, or holding a foreign customer's funds overseas, an FCM obtain from the customer a signed subordination agreement in the form set forth in that interpretation.

FIA strongly believes that the subordination agreement is unnecessary and should be eliminated. In its place, the Commission should amend Appendix "B" of Commission Part 190 rules to establish distribution procedures for FCMs that hold customer funds offshore.

FIA has worked with the Commission's staff in the past to revise the interpretation to address these and other concerns. Whenever it appears that we have made progress, another issue arises, and steps taken to revise the interpretation are set aside. We respectfully request the Commission to proceed promptly to address this issue. In light of the amount of effort both sides have expended to date, we are confident that we will be able to craft an acceptable alternative to the current interpretation with little difficulty.

Use of Non-U.S. Exchange Terminals: In a series of no-action letters issued in 1999, the Commission's Division of Trading and Markets authorized certain foreign futures exchanges to locate terminals for the execution of transactions on those exchanges in the U.S.

Each no-action letter was subject to a number of conditions, including a requirement that specifically identified the contracts that could be executed through those terminals. The purpose of this restriction was to assure that U.S. FCMs did not engage in transactions in futures contracts that had not been approved for trading by or on behalf of U.S. customers; i.e., futures on certain security index contracts.

Although FIA appreciates the rationale behind this restriction, it fails to take account of the fact that in a 24-hour trading environment, these terminals could be used to transmit orders for non-U.S. customers of either the U.S. FCM or the FCM's non-U.S. affiliates. Non-U.S. customers are not prohibited from trading in these products.

Standardization: FIA has been very active in promoting standardization in several areas, including standardization of practices and procedures, and technology protocols. The Commission's Technology Advisory Committee is currently considering a report which includes a recommendation of concern to intermediaries. "Recommendations for Standardization of Protocol and Content of Order Flow" generally creates a framework which the industry can utilize as a base in moving forward over the next several years. However, we believe the recommendations go beyond the mandate of the Commission or a self-regulatory organization.

From a short-term perspective, industry adoption of a standard protocol by a specific date will impose significant transition costs, while not providing an immediate benefit. The mandated time frame comes during a period when the industry is already under significant financial challenges due to the surge in technology infrastructure required for an FCM to compete in these markets, implementation of security futures, implementation of more sophisticated disaster recovery and business continuity procedures in the wake of September 11th, and competitive pressures to consolidate and reduce costs. Some participants question whether or not voluntary implementation could be truly voluntary, if the Commission supports and advocates standards as a best practice.

FIA strongly urges the Commission to endorse standardization without adopting it as a best practice, and to stop short of calling for standardization by a specific date.

Conclusion: FIA appreciates the opportunity to appear before you today. We welcome the Commission's study as an essential step in a process that will afford market intermediaries the same flexibility that the CFMA and the Commission have provided to the markets themselves. We have been patient as the Commission has focused its energies on the organized markets. We encourage the Commission to move forward quickly.

And I thank Mr. Wilmouth for yielding time. Thank you very much, Mr. Chairman.

CHAIRMAN NEWSOME: Thank you, Mr. Damgard. It's very clear to me that we're going to have to have you here more often than every two years to testify.

[Laughter]

CHAIRMAN NEWSOME: No, seriously--seriously--this is a very important and a very broad topic, and it requires quite a bit of time. All of you know that we had hoped to have had this type of meeting earlier, and we appreciate the patience, due to all the challenges that the industry has faced. So we thank you very much.

MR. DAMGARD: You're welcome. And I look forward to coming more often.

CHAIRMAN NEWSOME: Thank you.

We're going to finish with our presenters, and then ask questions at the end of this panel. So at this time, we have Mr. Jack Gaine, who is President of the Managed Funds Association.

And Mr. Gaine, we look forward to hearing your comments.

STATEMENT OF JOHN G. GAINE

PRESIDENT, MANAGED FUNDS ASSOCIATION

MR. GAINE: Thank you, Mr. Chairman. And I want to thank you and the members of the Commission for the opportunity to speak to you today regarding your ongoing study of the potential changes in the regulation of intermediaries pursuant to Section 125 of the CFMA.

MFA is located in Washington, D.C. It's a global membership association dedicated to serving the needs of the professionals worldwide who specialize in the alternative investment industry: hedge funds, funds of funds, and private and public managed futures funds. MFA has over 600 members who represent a significant portion of the $500 billion invested in alternative investment vehicles around the world. MFA members include many of the largest international financial services conglomerates, and are based in both the U.S. and Europe.

If I might just stray briefly, what I intend to do is just highlight some of the issues that are raised in my testimony, which I understand is submitted for the record. And I also note that your second panel is at least as distinguished--if not more so--than your first panel. And on the managed funds areas, you have at least Steve Olgin and George Crapple, who probably will in more detail discuss some of the things that I'm mentioning here. But I would just mention them here, because I think I lost some of my time, too, as well as Mr. Wilmouth--

CHAIRMAN NEWSOME: Yes, you've got 30 seconds left.

[Laughter]

MR. GAINE: I knew how the Democrats would get treated.

[Laughter]

MR. GAINE: But I'll address this to Mr. Erickson, and Barbara--

COMMISSIONER ERICKSON: You've got ten seconds.

[Laughter]

MR. GAINE: Well--I have one point I want to make. Roughly, on August 1st, it will be 25 years that I have appeared at a CFTC hearing room in one capacity or another--never under a subpoena, I might add.

[Laughter]

MR. GAINE: Which hopefully will not be the case in any federal agency.

I have never seen a more reasonable environment to discuss and grapple with some of the major issues facing us. Some of it flowed out from the CFMA attitude and approach, but I think it's a reflection both of the membership of the Commission and the staff that's here. And I commend all of you.

Certainly, when I was general counsel and we were first putting out this Part 4--yes, something or other--we didn't have the dialogue; we didn't know the industry; and quite frankly, we didn't do the job that maybe we could have done very early on the job. I see a much more responsive interplay between the staff. And I think having the second panel, instead of all the inside people here, is the kind of thing that will lead to better regulation and a healthier marketplace, which is what we're all striving for.

And briefly, let me go on, since we were formed over ten years ago, we've been committed to working closely with the CFTC on the regulatory framework under the Commodity Exchange Act. We find these questions to be even more important subsequent to the passage of the CFMA.

As part of this relationship, we've actually worked to aid the CFTC in fulfilling the obligations of Section 125; particularly, the CFTC's study on intermediaries. For purposes of the study, to ensure a thorough cross-section of the industry with a specific focus on CTAs and CPOs, MFA facilitated many meetings between the CFTC and a number of MFA staff.

MFA applauds the CFTC in its progress to date on this study. We are particularly pleased to see the light at the end of the tunnel of the long-debated notional funds issue. Despite myriad discordant opinions, MFA is confident that we're near resolution. And the ball on notional is now in our court, I happily report.

And my goal is: When this issue first surfaced, we used to speak of the "Big Eight" accounting firms. We now speak of "Big Five." I'd like to close this while there still are five. That would be my time line on notional funds. And I think we can probably do that.

Furthermore, MFA strongly advocates a harmonization of regulation of CTAs and CPOs by the different regulatory agencies; in particular, the SEC and the CFTC. As the managed funds industry grows exponentially, questions as to whether and how to regulate different investment vehicles will continue to proliferate.

We need one primary federal financial regulator. And I think that reasonable people could figure out--depending on your activities and your volumes and your markets and your advertising--who that should be. And in some cases, you're going to have futures and options probably under the SEC; and in some cases, you're going to have securities under the CFTC. Those lines are blurred; they're blurred in a number of different ways.

And I've got to add that the advent--or the proposed advent, or the alleged advent--of single stock futures will only exacerbate that situation between the agencies. So if I have any one clear message, Mr. Chairman, I know you've made great strides in inter-agency cooperation and comity; but there is no need for duplicative, and sometimes inconsistent, regulation. And it isn't so much who is going to regulate; let's have one clear set of regulations we can live by, and work toward that.

On a couple of issues that we are concerned with, on accounting procedures on commodity funds, they have been exempted from SOP 95-2, which applies to fund of funds. And that exemption was taken away last year. And we engaged in a lot of dialogue with staff about getting some kind of relief where our fund of funds would not have to disclose the exact nature of their investments.

I think we were making substantial progress, and then this blip occurred down in Texas with a firm and we've got slowed down. I'd like to think, as part of the process, that we can reopen questions like this as part of an ongoing dialogue with the Commission. I fully understand why we didn't get what we were asking for at that time.

Disclosure document delivery is almost a no-brainer, but it's an issue that is going to be discussed, I think, by Steve Olgin in a little more detail.

Probably the biggest thing I'm urging today is that we've had a rule proposal, on which we've had numerous discussions with staff, to provide--Well, another great concern of the industry--in particular, hedge funds--is the requirement for registration as a CPO if the hedge fund trades futures and options contracts on a futures exchange.

Currently, any such hedge fund is required to register as a CPO at the CFTC. MFA advocates our proposed Rule 4.9, a new exemption from CPO registration for CPOs of pools offered and sold only to sophisticated persons in private transactions exempt from registration under the Securities Act of 1933.

We wish to distinguish unregistered from unregulated. While hedge funds are largely unregistered, unless as a CPO, they are not completely free from regulation. Anti-fraud provisions of the Securities Act, among other things, apply. Furthermore, the exemption we seek under proposed Rule 4.9 would be carefully tailored to apply to only accredited and sophisticated investors, as defined under the CEA and other legislation.

Each direct investor that is an individual must be at least a qualified eligible person, and each investor that is an entity must be an accredited investor. Plus, the CPOs exempt from registration will continue to remain under the jurisdiction of the CFTC's authority, as clearly stated in the rule.

We believe such an exemption, while decreasing the number of registrants, actually will increase the number of CPOs subject to the CFTC's jurisdiction; thereby increasing the CFTC's role in the financial markets. Such a rule will not result in maverick hedge fund managers, but will bring sophisticated investors into a new market.

Once again, I wish to stress the importance of the limitation of the exemption to sophisticated and accredited investors. By no means do we advocate opening such a door to investors unfamiliar with the terrain of the derivatives and futures industry.

On a similar vein, NFA has a de minimis rule proposal for CPOs that use a small amount of their assets for futures transactions, and they provide an exemption from registration for that. We also support that strongly.

These are some of the major issues facing the managed funds industry today, at least in terms of the intermediaries the CFTC has been studying. You might have read that Chairman Pitt, the chairman of one of the other agencies, is holding a formal fact-finding investigation of the hedge fund industry, which hopefully will be as pleasant as this appearance here.

