



January 18, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Registration of Foreign Boards of Trade (CFTC RIN 3038-AD19)

Dear Mr. Stawick:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which are to establish a registration requirement and related regulation procedures and conditions that apply to Foreign Boards of Trade ("FBOTs") that wish to provide their members or other participants with direct access to their electronic trading and order matching systems as authorized by provisions of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act").

Introduction

The Proposed Rules pose a difficult conceptual issue. The Dodd-Frank Act establishes a comprehensive structure for the derivatives market. Many elements of the Dodd-Frank Act are intertwined, collectively designed to create a transparent, fair and reliable marketplace. Examples of those elements include the interconnected provisions relating to clearing requirements, regulation of swap dealers ("SDs) and major swap participants ("MSPs"), designated contract markets ("DCMs"), swap execution facilities ("SEFs") and derivatives clearing organizations ("DCOs"). Each part must be viewed independently and as part of the entire system when assessing how a change to one part might affect the other parts of the system.

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

Enabling FBOTs to provide direct access to members and other participants in the United States increases the interconnection between the US marketplace, which is subject to the Dodd-Frank Act regulatory structure, and other derivatives trading marketplaces, which are not subject to that regulatory structure. ***There is no escaping that this undercuts the effectiveness of the Dodd-Frank Act unless the safeguards and systems applicable to the FBOTs that are given direct access are the same as or equivalent to the Dodd-Frank Act structure.***

For instance, SDs and MSPs are subject to rigorous standards because safeguards for these important market participants enhance the continued financial integrity of the marketplace. Tying participants in the market established by the Dodd-Frank Act to trading entities (which would be SDs and MSPs if subject to the Dodd-Frank Act jurisdiction) through FBOTs is an obvious concern.

Transparent and fairly priced markets are also a central tenet of the Dodd-Frank Act. Contracts offered by FBOTs may be designed to mirror contracts traded through DCMs and SEFs (such contracts offered by FBOTs being defined in the Proposed Rules as “Linked Contracts”). The price of a Linked Contract refers to the mirrored DCM- or SEF-traded contract. The example cited in the Proposed Rules was a contract listed by ICE Futures Europe (an FBOT operating under a no-action letter) in which the settlement price was linked to the NYMEX West Texas Intermediate light sweet crude contract.

Because they are in all material respects the same as a contract traded by a DCM or SEF, Linked Contracts could frustrate the goal of transparent and fairly priced markets unless the regulatory regime governing the FBOTs and the administration of those regimes is equivalent to the US system.

As a result, it is difficult to see any reasonable circumstances where allowing interconnection between the system established under the Dodd-Frank Act and an FBOT’s system can ever be justified. There will inevitably be uncertainty that the parallel systems, even if they are determined to be adequately structured, will be administered and regulated similarly to the markets subject to CFTC oversight and regulation.

Even if this obstacle is overcome, the FBOT registration and oversight process in the Proposed Rules must address two issues differently:

- Requirements relating to an FBOT’s market participants in the home jurisdictions of such FBOT, in which market participants are equivalents of SDs and MSPs, must be the same as, or equivalent to, the requirements applicable to SDs and MSPs under the Dodd-Frank Act; and
- Linked Contracts must be more broadly defined to include contracts that are reasonably likely to influence prices of the DCM/SEF-traded contracts as well as contracts that directly reference the prices of DCM/SEF-traded contracts.

Regulatory Authority and Proposed Approach

The Dodd-Frank Act permits (but does not require) the CFTC to adopt rules and regulations requiring registration of FBOTs that provide direct access to members and other participants located in the United States.² Such access has been granted previously, but solely by the process of no-action letters.³ The registration process would bring uniformity and certainty to the process.

The Proposed Rules require registration of FBOTs providing direct access; establish standards for registration eligibility; establish registration procedures and requirements; address those FBOTs which are functioning currently under no-action letters; provide for conditions on registration, in particular for conditions related to Linked Contracts; provide for revocation of registration; and establish procedures for adding contracts.⁴

The transparency and predictability of a registration process is clearly in the public interest, especially in light of the systemic collapse that was partially caused by market participants that operated outside the scope of regulation.

Discussion of Proposed Rules

The approach used under the Proposed Rules relies heavily on a review by CFTC staff of the regulations, policies and procedures applicable to an FBOT seeking direct access to assess their comparability to the regulatory and oversight regime under the Dodd-Frank Act and their adequacy. We believe that this is a very difficult task and one that is conceptually flawed.

