FY 2001 BUDGET &
FY 2001 ANNUAL PERFORMANCE PLAN

Prepared for the
Committee on Appropriations

February 2000

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A Note on the Format:

This document is comprised of two sections: Part I is the FY 2001 President's Budget, which contains the traditional program-based budget structure in which the agency's FY 2001 President's Budget is summarized and justified, pages 1-134; Part II is the FY 2001 Annual Performance Plan, which incorporates the goal-based approach of the CFTC Strategic Plan and in which funds are distributed by Goal and Outcome Objective, see pages 135-286.

In addition, there is a cross-cutting analysis in each section. That is, the program-based analysis of the President's Budget is augmented by a programmatic distribution of resources by Agency Goal. Conversely, the goal-based analysis of the Annual Performance Plan also disaggregates resources by program. Our intent is to engender greater understanding among the public, the Congress, the Administration, market users, and the many other persons and entities with which we work of how the Commission resources contribute to the accomplishment of the agency's mission.

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EXECUTIVE SUMMARY

Introduction to the Commission

The Commodity Futures Trading Commission (the CFTC or the Commission) was created by Congress in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The Commission's mandate was renewed and expanded in 1978, 1982, 1986, and 1992. In 1995, the Commission was reauthorized by Congress and the President through Fiscal Year (FY) 2000.

The CFTC is responsible for fostering the economic utility of futures markets by encouraging their competitiveness and efficiency, ensuring their integrity, and protecting market participants against manipulation, abusive trade practices, and fraud. Through effective oversight regulation, the CFTC enables the commodity futures markets better to serve their vital function in the nation's economy—providing a mechanism for price discovery and a means of offsetting price risks.

The President's Budget for FY 2001 is $72.0 million with 621 full-time equivalents (FTEs). This is a $9.2 million or a 15% increase over the FY 2000 appropriation of $62.8 million and 561 FTEs. This proposed budget provides the Commission with the resources needed to perform its legislative mandate.

Compared to the FY 2000 appropriation, key changes in the FY 2001 President's Budget are:

$ +5.3 million to maintain current services levels for 561 FTEs.

$ +3.9 million to provide for the salary and expenses of 60 additional FTEs.

The FY 2001 President's Budget

Breakout of $72.0 Million Budget Estimate

The Commission is requesting $72.0 Million in FY 2001;

$62.8 Million is the base (FY 2000 Appropriation)
$9.2 Million is the increase in FY 2001. . . .

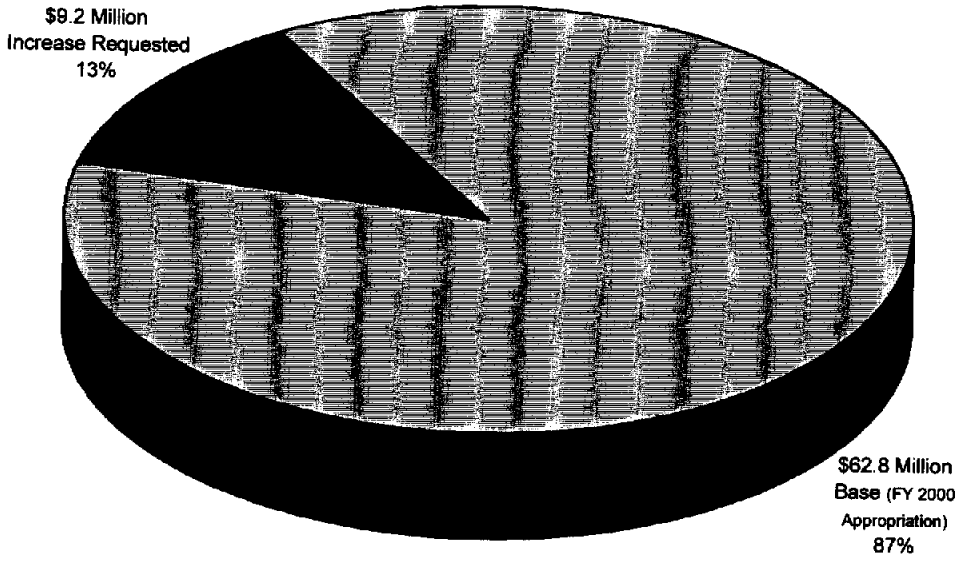

Figure 1: $72.0 Million Budget Estimate

Breakout of Requested $9.2 Million Increase

By Current Services Increase & Program Increase

. . . the requested $9.2 Million increase consists of $5.3 Million to maintain current service levels for 561 FTEs and $3.9 Million for 60 additional FTEs . . . .