We hope the Commission realizes their importance to both MFA and the industry as a whole. We also realize that new concerns will develop as new rules are promulgated. And we look forward to assisting the Commission in any way we are able. Thank you again for the opportunity to appear.

CHAIRMAN NEWSOME: Thank you very much, Mr. Gaine.

Mr. Wilmouth, you're the dean of this group. We saved you for last.

And Bob Wilmouth is President of the National Futures Association; has been before the Commission many times. And we look forward to your comments today.

STATEMENT OF ROBERT K. WILMOUTH

PRESIDENT, NATIONAL FUTURES ASSOCIATION

MR. WILMOUTH: Thank you, Mr. Chairman. As always, I welcome the opportunity to appear before you and your distinguished colleagues; this time, to comment on the intermediaries study required by the CFMA.

However, I am in somewhat of a quandary. This weekend I spent a lengthy period of time writing some very erudite, brilliant, distinguished comments to give before this audience today. I started out by listing 18 marvelous things that the Commission has done in the past two and a half years to respond to industry concerns. I then went on to talk about 1.10, 1.12, 1.15, 1.31, 1.35, 1.55, 1.57, 3.10, 4.13, 4.14, and 4.21 and 4.13 [sic].

But in view of the comments by my distinguished colleagues to the left of me, I have decided to condense those remarks into kind of an informal approach to this issue, if I may.

As I think we all know, the CFMA requires, in part, that the study that has to be done identifies whether core principles can replace certain of the Commission's rules and regulations. I think all of us recognize that in a rapidly changing business environment flexibility is key, not only for registrants, but also for regulators.

A core principles approach to regulation is one way to achieve that flexibility; but it's not the only way. In fact, I believe that the Commission has achieved great strides already in adapting CFTC rules to this changing business environment.

Even with these changes, there are still a number of CFTC rules that can be eliminated or amended to provide intermediaries with additional flexibility in meeting customer and business needs, with no reduction in customer protection.

In identifying these rules, we generally noted that they are problematic, for any one of three general reasons. Number one, the rules just don't tell the registrant what to do, but tell him how to do it. Number two, technology has made the requirements obsolete. And number three, the rules add no real regulatory value.

Our letter, which I assume will be placed in the record, of May 29th, summarizes our comments, but I wanted to make just a few brief, quick observations to emphasize my point.

First of all, several rules set appropriate regulatory standards, but are overly restrictive in how those requirements are met. Let me give you two examples. Part 1's general regulations don't just tell firms what kind of notices they have to file, but also dictate how to file those notices.

These rules should be amended to allow certified statements to be filed electronically, and to allow firms to file required notices by any form of electronic communication, not just by fax. And those notices should be filed with the DSRO only.

Another point in this area: Regulation 1.31 requires registrants to maintain books and records, but also dictates specific technology requirements relating to the electronic storage of books and records. The rules should be replaced with general reliability and accessibility standards similar to the language that we previously proposed to the CFTC--I think, several years ago, in 1999, if my memory serves me correctly.

Now, another point: Several rules have been rendered obsolete by technological developments. Just one example, Regulation 1.57 governing how IBs transmit orders was written before electronic exchanges and automated order routing systems were in place; and therefore, needs to be updated in order to respond to technological changes. This rule currently appears to impose greater restrictions on IBs than on the customers. And we have recommended to you a specific rewriting.

And finally, let me comment if I can about some rules which, in our minds, have no apparent regulatory value. Part 1's requirements mandate that firms file certain financial reports with both the CFTC and the DSRO. There is no need for these dual filings. Firms should file these items with their DSRO, which can then make their data bases available to the CFTC staff.

Regulation 30.8 requiring FCMs to file certain quarterly reports with NFA relating to their foreign futures and options transactions should be eliminated. This rule was adopted when the Commission began regulating these transactions, and NFA has never found a good use for the information that's reported to us under this rule.

Rule 155.3 and 155.4 require that copies of all statements and order tickets be sent to an individual's employer, if the individual is employed by another FCM or another IB. We believe that the employer should be able to obtain copies of the order tickets upon request, but we do not see a need to routinely provide copies of order tickets to the employer. And we suggest that the requirement be deleted from the rules.

Lastly, we note that the Commission has been responsive to many of the concerns expressed by the CPO and the CTA community over the years. But there are still a number of areas where the Commission's rules could further be revised to meet the business needs of the managed funds industry, without lessening customer protection.

I just wanted to highlight two of these areas. With respect to Rule 1.35, NFA recommends that it be amended to provide the benefits of post-execution allocation procedures to all customers of those account managers that meet specific criteria. We consider this change a high priority, so that smaller retail customers are not at a disadvantage when it comes to execution quality.

With respect to Regulations 4.13 and 4.14, NFA continues to urge the Commission to adopt an exemption from registration for CPOs who operate collective investment vehicles that do only a de minimis amount of futures transactions, and for CTAs who provide their trading advice solely to such vehicles.

In conclusion, as always, NFA wishes to stress its ongoing willingness to assist the Commission, not only in identifying those areas that need to be addressed, but also in drafting the general standards and related interpretive guidance and assuming any additional responsibilities delegated by the Commission.

We believe that our qualifications over the past two decades have been clearly demonstrated. Our longstanding and successful process of obtaining industry and user input has been extremely successful. And we stand ready and willing to assume the responsibility of developing guidance in all appropriate areas.

We appreciate the opportunity to provide input on this important study, and our staff is readily available to more fully discuss any of the issues raised in our recent discussions, as well as our May 29th letter. We look forward to a close working relationship with the Commission and the staff as you conduct your study. And thank you very much for your attention.

CHAIRMAN NEWSOME: Thank you, Mr. Wilmouth.

Again, I wanted to say thanks to all three of you because, not only in the written testimony and the oral testimony that you're giving today, each of you and your organizations have spent countless hours over the recent past and in letters that you've sent to the Commission regarding this topic. And it's very much appreciated.

I want to say at this time that the National Introducing Brokers Association also was invited to participate in this panel. They were unable to do so. And we have included their written comments in the record of this hearing.

MR. GAINE: Did they yield their time to Damgard?

CHAIRMAN NEWSOME: They must have. Must have.

[Laughter]

CHAIRMAN NEWSOME: At this time, we will get into a question and answer period. We'll start with the Commission, and then ask senior staff if they have any questions, as well. So at this time, Commissioner Holum?

COMMISSIONER HOLUM: I have no questions, thank you.

CHAIRMAN NEWSOME: Okay. Commissioner Erickson?

COMMISSIONER ERICKSON: If I might be able to just follow up on a couple of points that were raised, I really appreciate the comments that were brought to our attention today. They are issues, a lot of them, that we've been wrestling with for quite some time.

I'll just go down the row, but if you all have answers to some of these questions, I'd invite hearing from each of you.

One of the things you talked about, John, was fungibility of contracts. And I think that's something that people really did envision. I don't know what mechanisms you all are looking for, as far as trying to accomplish fungibility across exchanges. But once that happens, do we, as an agency, come into the same types of concerns that the SEC has wrestled with, I think, over the years, on issues of best execution?

Particularly, whose obligation: Is the burden placed on the intermediary to route a customer's order to the market that has the best price or has the availability, or is that something that you establish a centralized order book and place that burden on the exchanges?

MR. DAMGARD: Yes, I don't have a specific answer for that now, but I do think that--I mean, first of all, I think there's a lot of responsibility on the customer, as well as whoever his agent may be.

But it strikes us that a futures contract, particularly one that goes out sometimes two and a half to three years, is a relatively unique product. And simply a better price--or in some cases, a better product--isn't necessarily the determining factor in whether or not a customer ought to be using the marketplace.

So we have seen that, even with all the new entries in the world of creating futures exchange, we don't see any competition addressed to existing products. And at the same time that the exchanges are sort of puffing themselves up for their IPOs, there is naturally a tendency to charge what the market will bear.

And in the securities model, that is not the case, because the customer is able to get out of his contract--I mean, perhaps the fungibility could take place in a unified clearing entity. But to the extent that the SEC has required the options exchanges to multiple list, it seems to me that the end user, the customer, has been much better off.

And whether or not that invites more regulation with respect to best execution or not probably depends on whether or not there is a need. I mean, I think most brokers believe that if they don't treat their customers properly, that customer has many, many opportunities to go other places. The competition between FCMs for customers' business is quite intense, offering exactly the same service for the same product. And furthermore, they all know who the customers are; particularly in the institutional world.

So my sense is that we need not rush into worrying about best execution until such time that we see whether or not we can build more competition into the marketplace.

COMMISSIONER ERICKSON: Okay. Thank you. Any other responses?

MR. GAINE: Yes. As an association, we historically have promoted product innovation: foreign stock indices, for example; access for U.S. customers and U.S. CTAs and CPOs of the widest variety of products.

And to the extent that you introduce fungibility--I think you're suggesting perhaps making markets more efficient, presenting opportunities for arbitrage--we strongly would support it. We are very pro-competitive, with appropriate regulation.

I mean, your order flow question is very good. I've read something about it. Whether they successfully resolve it, or come close to resolving it, I won't even say. But I got a call from a reporter the other day, "What do you think of mutual fund complexes starting hedge funds?" I said, "Well, I think that's fine. That's more competition. Hopefully, they'll produce a better hedge fund than someone else made, or they may not." But they certainly shouldn't do it to disadvantage mutual fund customers.

And this is one of the issues that the SEC is currently looking at: Is there a conflict there? And I think, just as you're suggesting there could be some problems in the order flow and order execution, there could be some problems with a mutual fund manager of both a hedge fund and mutual fund. But as an overall general proposition, I think we favor "Let a thousand flowers grow," or whatever, but with the appropriate regulation.

COMMISSIONER ERICKSON: Okay.

MR. GAINE: I tried to be shorter than Damgard. That's all.

MR. WILMOUTH: I can be even shorter than that. With respect to your specific question, "Are we at the CFTC going to face the same issues as the SEC?", I think the answer to that is, "Yes."

And other thing I would like to support is John's comment about unified clearing. And I speak as a former president of a large futures exchange when I say that that goes a long way. We were close to it at one time. We didn't make it. I think that's extremely important in this issue of fungibility.

COMMISSIONER ERICKSON: Okay. A couple of you also talked about the allocation of bunched orders. And I'm just concerned--Well, I'm interested, actually, because I think there are obviously some real benefits to that.