Any regime of regulation, policy and procedure is given meaning by its administration. Regulators in other countries will undoubtedly adopt different approaches than the ones adopted by the CFTC; and some may even disregard elements of regulatory regimes that appear to be the same as or equal to the regime developed to implement the Dodd-Frank Act. As discussed above, because FBOTs will be interconnected with US markets, divergent regulatory approaches will, by definition, alter the effectiveness of the Dodd-Frank Act as implemented by the CFTC

If the CFTC pursues the path laid out in the Proposed Rules, it is critically important to continuously monitor both the structure of regulation to which an FBOT is subject and the quality of the administration of that structure. Most importantly, the CFTC must be able to terminate registration, even if the FBOT has done nothing wrong and its home regulations

² Dodd-Frank Act, Section 738.

³ Proposed Rules, Preamble.

⁴ Proposed Rules, Section 48.3-Section 48.10.

have not changed, because of the divergent approach taken by regulators administering those regulations. It is not necessary that the CFTC find the performance of these regulators to be inadequate; registration must be terminated if their approach is divergent from the CFTC, so as to create a materially different trading environment.

The Proposed Rules require as a condition of continuing registration:

The laws, systems, rules and compliance mechanisms of the regulatory regime applicable to the foreign board of trade will continue to require the foreign board of trade to maintain fair and orderly markets; prohibit fraud, abuse and market manipulation; and provide that such requirements are subject to oversight of appropriate regulatory authorities.⁵

This is simply too narrow and too focused on the letter of the law, rather than the realities of the marketplace and the actual application of the law to FBOTs and associated entities. We propose annual reaffirmation and demonstration of the appropriateness of the FBOTs regulatory regime, based on the standards applied in order to qualify initially for registration. These standards for initial qualification⁶ constitute a comprehensive assessment of the FBOT's regulatory regime. Each of the elements of the assessment is significant. ***If this regulatory regime changes in ways in which the FBOT would not be able to qualify for initial registration, the registration should be discontinued.***

In the Preamble to the Proposed Rules, the CFTC requests comments with respect to whether it should examine the regulatory oversight framework applicable to an FBOT's market participants.⁷ ***The answer is an emphatic yes.*** Such examination is critical and must be mandatory. The examination must assess the comparability to US rules relating primarily to SDs and MSPs, including rules relating to collateral, business conduct and trading behavior. Such an examination is required by the purpose for the SD and MSP rules established by the Dodd-Frank Act and the regulations that implement it.

If divergent or inadequate FBOT regulatory regimes could frustrate the regime established under and pursuant to the Dodd-Frank Act, they must be examined. There is no doubt that those aspects of the US regime that are designed to protect the financial system by making certain that ***all*** trading counterparties meet prudential and transparency standards must be equally present in the FBOT's regulatory regime. Similarly, because the FBOT will become inter-related with DCMs, SEFs and DCOs through common membership and participation if direct access is granted, rules governing market transparency, fairness and manipulation must be the same.

⁵ Proposed Rules, Section 48.8(a)(2)(iii).

⁶ Proposed Rules, Section 48.7(e)(1) - (3).

⁷ Proposed Rules, Preamble.

Finally, under the Proposed Rules, specific provisions address Linked Contracts. The Proposed Rules recognize that a registered FBOT that facilitates trading of a Linked Contract can directly and adversely affect the DCMs, SEFs and DCOs that offer the mirror images of the Linked Contract. The FBOT and the US entities are interconnected through the Linked Contract. This interconnection could affect the entire US market.

Under the definition of Linked Contract, the test is whether the Linked Contract settles against any prices of one or more contracts listed for trading by a DCO or SEF.⁸

This definition is far too narrow. It fails to recognize the price relationships that exist among various contracts. A contract offered by an FBOT may not settle against precisely a price of a US listed contract; but this contract's settlements could significantly affect US listed contracts and ultimately entire markets. The parallel is the approach to position analysis, focusing on groupings of price-related contracts, adopted by the Dodd-Frank Act and implementing regulation.⁹ The additional conditions required by the Proposed Rules in respect of Linked Contracts¹⁰ should apply to this broadened category of price related-contracts. They should be included in the definition of "Linked Contracts."

An overly narrow definition of "Linked Contracts" fails to extend the important requirements of the Proposed Rules that protect US markets from all relevant contracts. But it also opens a clear pathway to regulatory arbitrage. Market participants could tactically trade in price-related contracts on FBOTs in order to avoid regulatory rules and procedures applicable to DCMs, SEFs and DCOs. This pathway to regulatory arbitrage must be blocked.

Conclusion

The registration of FBOTs for direct access poses unique challenges because it increases the inter-connectedness of the US derivatives markets with markets in other jurisdictions. If this inter-connectedness is to be facilitated, the regulations must be cautiously structured.

⁸ Proposed Rules, Section 48.2.

⁹ Notice of Proposed Rulemaking, Position Reports for Physical Commodity Swaps, 17 CFR Parts 15 and 20, 75 FR 67258,

¹⁰ Proposed Rules, Section 48.8(c).

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We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,



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