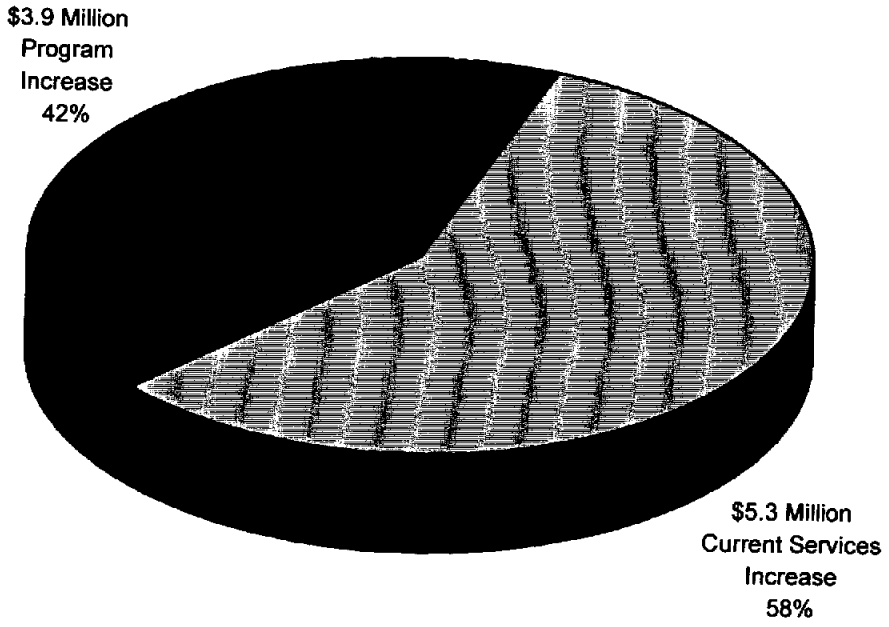

Figure 2: Requested $9.2 Million Increase

Breakout of $72.0 Million Budget Estimate

By Program Activity

. . . . the $72.0 Million Budget is allocated among five programs: Enforcement; Trading & Markets; Market Surveillance, Analysis & Research; Proceedings; and General Counsel. There is one support program: Executive Direction . . . .

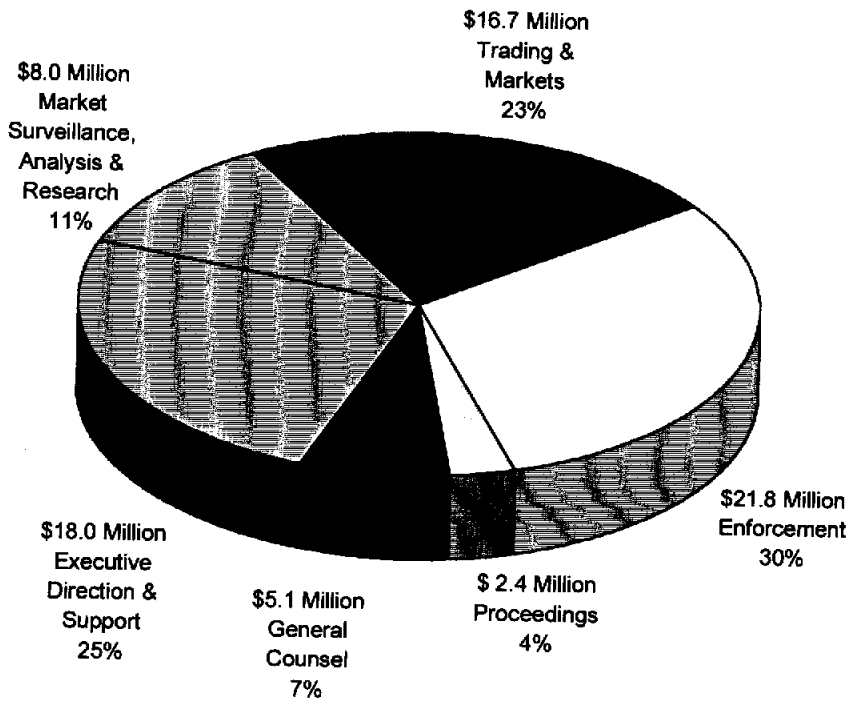

Figure 3: $72.0 Million Budget Estimate by Program

Breakout of Requested $9.2 Million Increase

By Program Activity

. . . . 85% of the requested $9.2 Million increase is earmarked for the five programs; only 15% is allocated for support . . . .