But the first part of the question would be by removing the burden from the FCM, what, if anything, needs to attach at the account manager level? And the other question that I just ponder over is, whether the benefit is in providing smaller customers with better pricing of the product? That's a theme that I've heard. What effect on competitiveness of the market? Is this something that you end up seeing greater utilization of non-competitive trades because you have a bunching of all customer order flow into the market, into block trading for example?

MR. GAINE: Well, from our point of view of the investment manager, we would be the one who would be putting together the bunched order at the best place; whether it's competitive or non-competitive, the best for a bunch of customers.

The current rule is unworkable because with a typical CTA there would be some clients who wouldn't qualify, but they're in the same program. So if you want to put a thousand lots of December corn and you want to go long, well, you can do that for 85 percent of your customers, but not the other 15.

COMMISSIONER ERICKSON: Okay.

MR. GAINE: Well, you do the 85, then you do the other 15. And the other 15 pay an eighth or a quarter higher. And Mr. Wilmouth sends his minions over and says, "Well, what happened to the little guy here?"

COMMISSIONER ERICKSON: Right.

MR. GAINE: And it's essential. And we made these comments during the hammering out of one point of this provision. I'd like to see it make it workable.

To your other question about whether this would, you know, go OTC or something, I think that would be the fiduciary judgment of the CTA, as to where to get this job best done. But the current rule is not workable.

COMMISSIONER ERICKSON: Okay.

MR. WILMOUTH: If I remember correctly, in our best practices, in order entry in transmission of exchange traded futures and options, I think we addressed this subject. And I think what Jack said is true, that this allows, I think, the account manager to fulfill his fiduciary responsibilities so that he's treating all customers fairly and equally. He can punch them all and go in at one particular time. But I think that best practices study addresses that.

COMMISSIONER ERICKSON: Okay. Yes. Does it? It does. Thank you.

MR. DAMGARD: And I would just add that there are multiple FCMs often involved in one account manager's activity. So it's almost impossible--particularly in an electronic world where the FCM has given a terminal to the account manager and he's directly affecting the market--it's impossible for the FCM often to monitor the activity of the manager.

COMMISSIONER ERICKSON: Thanks. And if I could have one more question, Mr. Chairman?

CHAIRMAN NEWSOME: Yes.

COMMISSIONER ERICKSON: John, you mentioned standardization. And that was also something that was brought up in the longer statement of the NFA. And I'm just curious, in your statement, John, you had indicated concerns about standardization of the protocol. And I think NFA's letter was suggesting that best practices would be a good thing on the issue of standardization of the content.

And I think the report, as I recall, recommends best practices for content standardization, and put out this marker on the standardization of the protocol--Because I think only one protocol right now fits the mark, but I know that was pretty heavily debated.

But John, from the FIA's perspective, the content standardization--that would be, as far as customer identification, all the things that regulators need or FCMs would need for back office purposes--if you all could take a look at that, and see if that might actually have some value in a context of also the question you raised about fungibility. Does content standardization increase the ability for the market to move to fungibility in products?

And that's just a question that I have. And maybe you guys can take a look at that and get back to me at another time.

MR. DAMGARD: Okay. I mean, with respect to standardization, we do endorse standardization. And we're just concerned about making sure, you know, that we don't establish unrealistic time tables, number one; and number two, how do we ensure that it becomes voluntary, if indeed it is a best practice, and not become a regulatory requirement.

COMMISSIONER ERICKSON: Right.

MR. DAMGARD: On fungibility, we do have a lot of ideas on that, and we'd be pleased to spend time with you on what we think would work best.

COMMISSIONER ERICKSON: Yes. Okay. Thank you, Mr. Chairman.

CHAIRMAN NEWSOME: There have been a number of specific issues and rules that were raised during this discussion. And certainly, we are, and there is a need to look more closely at those.

My question is, I want to approach from a little more of a general nature, in trying to determine how the Commission moves forward. Mr. Wilmouth, you talked about, specifically, the core principles and the flexibility that was built into the CFMA. And I believe that that flexibility was absolutely key, and certainly a key part of the CFMA.

Throughout the interviews of staff to industry participants looking at modernization for intermediaries, core principles I know have been one of the topics discussed. And there seems to be at least some disagreement over whether or not core principles are the appropriate route to take as we look at intermediaries. Certainly, I'm not married to core principles. If that is not the appropriate route to take, then how should the Commission look at flexibility on a broader scale as we move forward?

MR. WILMOUTH: Again, on a general basis and as a general observation, I think, as I said before, that a core principles approach to regulation does help you achieve flexibility. But the other way to do it is to amend some of your regulations, to eliminate some of your regulations, and modify some of your regulations.

The one on foreign options and futures, where reports are made to us, I don't know how long that's been done, how many years--and years--but we've never had any use for it. So one way to achieve this flexibility is just to eliminate some of those. Just plain write them off. You don't need them. They serve no regulatory value.

Or amend them: Why file dual reports with both the CFTC and the DSRO? We get a report and it's on our data base. If you want it, call us, and we'll send it to you. That's the type of thing that I'm talking about.

Core principles are essential and important, and they should be used. But there are some times when they can't be used, but you can do something else to achieve that flexibility: amendment, elimination, modification.

CHAIRMAN NEWSOME: That point is well taken.

MR. DAMGARD: And I would agree with Mr. Wilmouth. I mean, we strongly support core principles as the right approach. And yet we recognize that such things as financial requirements can't be core principles; they have to be more specific. So, you know, we would be pleased to work with the Commission and identify those areas where we think that core principles simply couldn't apply. But generally, we strongly support the approach, and we think it's worked very well.

CHAIRMAN NEWSOME: Mr. Gaine?

MR. GAINE: Yes, on core principles, we at MFA operate primarily through a government relations committee. I think we raised that three different types. And I felt like one of those electoral judges in Palm Beach County a couple of years ago: holding the ballots up, figuring out exactly who won.

[Simultaneous Discussion]

MR. GAINE: I know I lost, but there was--I think I'm trying to suggest there was some division within us. But I'd like to think that for us the flexibility might encompass when we go down the road here--Some areas lend themselves to core principles.

But I think a philosophical shift of the flexibility that you asked Mr. Wilmouth about is--It reminds me of Robert Kennedy's question. He used to say, "Some people ask why; I like to ask 'Why not?'."

We've had a wonderful, healthy, constructive dialogue on this Rule 4.9 that I referenced. And one of the areas: Why is registration so burdensome? Well, I don't think that should be the question, because it may or may not be. "What benefits do you get from registration?" should be the question. And you know, are they significant, or are they not? If they're not, well, it's not such a big deal. And I think that's what Bob was alluding to, as well.

I think there are some regulations in there that just have outlived their usefulness, assuming that when either Russo [ph] or I put them in initially they had a usefulness at all. Thank you.

CHAIRMAN NEWSOME: Thank you, sir.

Mr. Damgard, I want to go back to the fungibility question, and just look at that maybe a little more generally. Certainly, when you look at fungibility from the securities side, you've got the trading of stock of a publicly-held company; and on the futures side, you've got a contract that's been developed by an exchange.

Certainly, I am very much in favor of competition, and want to do everything that we can to develop competition within this business. But it appears that when you look at fungibility on the securities side there could be quite a difference, in terms of fungibility on the futures side, because of the difference in the contracts.

Would you go into some of those differences a little bit, and explain how you would perceive that we could move forward there?

MR. DAMGARD: Well, I think some of the new entries into the security futures world are spending a fair amount of time developing specific indices that they consider to be their proprietary product. And I don't think fungibility would work.

On the other hand, if there is a single stock future on GM, and you can trade it in one place and close your position in another, depending on the timing, the daylight hours, it seems to me that that would encourage competition between those two exchanges. And we have not-- At least, I personally haven't; I think our law and compliance division, our operations division, has spent more time thinking about this, and perhaps I should get better informed.

But on products where new entries would like to emerge and would like to be able to utilize, say, the same clearinghouse, it may be that the fungibility issue could be addressed at the clearing level and it would encourage competition as it has in the options world, and even in the securities world with the ECMs [ph]. So let's look at the securities model a little bit, to see how they have achieved the competitive benefits.

I mean, there was a time when the New York Stock Exchange was the only place where you could buy and sell a particular stock. And that gave them the same kind of monopolistic power that some of our futures exchanges have. And it's understandable that, as they become for-profit entities, they want to maximize that profit, and they see their responsibility as serving their stakeholders, as opposed to serving their customer. And in a monopoly, it seems to me that's bad.

And we've supported the concept of reducing the regulatory burden on the exchanges, in order to allow them to lower their costs of doing business--in theory, to compete with some of the European exchanges that they've worried so much about.

And I mean, I have one example here of what it costs to trade. The Muni [ph] S&P in Chicago, at the Merc: You pay a 39-cent-per-side fee for clearing. You pay a 25-cent-per-side Globex fee. And you pay a Globex customer fee of 50 cents. So that adds up to $1.14 per side, for a Muni S&P contract. And for comparison purposes, we picked the Dow Jones Euro Stock 50, that trades electronically at the Eurex. And that trades for 27 cents a side. And a buck-14 versus 27 cents is a rather big spread. And we believe that's a legitimate comparison.

And my sense is that the political pressures in the U.S. exchanges are making it necessary in some sense to keep side-by-side trading, in terms of open-outcry and electronic trading. And the customer and the FCM are bearing the additional cost in the United States of keeping businesses alive that perhaps in a competitive market might not survive.

And it also suggests to me that if some of the foreign exchanges begin to start listing U.S. products, it puts the U.S. exchanges at a tremendous disadvantage, if they continue to have to answer to a board that's totally dominated by people whose livelihood depends on keeping the pits open. And these are issues that, you know, are very difficult issues; particularly in light of the deregulation of the exchanges.

CHAIRMAN NEWSOME: I know we're going to have more on this topic with the next panel, but as we're looking at the CFMA and we're still implementing portions of it, do you think it's too soon to have this argument? Or do you see competition on the horizon? What are your thoughts there?

MR. DAMGARD: Well, I made some reference to the fact that it's too early to know for sure what the results are going to be with respect to competition. But I will say that in the stock futures area we've seen lots of new entries come into the marketplace and announce their intention to compete. And it's slightly disappointing that none of these entities have decided to go in and compete on some of the existing product bases.

And you can certainly understand the philosophy of an exchange that has decided that they are the only place to go to do a Euro dollar contract, or it's the only place to go to do an S&P contract, once they become a for-profit entity, to charge whatever the market will bear. And to the extent that these markets serve the public, there is a very, very serious public interest, as far as we're concerned, to make sure that there is not price gouging and monopolistic behavior.

