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August 7, 2000

Via E-Mail (jwebb@cftc.gov) and (secretary@cftc.gov)

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

COMMENT

Re: Proposed Rules Concerning Intermediaries; Exemption for Bilateral Transactions; and Regulatory Reinvention

Dear Ms. Webb:

In the June 22, 2000 *Federal Register*, the Commodity Futures Trading Commission published a number of proposals related to the Commission's staff task force's report entitled *A New Regulatory Framework.* NFA welcomes the opportunity to comment on these important regulatory reforms.

NFA strongly supports the Commission's initiatives to reinvent the regulatory structure in the futures industry. The Commission's proposals recognize the need for change to keep up with the technological and business developments that are invigorating the futures industry. The proposals also recognize that regulatory needs change with the type of product being traded and the nature of the investor. NFA agrees that the use of core principles supplemented by interpretive guidance is the right approach to provide the flexibility necessary to meet these needs in a rapidly changing industry. NFA also believes that the Commission appropriately adopted this approach in its proposal related to trading facilities by differentiating between the types of trading facilities and by developing a regulatory framework that regulates those facilities through core principles supplemented by interpretive guidance. NFA is concerned, however, that the Commission appears to have backed off this approach in its proposal related to intermediaries.

Obviously, every regulation cannot be replaced with a core principle. Capital and segregation requirements, for example, must be spelled out in detail to ensure the integrity of customer funds. In many other areas, however, where this type of specificity is not necessary and core principles would be appropriate, the Commission's proposal merely amends existing regulations. As discussed more fully below, NFA encourages the Commission to revisit the intermediary proposal and eliminate existing regulations where appropriate and rely more on regulation through core principles and supplemental guidance.

NFA also encourages the Commission to look to the industry, through its self-regulatory process, to develop the acceptable practices for satisfying many of those core principles. NFA's rulemaking process, for example, maximizes industry involvement and invites input from the end users who would be the primary beneficiaries of this guidance. That same process should be the primary means of developing the interpretive guidance applicable to NFA Members. The Commission, of course, would retain the authority to approve the interpretive guidance developed by NFA.

Some have raised concerns that the use of core principles would somehow weaken the Commission's enforcement efforts. NFA's experience indicates that the opposite is true. Many of the rules currently in NFA's rulebook are drafted along the lines of the proposed core principles. For example, NFA Compliance Rule 2-4 requires Members and Associates to observe high standards of commercial honor and just and equitable principles of trade in conducting their commodity futures business. Compliance Rule 2-9 requires Members to diligently supervise employees and agents conducting commodity futures business. And Compliance Rule 2-29, one of the most often charged rules in an enforcement action, is based on a core principle type tenet prohibiting Members from engaging in misleading sales solicitations.

Compliance Rule 2-29 is a perfect example of effective regulation through core principles. Rule 2-29 is a very comprehensive rule which contains both specific provisions and broad principles prohibiting misleading sales communications. In the over 100 NFA enforcement cases charging this rule during the last 15 years, the focus of the enforcement action was on Members or Associates engaging in misleading sales communications. In these actions, many different types of conduct – all of which could not possibly have been specifically listed in a rule – constituted the basis of the misleading sales communications that violated these broad prohibitions. Any technical charges for violating specific requirements in the rule were minor components of the case.

NFA believes that enforcement cases based on technical violations make bad enforcement cases. Throughout our enforcement history, NFA has always strived to enforce the spirit rather than the letter of the law. NFA believes that regulation through core principles actually makes this easier to do.

NFA also believes that it is difficult to enforce a rule designed to specify every potential type of misconduct prohibited by the rule. These types of rules often become unwieldy and difficult to read and understand. More importantly, because it is virtually impossible to capture every situation that would constitute a violation of a rule, the fact that a certain activity is not covered in the rule is used as a loophole by individuals and firms intent on violating the rules.

Having expressed our strong support for the overall proposal, NFA would like to take this opportunity to comment on some of the specifics in the proposal.

A. Use of a Uniform Definition

NFA applauds the Commission's use of a uniform definition to define an institutional customer. NFA also supports using the same criteria used for eligible participants under the swaps exemption. NFA does, however, question one small part of that definition. The definition used by the Commission imposes an asset test on commodity pools but does not impose a similar test on investment companies. NFA sees no reason for this distinction. In fact, the Commission itself rejected this distinction when it adopted Part 36, where it imposed the asset requirement on both investment companies and commodity pools. We recommend taking this same approach in Regulation 35.1(b), which would then carry over to the definition of "institutional customer" in regulation 1.3(g).

B. Core Principle One: Registration

NFA supports the Commission proposed amendment to the definition of "principal." NFA has been advocating a change in this definition for some time because the current definition is oftentimes over-inclusive, resulting in firms listing as principals companies and individuals who have no controlling influence over the registrant's activities. We believe that the collaborative effort on the part of NFA and the Commission to revise this definition has resulted in a definition that will alleviate the complexity related to the current holding company rules while capturing those individuals who actually have a controlling influence over a registrant's activities.

This amended definition will also result in more relevant disclosures under the Part 4 requirements. By narrowing the definition, the disclosures related to business background, trading results and litigation history required to be included in a CPO/CTA disclosure document under Part 4 will be limited to individuals who participate in making trading or operational decisions or supervise those who do so, rather than any individual with an officer title.

NFA also supports the Commission's proposal to provide for simplified registration for FCMs and IBs trading solely for institutional customers on a DTF if they are already registered with another federal financial regulatory authority. NFA encourages the Commission, however, to extend this same treatment to regulated entities that intermediate trades for institutional customers on RFEs. NFA believes this same relief is appropriate because the regulatory needs of institutional customers do not vary with the type of market. In addition, the only protections that customers lose by passporting is the Commission's capital requirements and a background check conducted by NFA

on the Commission's behalf – both of which protections are provided in some measure by the passported firm's primary regulator.

NFA also encourages the Commission to reconsider whether there is any need for a duplicate background check for any securities-registered person even when that person services retail customers. Redundant background checks are no more helpful for retail customers than for institutional ones.

Although not addressed in the Commission's proposal, NFA believes that the Commission can streamline the registration process further by eliminating the requirements regarding the collection of employment, residential and education information on the registration application. Currently, individuals must list their employers, dates of employment and periods of unemployment, military service and schooling, for the ten years preceding their application. They must also provide their residential addresses for the same period and list each college or university, or alternatively, last high school, attended. Additionally, sponsors must contact all listed employers and education institutions within three years of the application, specify who they spoke to and certify that they verified the information.

None of this information relates to or is used by NFA to determine an applicant's fitness for registration. The only information that is related to fitness is registration history, and NFA has that in its databases. Employers who wish to collect and verify past employment and education history are free to do so; requiring them to do this and certifying that they have done so adds nothing to the registration process.

Although NFA supports streamlining the registration process, NFA does not believe that the Commission should eliminate the certified financial statement requirement for FCMs filing an initial registration application. There is a significant difference in the role of FCMs and IBs in terms of safety of customer funds. The one-time filing requirement for FCMs is not unduly burdensome, especially in light of the potential exposure if the initial financial statement is incorrect. NFA does support eliminating the requirement for independent IBs but suggests that the DSRO should be able to hold the interview called for in the Commission's proposal telephonically if the DSRO has no reason to be concerned about the IB's capital.

The Commission's proposal also requests comment on changes to its minimum net capital requirements to provide for a risk based net capital requirement. Specifically, the Commission requested comment on the most effective approach to developing this type of change. NFA fully supports the concept of a risk based capital requirement, as evidenced by our recent amendment to NFA's capital requirements to include this type of requirement.

Finally, NFA would like to briefly address one area not covered in the Commission's proposal. As exchanges become electronic and demutualized, the concept of exchange "members" may be replaced by exchange "subscribers," who would not be required to be registered. Under the current proposal, there is nothing to prohibit a subscriber barred from one exchange for serious misconduct to simply begin trading on another exchange. NFA encourages the Commission to address this issue in its final rules by providing that exchanges may not grant access to any subscriber barred by another exchange.

C. Core Principles Two and Six: Fitness and Supervision

The Commission's proposal also suggests that the Commission favors lifting proficiency testing requirements for APs who deal solely with institutional customers. As the Commission recognizes, Congress gave NFA the responsibility for imposing testing requirements and it is our rule that would require changing to implement this recommendation. NFA staff would be happy to raise this issue with our Board of Directors and work with the Commission's staff in reaching an appropriate result.