CHAIRMAN NEWSOME: Okay. Thank you, sir.

Any other comments from the panelists about that topic?

[No Response]

CHAIRMAN NEWSOME: Okay. I've got one more. As we look at common clearing, what should be the role of a government regulator in terms of moving toward that?

MR. DAMGARD: Well, as you know, Mr. Chairman, the FIA was very close to a common clearing agreement with the two Chicago exchanges. And the law, as I understand it, requires a designated exchange to have a clearinghouse, to be able to consider itself a designated marketplace.

But nothing in the law prevents more than one clearinghouse from being able to clear those products. And I think it's exchange rules at some of the exchanges that say, "If you're going to trade our product here, then we're going to force you to clear it here and only here."

And one of the things that we might want to look at is whether or not clearinghouses could compete with each other as an alternative to a clearinghouse that clears for everyone. And that would be a separate approach than the one that I've advocated in my testimony.

I mean, in the securities markets, what we have is one central clearinghouse, the monies of which are put up by the clearing members on the basis of what their risk profile is. And they have chosen to run that clearinghouse as a utility. And to the extent that they have a big year in the clearinghouse, they will rebate money back to the clearing members, based on the business that they do.

As exchanges become for-profit, there is something inequitable about an in-house clearinghouse which is capturing all the business, charging a clearing fee that is profitable, and not rebating that back to the people who put up the money for the clearinghouse in the first place.

And these are arguments that we have on an ongoing basis with those exchanges in the United States that are very proud of the fact that their clearinghouses are in-house.

I mean, we believe that the clearinghouse at the Chicago Mercantile Exchange runs very efficiently, and it runs very well. We believe the governance of the clearinghouse ought to be the clearing members, and not subject to, you know, the locals who sit on the big board at the Chicago Mercantile Exchange.

There is a committee that oversees the clearing entity, but to us that's not good enough. We believe that the model of the Chicago Board of Trade, with an independent clearinghouse, is a much better model. And we would like to see the BOTCC be more competitive with other clearinghouses.

We would like to be able to see a firm take their contract that was executed on an exchange somewhere else, and take that exchange [sic] to the clearinghouse of their choice.

CHAIRMAN NEWSOME: Okay. Thank you.

Any other comments from panelists?

[No Response]

CHAIRMAN NEWSOME: Any other questions from my fellow Commissioners?

COMMISSIONER ERICKSON: No, thank you.

CHAIRMAN NEWSOME: John, any questions from staff to this panel?

MR. LAWTON: No, staff has no questions, Mr. Chairman.

CHAIRMAN NEWSOME: Okay. Thank you very much.

Again, thank you guys. We appreciate the time and effort that have gone into your testimony. Again, I expect that there will be more questions and more hearings from the Commission as we move forward on this topic. Thank you.

MR. DAMGARD: Thank you very much.

[Whereupon, the first panel members were excused from the witness table.]

CHAIRMAN NEWSOME: Okay, if the second panel would come to the table, please?

Again, as with the first panel, we appreciate each of you taking time away from your jobs to be here. Prior to my employment at the Commission, I used to serve as the head of an industry organization, and fully understand and recognize how important industry organizations are. But at the same time, I think it's very important to hear from the industry participants themselves, and therefore we appreciate your taking time to be with us today. We look forward to hearing your thoughts and comments.

We'll start with our first speaker from this panel, Mr. George Crapple. George is Co-Chairman and Co-Chief Executive Officer of the Millburn Corporation. We've had the opportunity to hear from Mr. Crapple before. And we look forward to your comments now. George?

STATEMENT OF GEORGE E. CRAPPLE

CO-CHAIRMAN AND CO-CHIEF EXECUTIVE OFFICER,

MILLBURN RIDGEFIELD CORPORATION

MR. CRAPPLE: I thank you, Chairman Newsome and Commissioners, for the opportunity to participate. Besides my positions at Millburn, I'm a former chairman of the Managed Funds Association.

Our company is a CTA, a CPO, and a registered investment advisor. We manage public and private currency and futures funds, hedge funds, and funds of funds, and we provide currency overlay services.

The first issue I would like to address is the requirement that solicitation of futures accounts and private and public futures fund investments be made only by disclosure document. My premise is that so long as the disclosure document is delivered and acknowledged before money is accepted, there is no harm to investors if reasonable, balanced, non-misleading, non-fraudulent communications are used to locate interested potential investors.

I served as chairman of the NFA Eastern Regional Business Conduct Committee for ten years, and currently serve as chairman of NFA's Appeals Committee. So it is fair to say that I have seen quite a few solicitations--scripted spiels, written materials, and "infomercials"--which fall somewhat short of my suggested standard of reasonable, balanced, non-misleading, and non-fraudulent communications.

But communications which do meet this standard cannot reasonably be considered to so mesmerize the potential investor that he cannot make a rational decision, when all information, including the disclosure document which he must acknowledge, is before him.

Since all solicitation costs somehow or other end up coming out of investors' pockets, it is relevant that the approach I recommend would save considerable expense. The complete disclosure document package is often a lengthy and expensive document. If 99 out of 100 are thrown away unread because recipients have not been qualified as interested and suitable, it's wasteful.

I believe the disclosure document delivery rules are more restrictive than corresponding securities law rules. Public offerings allow limited tombstone announcements--which I also believe are unnecessarily restrictive. The practice in private placements does not require that initial contact be made by any particular document. Anti-fraud rules are the investors' protection. I see no reason why solicitations for futures investments should be more restricted than any other type of investment.

Second, I would like to recommend a de minimis exception to CPO registration. I generally support the concept of NFA's proposed de minimis rule which would exempt from CPO registration pools which utilized 1 percent or less of their assets as non-hedge futures margin. However, I believe 5 percent would be a better number.

In addition, I want to propose another de minimis approach which would be helpful to funds of funds which use no assets directly as futures margins, but may invest with CPO managed pools. I understand the NFA's rule would attribute to a fund of funds the sub-adviser's futures margin, so if 10 percent of a fund of fund's assets were invested in a fund which used 20 percent of its assets as margin, 2 percent would be attributed to the fund of funds. I have difficulty seeing how it's going to be practical to keep track of that sort of attribution.

There are quite a few hedge funds which are CPO registered because they do a very small amount of non-hedge futures business. These would benefit from NFA's de minimis proposal. However, it's not clear that a fund of funds which invested in such pools would be exempt from CPO registration.

Further, some fund of funds firms have declined to invest in CPO sponsored futures pools because of reluctance to become CPO registered themselves. I am under the impression that a number of fund of funds operators are misinformed about their obligation to register as CPOs when they invest in CPO-sponsored hedge funds. But they definitely seem to believe an investment in a futures fund would require them to register as a CPO.

I propose a rule that would exempt from CPO registration fund of fund operators who invest less than 40 percent of their assets at the time of investment in CPO-sponsored pools, and that any hedge fund which utilized less than 5 percent of its net assets as non-hedge futures margin would not be counted as a CPO-sponsored pool for this purpose.

I propose 40 percent, in an effort to define funds of funds whose principal purpose is not futures trading. Under the Investment Company Act of 1940, futures pools are not considered investment companies, even though 100 percent of their assets may be invested in Treasuries, because the principal purpose is futures, not securities trading.

I believe such a rule would result in a beneficial increase in futures market activity by funds of funds with no detriment to investors, since the fund actually making the futures investments would be a CPO, or exempt from CPO registration.

Fund of fund operators invest in hedge funds, futures funds, venture capital, private equity, real estate, mutual funds, and other categories. As long as the manager making the trading decisions has the required registrations, I do not believe investor protection also requires fund of fund sponsors to have the same registrations.

I would also like to express my support for the Rule 4.9 proposal by MFA which would base CPO exemption on the qualifications of clients.

I should mention for the record that none of the proposals that I've mentioned would exempt my firm from CPO registration.

Third--and I recognize that this is not in the Commission's jurisdiction--I believe the Commission should enter into discussions with the SEC to remove from SEC review all parts of S-1 registration statements for futures pools which pertain to the futures markets; or better yet, delegate complete review to the NFA.

The SEC continually has new examiners assigned to futures pools, and updated registrations of existing registered pools can call forth 25 pages of comments. The situation is ridiculous, and has cost investors many millions of dollars; since by and large these costs are passed on to the pools.

Thank you.

CHAIRMAN NEWSOME: Thank you, Mr. Crapple.

At this time, we will turn to our next speaker, Mr. John Davidson, who is Managing Director of Morgan Stanley Dean Witter and Company, Incorporated.

Mr. Davidson, we're glad to have you with us today, and we look forward to your comments.

STATEMENT OF JOHN P. DAVIDSON

MANAGING DIRECTOR,

MORGAN STANLEY DEAN WITTER & COMPANY, INC.

MR. DAVIDSON: Thank you very much, Chairman Newsome, Commissioner Erickson, Commissioner Holum. I'd like to state at the offset that the opinions I express today are my own. They are not necessarily those of Morgan Stanley.

The Commodity Futures Trading Commission should adopt a core principles approach to the regulation of futures commission merchants analogous to its recently adopted regulation for contract markets. These core principles should reflect the role of intermediaries in the marketplace; the public policy interest in preventing systemic risk; and a recognition that only a very few FCMs act exclusively in that capacity, and thus regulation and supervision are shared with other authorities. These core principles should recognize the following points:

Transparent Financial Reporting: The single most important decision that an investor makes with respect to participation in the futures markets is the choice of FCM to carry its funds and positions. Consequently, an ability to easily compare and contrast the financial strength of various FCMs is fundamental.

Information about required and surplus regulatory capital, as well as timely access to audited financial statements of FCMs, and audited and quarterly reports of the parents of FCMs where relevant, are vital to investors and potential investors.

The Commission has taken the lead in providing transparent information to investors. I refer in particular to the comparative information on FCM regulatory capital published quarterly on the CFTC's website under the title "Selected FCM Financial Data." To my knowledge, there is nothing comparable, particularly in such an easy-to-use format, from other U.S. regulatory agencies.

Still, this service could be taken several steps further; for example, with a hot link to the Securities and Exchange Commission's EDGAR service, so that the "10-Q" reports of the publicly traded parents of FCMs could be easily accessed. A joint listing with the SEC to include similar information for broker-dealers would also be useful for investors.