Turning to the Commission's proposal regarding ethics training, NFA strongly supports the elimination of the current ethics training rule, which is far too detailed and administratively cumbersome. NFA also believes that the Commission's proposed approach to regulating this area in the future – a general standard accompanied by a safe harbor – is right on target and should be used as a model for regulation in other areas related to intermediaries.

D. Core Principle Three: Financial Requirements

NFA also fully supports that portion of the Commission's proposal which would allow retail customers access to DTFs provided they can be adequately protected in their dealings in those markets. NFA does not believe that retail customers should be locked out of regulated markets and therefore we support the idea of giving retail customers access to DTFs through registered FCMs who meet a super-capital requirement.

The Commission has also requested specific comments on changes to the segregation requirements. At the outset, NFA believes that the segregation rules have provided valuable protection of customer funds in the futures markets. We also agree with the Commission that retail customers should not be allowed to opt out of the segregation requirements and the protections that go along with those requirements. NFA also is not convinced that there is any real need or interest in allowing institutional customers to opt out of segregation requirements. Based on informal feedback NFA has received from the FCM community, FCMs are more interested in being able to provide their customers with a unified account statement reflecting their holdings across all

products – not just futures contracts – in the customer's accounts with the FCM. NFA encourages the Commission to seek input from the industry regarding this issue before making changes to the segregation rules. Moreover, NFA does not believe that any opt out provision should be allowed until after the bankruptcy laws have been clarified to address how these funds would be treated in the event of a bankruptcy.

NFA supports the idea of allowing FCMs to maintain both futures margin money and other various instrument in the same customer segregated account. Again, however, NFA urges the Commission to hold off on any changes to these rules until after the bankruptcy laws have been clarified regarding the treatment of these additional investments in the event of a bankruptcy.

With respect to broadening the eligible investments for segregated funds, NFA is in full support of the Commission's proposal. This proposal will allow FCMs and clearing corporations to follow a more diversified investment strategy while ensuring that the funds are still conservatively invested.

E. Core Principle Four: Risk Disclosure and Account Statements

Although NFA agrees with the Commission that non-institutional customers should continue to receive the disclosure set forth in Rule 1.55, NFA does not believe the Commission's rule should dictate the specifics of how disclosures and consents are delivered and acknowledged. NFA would be willing to develop best practice guidance in this area.

NFA does support the Commission's idea to develop more streamlined disclosure for domestic exchange traded options. Again, NFA would be happy to refine this disclosure and develop the appropriate guidance for its use.

F. Core Principle Five: Trading Standards

NFA agrees with the Commission that the rules governing trading standards have proven effective. Moreover, NFA does not believe that these rules have been overly burdensome and we are not opposed to their current format. NFA is concerned, however, by the Commission's proposal to regulate this area differently for RFEs and DTFs. Since these markets will be trading the same products, or products with similar economic terms, the Commission must ensure that it does not impose stricter standards on one type of facility and therefore favor one market over the other. NFA encourages the Commission to treat these markets the same with regard to trading standards – whether it be through the existing regulations or a core principle with the appropriate guidance. NFA also believes that this is one area where there should not be any difference between institutional and non-institutional customers.

G. Core Principle Seven: Reporting Requirements

NFA agrees with the Commission that the Large Trader reporting requirements have worked well over time and should continue to be in place for intermediaries on RFEs. NFA also supports the Commission's proposal to allow DTFs more flexibility in gathering this information from intermediaries trading on DTFs. Although the large trader reports have worked well, NFA recognizes that there are other means to collect this information, and we support flexibility in this area as long as DTFs have a means to keep abreast of the market positions on their participants. Moreover, NFA believes that it is important that markets trading products with like economic terms share information on market positions. In fact, NFA encourages the Commission to work with the exchanges to develop a system to share this information.

H. Core Principle Eight: Recordkeeping

NFA fully supports any efforts on the Commission's behalf to encourage greater use of information technology for recordkeeping purposes. NFA believes that one way to do this is to replace Rule 1.31 with a core principle and acceptable practice guidance which would follow the proposal NFA informally submitted to the Commission in December 1997.[1] Specifically, the acceptable practice guidance would not contain any reference to specific technology but would require the registrant to meet general reliability and accessibility standards. NFA continues to believe that this approach provides for greater flexibility in dealing with constantly changing technology and eliminates the need to amend Rule 1.31 every time technology changes.