Risk Management and Regulatory Capital: Sound risk management and internal control procedures, backed up by a regulatory capital regime that directly relates capital requirements to market and operational risk, is the only effective means to control systemic risk.

Today the balkanized regulatory structure in the United States severely limits the effective supervision of internal control and risk management programs at FCMs and other intermediaries. But this deficiency is not inherent. Working with the SEC and, where relevant, the appropriate banking supervisors, the Commission should strongly encourage self-regulatory organizations and other supervisory authorities to perform joint and simultaneous reviews of risk management and internal control procedures across all U.S. regulated entities of a financial services company.

Notwithstanding published staff recommendations as recent as April of 2001, the Commission does not today have a risk-based regulatory capital regime. Once such a regime is adopted, the Commission should carefully review its regulatory capital requirements for dual registrants in light of the regulatory capital requirements of the SEC.

If those two regulatory capital regimes indeed measure different risks, then it is not sensible to have the total regulatory capital requirement of a dual registrant be the greater of the SEC or the CFTC requirements. If the risks are really different, it must be the case that the right answer is the sum of the two requirements.

FCMs Are Not Regulators: The Commission's regulations need to be modified to recognize that FCMs do not have the ability to govern the market behavior of their customers. Customers understand that an FCM must take certain steps to protect itself from unlimited counter-party exposure through mechanisms such as limiting credit exposure--for example, through margin requirements--and limiting legal exposure--for example, through client identification and documentation requirements.

It is much more difficult for customers to understand why FCMs should be involved in things like the oversight of the customers' investment management practices. This is even more challenging where an affiliate of the FCM may be a competitor of the customer, as is frequently the case today.

If--if--there is a legitimate public policy reason to limit the investment management practices of various investment advisors and/or investment managers, the only intellectually honest means to carry out that policy is to impose the limitation directly on investment advisors and investment managers.

Lack of jurisdiction by a regulatory authority over investment advisors and managers in certain domiciles, or of certain types, should be an indictment of the legitimacy of the public policy goal; not an excuse to impose regulatory jeopardy on uninvolved and uninterested intermediaries.

The current bunched order processing rules seek to have FCMs intervene between an investment advisor or manager and its clients in the non-preferential allocation of executions to accounts. This rule puts a completely unrealistic burden on an FCM, and should be abolished.

Relations With the Securities and Exchange Commission: While many may lament the amount of time it has taken to craft a workable regulatory framework for the trading in security futures, I think it more appropriate to applaud the remarkable progress that has been made by the staffs of the two commissions. The world view of the two organizations is understandably, but dramatically, different.

Congress clearly took the easy way out, and left the reconciliation of those two fundamentally different approaches to market regulation and oversight to the commissions, with remarkably few guidelines. I suspect that most staff would like to get the final regulations published, take some vacation, and hunker down back in their familiar territory. That, however, would squander an unprecedented opportunity for further dialogue and the development of mutual approaches to common supervisory issues.

It should be evident to all that, despite the occasional rhetorical flourish to the contrary, Congress is not going to modify its internal distribution of power and prestige in a manner sufficient to create a unified regulatory environment for U.S. financial intermediaries.

While the President's Working Group on the Financial Markets has brought an environment of cooperation among the financial regulators, what is needed today is a set of proactive joint initiatives. Areas for attention include transparent financial reporting, regulatory capital requirements, supervision of internal controls, oversight of customer protection regimes, facilitation of enhanced market structures, prudent risk-based systems for handling collateral requirements and the extension of credit, continued access to cross-border investment opportunities, and the oversight of clearing arrangements.

None of our financial regulatory agencies has a monopoly on good ideas or talented staff. Working closely and collaboratively is in the best interests of all market participants and the public at large.

A Zero-Based Examination of Customer Protection Mechanisms: The keystone of a transition to a core-principles-based approach to the regulation of intermediaries should be a "zero-based" examination of the customer protection regime in place in the industry. Is customer segregation, SIPC insurance, or something else, the optimal means to protect customers from the insolvency of an intermediary?

Previous examinations of this issue have not been zero-based. Instead, they have been surrounded by a near religious zealousy [sic] on the part of exchanges convinced a priori that any change would necessarily impose greater transactions charges on their floor-based members and smaller intermediaries.

I would suggest the examination of the following issues:

What do customers want? Just as we ask customers, in providing better customer service, what they want, we should, too, ask customers, in providing optimal customer protection, what they want.

Does the existence of distinct customer protection regimes unnecessarily limit cross-market investment strategies?

Does the lack of clearly specified priorities and instructions to the trustees of the estate of a dual registrant unfairly jeopardize customers or pose material systemic risk?

Could a uniform client money rule jointly administered by the CFTC and the SEC work as well in the United States as it seems to work in the United Kingdom?

Can SIPC coverage be extended to futures accounts without the imposition of burdensome transaction charges?

To what extent will the potential success of security futures and the growing number of cross-margin systems dilute the distinctions between the two customer protection regimes?

Even if a finding is made that the current customer segregation - customer protection regime has the greatest utility for U.S. futures markets, certain important modifications need to be made. In particular, the current treatment of customer funds held outside the United States and/or denominated in a currency other than U.S. dollars is unnecessarily confusing and administratively burdensome.

A far more optimal result would be obtained by amending the Part 190 rules and associated appendices to establish specific distribution procedures and priorities in the event of the insolvency of an FCM holding customer funds offshore.

Clearing Arrangements: The recent reorganization of the Commission's divisions undertaken by Chairman Newsome demonstrates a keen understanding of clearing issues. The oversight of clearing organizations and the oversight of intermediaries is inextricably linked, and fundamentally distinct from the oversight of markets.

In that context, I would encourage the Commission to charge the very talented new director of the Division of Clearing and Intermediary Oversight and her staff to undertake an examination of the impact of derivatives clearing organizations on the market structure and competition.

I have argued elsewhere that clearing organizations have many of the elements Richard Posner attributes to natural monopolies. As such, the "Doctrine of Essential Facilities," first described in a 1912 Supreme Court case, United States versus Terminal Railroad Association, and elaborated upon in a case involving MCI and AT&T in 1983, may be relevant in evaluating the public policy implications of the behavior of clearing organizations in certain circumstances.

This doctrine in essence holds that a monopoly owner of a key input cannot deny access if an entity seeking access cannot practically obtain the input elsewhere. Open interest in listed derivatives contracts, the pool of collateral, and the claims on capital supporting that open interest, could be deemed to be key inputs.

The vertical integration of those key inputs with the facilities of a specific market could be deemed to be a denial of access. It may be that the antitrust immunity granted in contract market status designation by the Commission appropriately recognizes the public policy implications of this apparent natural monopoly.

Alternatively, particularly in the case of a futures contract on an index exclusively provided by a third-party vendor, these clearing arrangements may unfairly limit investors' ability to obtain the benefit of competing market centers.

Portfolio Margining: The application of portfolio margining concepts to the collateral and credit relationships between an intermediary and its customers of all types is an area where the U.S. futures industry, under the oversight of the CFTC, has set the standard.

The securities industry, led by a committee of the Securities Industry Association with the active participation of the Options Clearing Corporation, the New York Stock Exchange, and the various options exchanges, is currently undertaking a rigorous examination of the merits of extending portfolio margining beyond the currently limited population of market professionals.

While there are indeed many legitimate differences between the concept of margin in a securities account and in a futures account, and material differences in the scope, diversity, concentration, and economic function of futures and securities markets, it is nonetheless the case that the Commission can and should provide valuable insight gained from the oversight of the operation of complex portfolio margining systems.

Finally, Cross-Border Investing: The Commission needs to continue to provide leadership in reducing the barriers to cross-border investing, both into and out of the United States. One important area that needs additional focus is that of foreign stock index futures. While 42 such contracts have been grandfathered, there still exist contracts that are currently offered or are being contemplated by exchanges outside of the United States, which had not obtained a no-action letter prior to the passage of the CFMA. To the extent that these contracts have the same characteristics as the existing 42, they should also be afforded similar no-action status.

Mr. Chairman, the financial services industry in the United States is going through a very traumatic period. Investor confidence in our markets has been shaken. Profit pressures on intermediaries are intense. Consolidation continues. The pace of innovation is intensifying.

Among the strengths of the U.S. capital markets is the willingness of all types of participants--customers, intermediaries, markets, and regulators--to reinvent themselves. This willingness must continue in good times and in bad, if our competitive advantage is to persist.

I appreciate the opportunity you have afforded to provide input into the potential renovation of the regulation of intermediaries in the futures industry. Thank you very much.

CHAIRMAN NEWSOME: Thank you very much, Mr. Davidson, for your very deep and helpful comments.

Our next speaker is Mr. Kevin Davis, the President of Man Financial. We're glad to have you with us today, Mr. Davis, and we look forward to your comments.

STATEMENT OF KEVIN DAVIS

PRESIDENT, MAN FINANCIAL, INC.

MR. DAVIS: Good morning to you. Thank you, Mr. Chairman and Commissioners, for allowing me to appear today. Quite a privilege. I actually started in the futures business 20 years ago, about this month, as a runner of the Chicago Board of Trade. So to appear here today is quite a moment for me.

I want to just quickly describe Man Financial. We are primarily a futures and options broker. We are engaged in both the institutional market, and also in retail, having acquired several retail futures companies over the past four or five years.

I haven't written a very long piece today, because I wanted to talk to my points. And whenever I do read out speeches, I end up sounding like a robot, so I'm conscious to try not to do that.

To give you some context about Man and where we rank in the business, we're the number-one executing member on LIFFE, number-one clearing and executing member on NYMEX, number-one clearing and executing member on CME. In the IPE in London, we're the number-one clearing and executing member. And in Singapore we are the number-two executing and clearing member. And at various points, we've been number one or number three.

So I mention that to give you some context as to where we sit in the industry. I, myself, spent the first 18 years of my career, 19 years of my career, primarily in the U.K. And so I've been very much involved in the transition of the markets from floors to screens during that period.

Turning to the CFMA, the Act of 2000 permits the exchanges to exercise much more unfettered authority at precisely the same moment when they're becoming private corporations primarily focused on the interests of their shareholders.

The majority of their shareholders are locals whose interest is in maintaining the grip of the open-outcry system of futures trading. This hold often prevents those customers who wish to take advantage of other forms of trading--such as internalization or crossing between major market participants--from doing so, because of the rules requiring exposure to the floor.

We believe that the exchanges in North America, the futures exchanges in North America, are increasingly using their compliance departments to perpetuate and to solidify the open-outcry system of trading.