NFA fully supports the Commission's Advisory relating to electronic transmission of account statements. We would prefer, however, that the Advisory be treated as best practices guidance rather then a rule.

The Commission's proposal also recommends that customers or account controllers be given the flexibility to offset positions in their account in a manner other than the first in, first out (FIFO) method. NFA supports giving customers/account controllers this discretion provided that a customer uses a consistent approach in offsetting his positions. This discretion should not be misused to permit customers to change offsetting instructions on every position and raise issues relating to improving delivery positions, tax avoidance or money laundering.

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[1] See December 24, 1997 letter to I. Michael Greenberger from Daniel J. Roth.

NFA also notes that the Commission's proposal related to offsetting positions would require CPOs and CTAs to disclose it if they instructed the FCM to offset positions in a manner other than the FIFO method. NFA does not agree that there is any need to amend Commission regulations to require this disclosure. This disclosure is only material to a participant or client if a CPO/CTA calculates its compensation based on realized gains. If this is the case, then the CPO/CTA is already required to disclose how positions are closed out and what effect that has on fees. Therefore, amending Commission regulations to require this disclosure is unnecessary in some situations and redundant in others.

Dispute Resolution

In addition to the areas discussed above, the Commission's proposal on intermediaries included recommendations related to pre-dispute arbitration agreements in its discussion of Core Principle Four. Moreover, the Commission's trading facilities proposal also contained a number of recommendations related to the arbitration process.

NFA supports the Commission's proposal to delete Part 180 and replace it with a core principle for dispute resolution and appropriate acceptable practice guidance and to apply this same concept to registered futures associations. This approach will provide NFA and the RFEs with the flexibility to design the most effective dispute resolution program without requiring changes to CFTC regulations every time a forum wants to implement a procedure that does not strictly comply with the Part 180 regulations.

For example, NFA is currently considering an increase in the ceiling amount for summary proceedings at NFA. Under the Commission's current rules, however, NFA would have to petition the Commission to amend Part 180 in order for NFA's proposal to comply with the Commission's regulations. If the Commission eliminates the ceiling, NFA would only have to seek the Commission's approval of NFA's rule change.

NFA also believes that intermediaries and institutional customers should not be confined to specified language in any pre-dispute arbitration agreements (PDAs) between them. These parties should be permitted to negotiate all terms in these agreements, including the ability to waive reparations and to identify upfront the specific arbitration forum where any dispute would be heard. Moreover, intermediaries should be able to decide not to do business with any institutional customer which does not agree to sign a PDA.

NFA also encourages the Commission to use this opportunity to clarify the reach of pre-dispute arbitration agreements. There have recently been several court cases where registrants have successfully argued that the PDA does not apply to their claims against the customer. NFA questions the logic of this argument since there is no consideration for a customer to sign a PDA if it does not apply to the intermediary. At least with respect to NFA Members, the customer always has the right to arbitrate any dispute even without a PDA. This would be an opportune time for the Commission to either clarify that PDAs flow both ways or that the agreement must make it clear when it does not bind the registrant to arbitrate its claims.

The Commission's proposal would also permit the forum to accept any counterclaim which arises out of the same transaction or occurrence. Other counterclaims would be allowed only if the customer agreed to it being heard after the counterclaim has arisen. NFA disagrees with this provision of the proposal. For both retail and institutional customers, NFA believes that the parties should be allowed to agree in advance that any counterclaim would be required to be included in the arbitration proceeding.

In closing, NFA is pleased with the Commission proposal and believes it is an excellent first step in eliminating the one-size fits all approach to regulatory these markets. NFA encourages the Commission to consider the comments of all market participants in drafting the final rules. NFA also wishes to make it clear that its staff is available to more fully discuss this proposal with Commission staff and is ready and able to assume any responsibilities delegated by the Commission in carrying out the new regulatory regime.

Very truly yours,

Daniel J. Roth
Executive Vice President
and General Counsel
National Futures Association

/nam(LTRS:Comment Letter 080700)