Now, I'm not going to comment on whether open-outcry or electronic trading is better, or which one of those is better. But I would say that it's impossible to actually determine in the United States one way or the other, because of the grip that the exchanges and the floor community have on the current trading practices.

For example, in London the view taken by the LIFFE Exchange was that if two major market participants want to transact their order off the floor--or even, indeed, off the screen--provided that they are suitable, qualified participants in the market, they are, for want of a better phrase, big enough and ugly enough to sort out the transaction between themselves.

If Man and Morgan Stanley, for example, want to buy or sell options or futures between each other, we don't need the exchange to regulate that transaction. We are smart enough, bright enough, and sharp enough to be able to transact the transaction between each other.

In the United States, in Chicago and New York, we are forced to put all orders into the pits; which means that if we have a large buy or a large sell, and even if we could find the other side of that, from a Morgan Stanley or from any other major player, we are both forced to hit a bid or to take an offer. And so we are routinely forced, on behalf of our customers, to leave a spread in the pit for the locals.

That doesn't serve, as far as I can see--I can't see what benefit to the general public that is serving. I can see that it certainly benefits the locals' community. But I can't see how it benefits the general public who, ultimately, we're transacting business for.

The enforcement power of the newly privatized exchanges, particularly when relieved of stringent regulatory oversight authority, permits them to protect their own vested interests. Thus regulatory schemes and requirements can be structured to favor locals and to prevent a level playing field for all market participants.

The local-controlled exchanges often exercise virtual monopoly power over the products traded almost entirely by public customers. Moreover, the exchanges may exercise this monopoly power to the detriment of private investors by increasing the costs and fees for such customers.

I think earlier on Mr. Damgard illustrated the difference in fee structure between a Eurex traded stock index future and the S&PE Mini [ph] in Chicago. And that fee differential runs across virtually all products that we trade on the U.S. futures, compared to similar products in Europe.

The monopoly effect is particularly burdensome when applied to products for which a given exchange is the sole licensee of the underlying index of products.

Although the CFMA does permit a broader range of types of exchanges, those alternative markets are generally not available to the average retail investor, who remains subject to the monopoly power of the traditional contract markets.

We believe that, whilst we are absolutely in favor of the rolling back of too much regulation, we feel that in some instances exchanges in North America have taken advantage of the new freedom to perpetuate the interests of their shareholders, as opposed to uphold the interests of the investors who actually use those exchanges.

Thank you very much for allowing me to speak to you today. And I'm sorry if I've been a little bit too brief, but that means there's more time for other speakers to speak. Thank you very much, Mr. Chairman.

CHAIRMAN NEWSOME: Thank you, Mr. Davis. And I assure you, it's never too brief.

[Laughter]

CHAIRMAN NEWSOME: I appreciate it. And we look forward to hearing more of your comments as we get into the question and answer period.

Next, we have Steven Olgin, who is the Chief Administrative Officer of Merrill Lynch Investment Managers Alternative Strategies.

We're very pleased to have you with us today, and we look forward to your comments.

STATEMENT OF STEVEN B. OLGIN

CHIEF ADMINISTRATIVE OFFICER, MERRILL LYNCH

INVESTMENT MANAGERS ALTERNATIVE STRATEGIES

MR. OLGIN: Thank you, Chairman Newsome and Commissioners Holum and Erickson, for the opportunity to participate in this hearing today. My name is Steve Olgin, and I am the Chief Administrative Officer of MLIM Alternative Strategies, an affiliate of Merrill Lynch which acts as a sponsor of managed futures and hedge fund investment products.

MLIM Alternative Strategies and its predecessor entity have been registered with the CFTC as a commodity pool operator and commodity trading advisor and a member of the NFA since 1986. MLIM Alternative Strategies is also registered with the SEC as an investment advisor and transfer agent. MLIM Alternative Strategies has sponsored over 75 different investment vehicles, both publicly and privately offered to United States and non-U.S. investors, in its history.

I greatly appreciate the opportunity to appear before the Commission to assist in its study of potential changes in the regulation of intermediaries pursuant to Section 125 of the CFMA. My remarks today will focus on regulatory issues affecting commodity pool operators and commodity trading advisors offering managed futures and hedge fund investment products.

Specifically, I will discuss--as contemplated by the CFMA itself in mandating this study--several areas of commodity pool regulation which the Act did not address and which could be simply changed, which would not only rationalize the regulation of commodity pools and other investment products, but also harmonize the various overlapping bodies of regulatory jurisdictions applicable to commodity pools; a legislative policy objective expressly approved by both the National Securities Market Improvement Act of 1996 and the CFMA.

Commodity pools seek to provide a wide range of investors with an investment opportunity that is not highly correlated with more traditional stock and bond investments, through a vehicle which offers limited liability, daily valuations, and far greater liquidity than most alternative investment products.

Commodity pools also provide a much-needed liquidity to certain futures markets--in particular, the agricultural markets--increasing the efficiency of the price discovery and hedging functions served by these markets. However, over the past ten years, the number of publicly-offered commodity pools available to U.S. persons has been significant reduced, due in large part to the enormously high entry barriers created by five overlapping regulatory jurisdictions: the CFTC, the NFA, the SEC, the NASD, and the 50 states.

I will discuss seven different suggestions in connection with the study mandated by the CFMA.

First, the Requirement of Delivery of a Disclosure Document Prior to Any Direct or Indirect Solicitation: Commodity pools are the only investment product--or security, for that matter--for which it is required that a complete disclosure document be delivered to prospective investors prior to any direct or indirect solicitation.

Rather than inquiring of prospective investors whether they are sufficiently interested to want to receive a prospectus, commodity pool sponsors must first send a prospectus, prior to even ascertaining the investor's actual interest in this investment product. This requirement imposes a unique and costly burden on this one form of investment, without adding significantly to investor protection.

Of course, no one should be permitted to invest until they have received a complete disclosure document. However, by requiring that the disclosure document be delivered before even an indication of interest can be ascertained, commodity pools--which generally bear such ongoing offering expenses--and therefore customers, are subject to costs significantly greater than other pooled investment products subject to different regulatory regimes.

In addition, the need to deliver a disclosure document before any direct or indirect solicitation prohibits tombstone-type advertisements that contain a limited amount of straightforward, factual information about the offering by CTAs and CPOs that are otherwise permissible under the federal securities laws. Under existing law, any advertisement, on its face, is at least an indirect solicitation.

I would recommend that the CFTC consider amending the CEA to adopt the approach applied by the SEC to registered investment advisors: requiring the delivery of their disclosure document at least 48 hours prior to entering into an actual agreement with the client; not prior to any direct or indirect solicitation.

The manner of offering and prospectus delivery requirements imposed by the securities laws, designed to prevent the improper dissemination of securities-related advertisements, are as sufficient in the case of CPOs and CTAs as in the case of RIAs. This would be one step forward in harmonizing the securities and commodity regulation to impose the same requirements on CTAs and CPOs as on RIAs.

Number Two, SEC Deference to the CFTC in the Review of Commodity Pools: Currently, commodity pools must submit and have their prospectuses cleared by both the SEC and the CFTC, as well as filed in all 50 states, a large number of which still conduct extensive reviews. The SEC in its review applies the general provisions of Regulation S-K, the basic SEC disclosure rule. However, as one would expect, many of these provisions are almost wholly irrelevant to a commodity pool. As a result, there have been years of negotiations between the industry and the staff of the SEC concerning how to modify Regulation S-K to fit the disclosure needs particular to commodity pools.

The irony is that the CFTC has promulgated and spent years developing and refining disclosure rules specifically created for publicly-offered commodity pools; devoting, for example, detailed analysis regarding the treatment of performance information, the importance of trading principles, the portability of performance records, etcetera--issues which are of material and immediate importance to commodity pool disclosures, but also wholly irrelevant to the disclosures relating to operating companies to which Regulation S-K is primarily directed.

Although the most recent extensive revision of the CFTC's Part 4 Rules was in 1995, the CFTC's updating and review of its disclosure rules is an ongoing process, and the CFTC is well attuned to the disclosure issues which arise in the industry.

The SEC staff has many other important demands on its time. As it is, the efforts that the CFTC has put into refining the commodity pool disclosures are largely abrogated due to the need of the pools to conform to Regulation S-K. In fact, in some instances, combining the SEC's and the CFTC's regulations is not only burdensome, but also counterproductive from a disclosure perspective.

For example, the SEC requires that public offering prospectuses include a section on quantitative and qualitative disclosure regarding market risk. The purpose of this requirement is to force operating companies to disclose the contingent risk in their open derivatives positions incidental to their main line of business. However, in the context of a pool whose only business is trading in derivatives positions, the Regulation S-K disclosures are not only redundant, but potentially misleading.

I would recommend that the Congress consider amending the 1933 Act to provide that securities issued by commodity pools be subject to review by a single regulator, rather than disparate and overlapping SEC, CFTC, and state standards that currently apply. Congress took similar action when it enacted NSMIA in 1996, which preempted substantive reviews of mutual fund prospectuses by the states in order to ensure that mutual fund sponsors would be subject to a single regulator, the SEC, rather than a multiplicity of reviewers.

Similar action regarding commodity pools would not only improve the quality of commodity pool disclosures, but also conserve valuable resources at regulators other than the CFTC that are better directed towards products not otherwise expressly regulated by another agency expert in the matter.

Pools Should Be Exempt From 1934 Act Reporting: Inconsistent regulations also exist in connection with the requirement that publicly-offered commodity pools file standard 1934 Act reports--10-Ks, 10-Qs, etcetera. These reports are also governed by Regulation S-K, and result in the same confusing disclosures as does the application of S-K to public offering documents of commodity pools.

Investment companies are expressly exempted from the 1934 Act reporting requirements precisely because the Investment Company Act of 1940 has its own reporting system. The CEA and the Part 4 regulations impose on commodity pools reporting requirements that were specifically designed for these types of investment products, and in fact require more frequent reporting--monthly, rather than quarterly--than required under the '34 Act.

State Deference to the Federal Regulation: Commodity pools are one of the few investment products which remain subject to substantive regulation by the states. Not only do the states impose material substantive restrictions on the structuring of publicly-offered commodity pools; but also, the sheer administrative burden of having to file with each state, and negotiate with the administrators in each of the merit review states, is and has for years been criticized as one of the primary entry barriers to the offering of public commodity pools.

The debate concerning the proper role of the states in reviewing public commodity filings has been ongoing for at least the last two decades. The state regulation of commodity pool offerings seems directly contrary to the federal preemption of the states in the regulation of futures trading itself, as well as to the federal preemption of the states over investment company regulation established by NSMIA. The commodity pool industry is no longer in its infancy, and the status of its regulation should reflect that fact.

Publicly-offered commodity pools which have been cleared by the CFTC should be subject to notice filings, but no substantive review at the state level. A resurgence of the domestic commodity pool industry would be significantly enhanced with the elimination of the entry barrier of state regulation.

Private Commodity Pool Operators Should Be Exempt From Registration: For at least two decades, there has been a disconnect between the SEC and CFTC regulations, in that the former provided that a manager could privately advise up to 15 funds without need of registering as an investment adviser; whereas the CFTC took the position that managing any fund, even a private pool, was holding oneself out to the public as a CPO, which required CPO registration.

There is no justification for this distinction, and it has caused a generation of discontent among hedge fund managers. These managers, even though their trading is overwhelmingly securities based, have been required to register with and be audited by the CFTC, simply because they would occasionally use an S&P futures as a hedge. The principal regulator, the SEC, was on record as taking the position that there was no need to regulate the persons who limited their advice to a limited number of sophisticated hedge fund investors. The CFTC jurisdiction was very much the tail wagging the dog.

I would recommend that a new exemption from CPO registration be created for CPOs of pools offered and sold only to sophisticated persons in private transactions exempt from the '33 Act, unless they manage 15 or more funds, or hold themselves out to the public as a commodity pool operator.

At a minimum, this would be appropriate for those managers which are engaged primarily in securities trading, not hedge fund futures trading--a distinction which the CFTC is well used to under its Rules 4.5 and 4.12(b). These managers are properly the purview of the SEC, not the CFTC.

Conform the CPO Exemption From Investment Adviser Registration to That Available to CTAs: The CFMA provided that registered CTAs which primarily trade futures need not register as an investment adviser, and vice-versa. However, the same exemption was not extended to CPOs. This is particularly ironic because CTAs manage unlimited liability managed accounts; whereas CPOs sponsor limited liquidity collective investment vehicles.

Given the high degree of leverage used in most futures trading, it is clearly imprudent to steer investors towards managed accounts, as opposed to pools. But that will be the inevitable effect of failing to include CPOs within the scope of the CFMA's "primarily engaged" exemption from investment adviser registration. No purpose is served by this distinction.

Finally, the Adoption of Two Uniform Standards for Certain Categories of Commodity Pool Investors: Over the course of years, the CFTC and the SEC have engaged in an effort to expand and clarify those groups of persons to which certain provisions of the Investment Company Act, the Commodity Exchange Act, the '33 Act, the Investment Advisers Act, and other laws, had no need to apply.

However, as a result of the separate paths taken by the agencies and the ad hoc method in which they produced their criteria for the qualified investor, we are left with a crazy quilt of largely--but not completely--overlapping investor qualification standards. Currently, we have accredited investors, qualified institutional buyers, eligible contract participants, qualified clients, qualified eligible persons, and qualified purchasers.

I would recommend that Congress adopt the "accredited investor" standard as a disclosure-oriented standard defining persons exempt from specific regulatory disclosure requirements and to whom manner of offering restrictions do not apply; and the CFTC "qualified eligible person" standard as a substantive standard defining persons who can fend for themselves and, accordingly, are exempt from the Investment Company Act numerical limitations, able to deal in derivatives markets. Two uniform standards would represent a major conceptual improvement over the current array of different standards and regulatory requirements.

I thank you very much for your time. I welcome this study as an excellent opportunity to eliminate some of the historical artifacts of commodity pool regulation, which for years have put the industry members and U.S. investors at a distinct competitive disadvantage. By leveling the playing field we can help U.S. investors by reducing entry barriers and administrative costs, and by conserving regulators' limited resources. Thank you very much.

CHAIRMAN NEWSOME: Thank you very much, Mr. Olgin. You bring up some excellent issues that the Commission will look at.

MR. OLGIN: Thank you.

CHAIRMAN NEWSOME: Our last panelist is Mr. Jan Waye, Senior Vice President of Cargill Investor Services.

Mr. Waye, we appreciate you taking time to be with us today and, again, we look forward to your comments.

STATEMENT OF JAN R. WAYE

SENIOR VICE PRESIDENT

CARGILL INVESTOR SERVICES, INC.

MR. WAYE: Thank you, Chairman Newsome and Commissioners Holum and Erickson. My name is Jan Waye, and I'm a Senior Vice President with Cargill Investor Services. CIS is a wholly-owned and separately managed subsidiary of Cargill Incorporated. We are global FCM, providing execution, clearing, and risk management services to risk managers, brokers, and a variety of futures fund managers. We are celebrating our 30th anniversary this year as an FCM--three years older, I see, than the CFTC itself.

I'd like to thank the Commission for an invitation to appear--this early afternoon, as it turns out--to discuss intermediary relief under the CFMA Act of 2000. The CFMA made major progress in bringing about regulatory reform for exchanges. We welcome the Commission's study into relief for market intermediaries. My remarks will be brief, and cover five specific areas.

First, and not necessarily most important, is the area Mr. Davidson mentioned earlier; that being the area of risk-based capital. We applaud the Commission's move towards adopting risk-based capital requirements.

Today FCMs need to carry capital equal to 6 percent of the value of all client assets on their books, whether for initial or variation margins. Proposals under study would change that, by increasing the capital requirement on initial margins only, to 8 percent; but reducing the capital requirement on any excess assets beyond the initial requirement, to 0 percent.

We believe that's a step in the right direction. It potentially strengthens the FCMs. It encourages them to carry more client assets on their books, without those assets resulting in an undue capital burden in terms of their trying to demonstrate a return on capital. Because the way this system operates today, in terms of getting a return on capital, an FCM wants to have the least amount of capital possible from their clients, and carry no excess. But in terms of having a strong FCM community, we should be encouraging FCMs to carry excess client assets, without putting on a regulatory capital burden.

Secondly, I'd like to comment just briefly about security futures; although I understand that's not the main topic of the day, and there have been several other open hearings on that question.

FCMs need to maintain an ability to compete on a level playing field under broker-dealer light registration, which is reflected in the regulatory mandate that the economic impact of broker-dealers and FCMs be economically neutral.

We are anxiously awaiting the final outcome of the rules between the SEC and the CFTC. We're very impressed by the cooperation and progress that have been made so far, and believe a lot of that is due to the initiative of the CFTC.

We are somewhat concerned that in the final analysis FCMs might be slightly disadvantaged in the regulatory scheme, relative to broker-dealers. And my only point this afternoon is to continue to encourage the CFTC to defend the right of FCMs to be treated with regulatory parity; and that these products, as they begin trading, are truly viewed as hybrid products, and not necessarily any more as equity products than they are futures products.

An equally interesting area perhaps, but one that receives significantly less discussion--certainly by the panel this morning--is the issue of ag. trade options, which would be my third point.

Rules exist today for the CFTC's pilot program in agricultural trade options. And those rules are designed to encourage participation in this pilot. But unfortunately, that participation hasn't taken place. Producers are effectively unable to enter into off-exchange options to manage price risk. Instead, they must either use the futures markets directly, which may create significant basis risk; or they have to enter into physical transactions for the underlying commodity, and those transactions might include risk management characteristics in them.

We believe the program still has merit, and that steps should be taken to make it more effective. One of those steps would be to lower the exemption for eligible participation from $10 million to $1 million, in line with the swap exemption. These products should not be limited to the most wealthy participants only.

The CFTC should encourage guidance and provide guidance on solicitation to be overseen, rather than records of all solicitation. The program needs to provide fair protection for both buyers and sellers. And the CFTC should shift from its current protective approach of regulating ags. to one more in keeping with the overall mandate of the CFMA, to base regulatory oversight on the nature of market participants being regulated.

Ag producers vary widely in their sophistication, and in their financial worthiness. Regulations should be written to reflect this fact; not categorically with respect to all ag-based futures contracts.

We're here to discuss regulatory relief this afternoon, but I think it's important to mention one area that FCMs need to adopt greater regulatory responsibility, and that would be my fourth point. And that's in the area of Anti-Money-Laundering: I think we all accept--and FCMs, in particular--that we have a greater role to play going forward, in knowing our customer and being much more vigilant on anti-money-laundering rules than we have been in the past.

And so, let's not think that we're trying to get rid of all regulation, or we're trying to be so general as not to focus on very specific issues. But we accept the fact that we are in a unique position to demonstrate greater vigilance than may have been the case prior to today.

Finally, I would like to comment in terms of Global Overview: Several earlier speakers mentioned analogies to regulatory environments in the U.K. and other countries. The CFTC has undertaken such reviews of foreign exchanges in the past, in terms of the Global Markets Advisory Committee, which was chaired by Commissioner Holum. But the CFTC, we believe, should continue to review regulatory requirements--indeed, global core regulatory requirements--to foster and adopt common best practices between regulatory agencies of futures markets that would impose increased uniformity and predictability on FCMs, and reduce the cost on FCMs in terms of implementing and complying with those various regulations.

I thank the Chairman and the Commissioners for their attention this afternoon. And I look forward to participating in any questions.

CHAIRMAN NEWSOME: Thank you, Mr. Waye.

Commissioner Holum, any questions or comments?

COMMISSIONER HOLUM: Thank you, Mr. Chairman. I have no questions. But I would like to say that I appreciate all of your remarks. They were very enlightening, and will be very helpful to me and all of the Commission I think, as we enter into our deliberative phase. And I just want to thank all of you for coming.

CHAIRMAN NEWSOME: Thank you very much, Commissioner.

Commissioner Erickson?

COMMISSIONER ERICKSON: Thank you.

You've given me, and I think all of us, an awful lot to think about and consider. The options and alternatives that seem to be on the table here are worth a lot of consideration. And I know that we're also looking at trying to meet a deadline in putting forward a report.

But I'm really thankful that you took the time to probe pretty deeply and look at what not only this Commission might need to consider doing as far as not just relief for intermediaries, but what an appropriate structure for regulation and oversight might be for intermediaries; but also, how we need to look at that in the context of the larger federal effort, and what Congress may need to be considering and taking up; as well as our own initiatives with federal financial regulators.

That point has been driven home to me quite clearly here this morning. And I have no real questions. I think we've just got an awful lot to think about. Thank you very much.

CHAIRMAN NEWSOME: Thank you, Commissioner.

One theme that has been discussed today in regard to the CFMA--and many have gone back to the CFMA--certainly, I think, through the CFMA the intent was to encourage competition in multiple areas. When we look at transaction facilities, clearinghouses, the intent was to provide more flexibility.

But I've heard the theme today that maybe the competition aspect of the CFMA has not worked as intended. And I think as we look and think at that, again, I would like to propose a similar question to this panel as I had posed earlier. When we look at the competition aspect of the CFMA, have we been patient enough? Have we given enough time for that competition to properly develop?

Or if not, then in place of competition, what would be the role of a government regulator, in terms of stepping in? And I would like a response from any of the panelists in regard to that question. Who would like to start? Mr. Davidson?

MR. DAVIDSON: I'll give that a shot. I do certainly think that competition is something which evolves over time. And these are very early days vis-a-vis the changes that have been brought about by the CFMA.

But I do think it's profitable, as some of the other speakers have also suggested, to look at some of the structural enablers to competition, and to make certain that it's the marketplace which is preventing competition from arising, or limiting the types of competition which do arise; as opposed to some artificial constraints which don't necessarily have the public interest at heart.

I would commend for your review the legislative history associated with the 1975 amendments to the Securities Acts, which established the intent by Congress to create a national market system. Certainly, comparing today to 1975, one would have to say that indeed a great deal of time went by prior to competition working itself out with the level of investor benefit that we've seen in the past couple of years.

But on the other hand, one of the fundamental precepts of that legislative history is the notion that there is certain fundamental market-wide infrastructure, and that that market-wide infrastructure needs to inter-operate; doesn't need to necessarily be common, doesn't need to necessarily be commonly owned, it needs to inter-operate.

So that there are no barriers to particular marketplaces from obtaining the benefits which, after all, are benefits associated with the reduction of systemic risk, the protection of customers, and the efficient operation of the markets.

And I think those requirements that, for example, clearing organizations and depositories inter-operate, are just as legitimate goals in the listed derivatives markets as they are in the securities markets, or as they were in the securities markets in 1975 when there were in fact clearing organizations for each of the multiple regional exchanges and securities depositories for each of the multiple regional exchanges.

There was not a mandate for common clearing by either Congress or by the Securities and Exchange Commission. There was, however, a mandate for interoperability and the ability to have an intermediary choose where it desired to interact with the marketplace for these infrastructure services.

CHAIRMAN NEWSOME: Okay. Thank you, Mr. Davidson.

Mr. Crapple?

MR. CRAPPLE: I think the question of whether competition may be forthcoming is--It's an open issue. And if we had a large wealth-enhanced organization which wished to list all of the U.S. exchange contracts, that would become a very interesting competitive situation.

I'll refer to one other thing that isn't in your power to fix. But if that happened to be a non-U.S. exchange, the tax law would be at a great disadvantage to the non-U.S. exchange. Because we have the mark-to-market system for U.S. exchange traded futures contracts, 60 percent long-term capital gain, 40 percent short-term. Doesn't apply to contracts listed on non-U.S. exchanges. And I think that would be a crushing competitive disadvantage.

And I've mentioned this in other contexts. I think that all of U.S. and non-U.S. contracts on legitimate exchanges should be under the mark-to-market system for U.S. taxpayers.

CHAIRMAN NEWSOME: Okay. Thank you, Mr. Crapple.

Mr. Waye?

MR. WAYE: I guess I'd make two comments. First, the clearinghouse side as it applies to competition is critical. As an FCM, we really don't want to spread our capital base across more and more clearinghouses that we think might be less and less financially viable. Because we're the ones that carry the risk between the customer and the clearinghouse.

To the extent the Commission can encourage one or more clearinghouses in the U.S. to be able to clear products on other exchanges, it would be a step in the right direction. It would increase our capital efficiency. It would reduce the risk in margining. Various products on different markets might have cross-margin possibilities. It might be more analogous to the London clearinghouse, which clears a variety of unregulated markets in a fairly efficient manner.

And so, moving towards common clearing, or encouraging one clearinghouse to be able to clear products from multiple exchanges, would be one step.

Secondly, I would say, in terms of electronic markets, none of us know whether it takes more time. A lot of them have raised the flag. We've got ICE coming, in terms of energy. We've got BrokerTec, trying to copy financial instruments. We've got the Merchants Exchange, trying to do something on energy. We've got Island, trying to compete with One Chicago and QLX, even before equity futures get launched.

And so there are a lot of electronic "wannabes." There's insufficient liquidity to make any of them particularly viable yet. But it's unclear whether or not more time is the answer, more efficient clearing for them that the Commission should perhaps be encouraging. I think the jury is still out.

CHAIRMAN NEWSOME: Okay. Mr. Davis?

MR. DAVIS: Mr. Chairman, I believe that when you ask the question, "What should the government be regulating? What's the role of the government regulator?", I think, referring to one of the comments Mr. Damgard made earlier about the role of the clearinghouses, we find it at Man increasingly disturbing that exchanges which do control their own clearinghouses are able to use their collateral levels or their margin requirements as a competitive influence.

Or let me put it another way. The levels of margins are sometimes set with as much view to the competitive edge of the exchange as to the collateral required for the underlying product.

For example, if you have two very similar stock index futures contracts trading at two different exchanges in the same city, if an independent body was responsible for setting those margins, their focus would be on the risk associated with the contract. But where you have both a sales and a risk function, a close eye is also kept on what are the initial margin requirements of the competitive contract on another exchange.

And I think that it's inappropriate for those margin levels to be set by the exchanges themselves, because, after all, as they're now for-profit businesses, they are interested in attracting as much business as they possibly can. The net loser is the FCM, because we're the ones who stand between the clearinghouse and the customer, and we don't have the power to stop that from happening.

I don't know how Mr. Waye feels about that.

MR. WAYE: [Nods Head in the Affirmative.]

CHAIRMAN NEWSOME: With regard, more specifically, to common clearing, again, when I look at that issue, I question what the role of the government regulators should be toward pushing common clearing. At the same time, I don't diminish the fact that it could be very important, from an industry standpoint.

Are there discussions currently underway by industry segments? I know there have been in the past. Are there currently? Are any of your firms involved in those discussions, if so?

MR. DAVIDSON: None that I'm aware of.

MR. DAVIS: None that I'm aware of, either.

MR. WAYE: Nothing new that I'm aware of.

MR. CRAPPLE: No one asked the CTAs that kind of question.

[Laughter]

CHAIRMAN NEWSOME: Well, just it seems to me that that's been an issue that's been brought up by multiple members of the panel. And if so, it seems to me that that would be an issue that I would want on the table, as industry participants, exchanges, FCMs, to sit down and discuss what's important to them.

Mr. Waye?

MR. WAYE: Mr. Chairman, to those exchanges and to those people here today that fear that by separating the ownership of the clearinghouse from the ownership of the exchange it might somehow significantly reduce the value of the exchange, I think we only need to look to the LIFFE Market in London, which does not own its clearinghouse, and managed to sell itself in an auction for an extraordinarily high value--higher than any of the owners ever expected--to the EuroNext Exchange in Paris.

And so we shouldn't confuse--and I hope the exchanges don't--that the value of that marketplace is much, much greater than the necessity of perhaps including clearing along with it.

CHAIRMAN NEWSOME: Okay. Thank you, Mr. Waye.

Do any of my fellow Commissioners have any other comments or questions at this time?

COMMISSIONER ERICKSON: If I might, it just strikes me, I'm just kind of fascinated, that we've gone through this period of talking about market structures, and setting them up in a way to encourage competition. And today we're talking about: How do we provide that structure in the intermediary context? And some of the answers seem to be: We need to be imposing additional obligations, duties, and rules on the marketplaces themselves.

And we're looking at a new law, the CFMA, that has set up designated clearing organizations, a new area of regulation for the CFTC, envisioning multiple clearing organizations. And we're back to talking about the need for common clearing. And I'm really personally not sure what this agency has, as far as authority, to take action in that area.

But certainly, I think, as market participants, these are things that are going to have to be discussed and vetted within the industry. Because we are operating in an environment, as you've all recognized, where there is much less oversight, much less hands-on regulation of the marketplaces or the clearing organizations themselves.

And so, we've got a lot--a lot--to think about, as far as these issues, from your perspective. But in the overall context of market regulation, it is, I think, striking that some of the answers seem to be that we need to have a firmer grip on what's going on in the markets.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Before I ask the staff if they have any questions, Mr. Waye, I wanted to go back to your comments on security futures products. Obviously, that's an area that this Commission has spent a tremendous amount of time and resources. And it's my hope that we're very close to finalizing those rules.

In regard to some of your comments, how much of the perceived disadvantage to FCMs, relative to broker-dealers, in trading SFPs is statutory? And then, how much of that might be regulatory in nature?

MR. WAYE: I'm not sure I could give an easy answer to that. And I would say, regarding my comments earlier, that it's as much of a preventative thing, as we're counting on you to represent the interests of FCMs and to represent the interests of Congress' direction in terms of comparability. And so it's not meant to be a criticism, but it's meant to be, you know, stay in there and fight the fight. Because we understand it isn't easy.

CHAIRMAN NEWSOME: Thank you. It's not easy, I promise you.

[Laughter]

CHAIRMAN NEWSOME: John, senior staff, any questions that you'd like to pose at this time?

MR. LAWTON: No question, Mr. Chairman.

CHAIRMAN NEWSOME: Okay. Any further questions by my fellow Commissioners?

[No Response]

CHAIRMAN NEWSOME: Okay. Again, I would like to thank each of you on this panel. Your comments were excellent. Certainly, there are some very specific areas which the Commission needs to spend some resources addressing. And then, as Commissioner Erickson indicated, there are some much broader areas, I think, that we have to just spend some time looking at and thinking about, as well. And you have given us excellent information to take forward on which to base our deliberations. So thank you very much.

At this time, I'd like to ask my fellow Commissioners if they have any final comments that they would like to make?

COMMISSIONER HOLUM: None, thank you.

COMMISSIONER ERICKSON: No, thank you, Mr. Chairman.

CHAIRMAN NEWSOME: Nor do I. So at this time, I will entertain a motion that we adjourn this hearing.

COMMISSIONER HOLUM: So move.

COMMISSIONER ERICKSON: Second.

CHAIRMAN NEWSOME: All in favor, say aye.

[Chorus of ayes.]

CHAIRMAN NEWSOME: The vote is unanimous, and the hearing is closed. Thank you very much.

[Whereupon, at 12:29 p.m., this public hearing of the Commodity Futures Trading Commission was adjourned.]