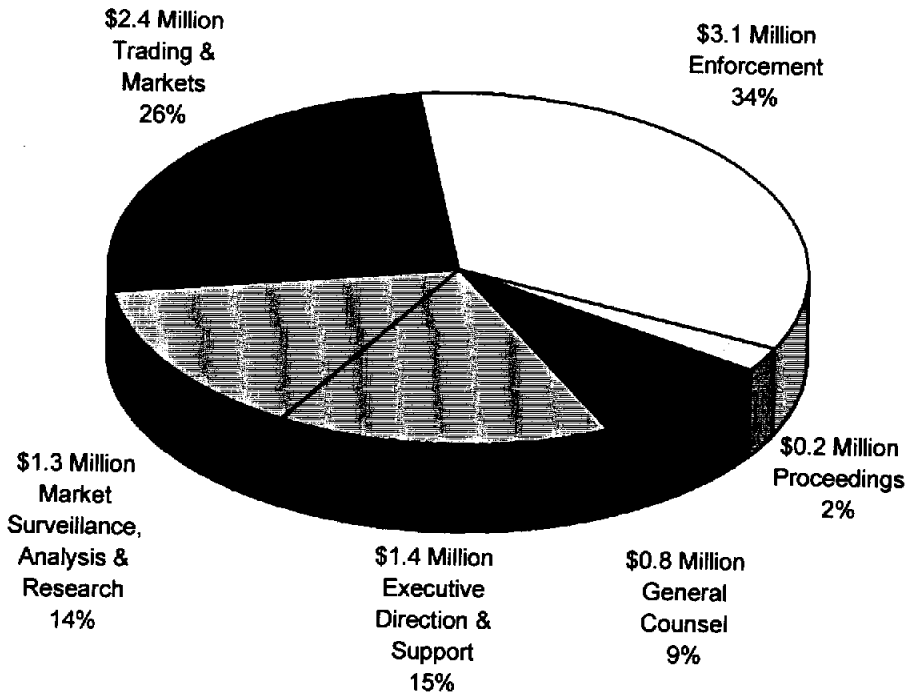

Figure 4: $9.2 Million Increase by Program

Breakout of $72.0 Million Budget Estimate

By Object Class

. . . . approximately 75% of the CFTC's budget covers staff salaries and benefits . . . .

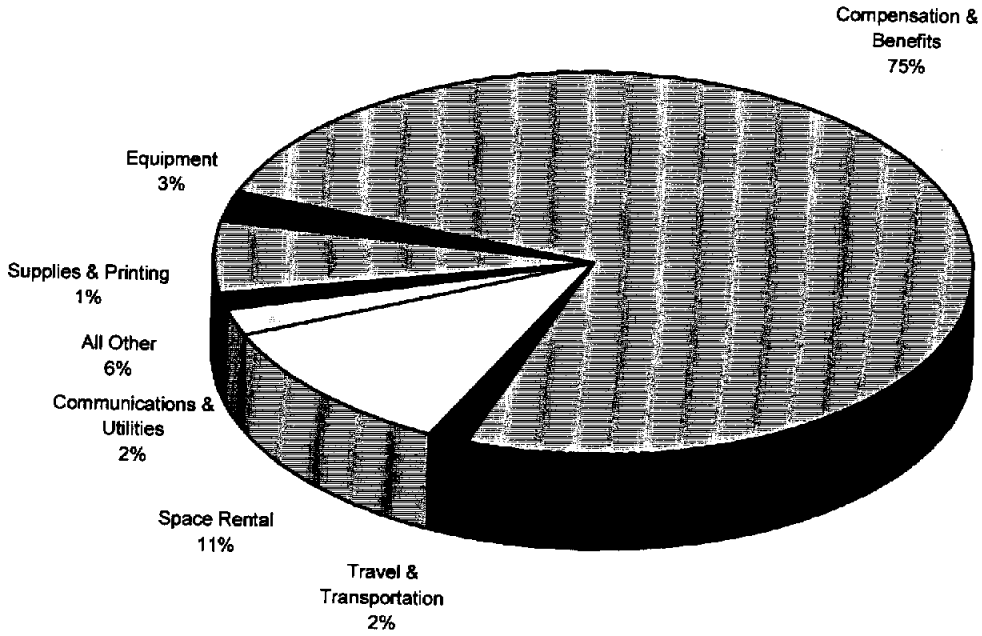

Figure 5: $72.0 Million Budget Estimate by Object Class

Breakout of Requested $9.2 Million Increase

By Object Class

. . . . over 70% of the requested $9.2 Million increase covers staff salaries and benefits. . . .

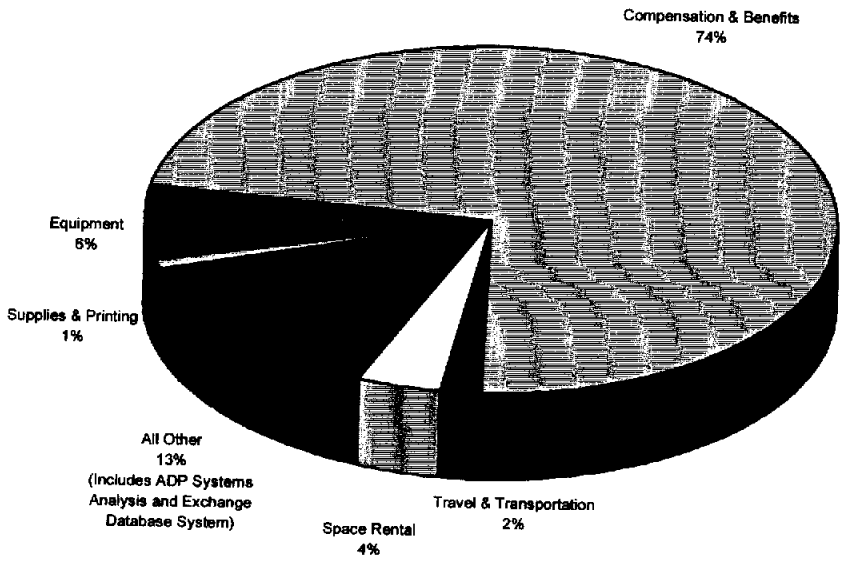

Figure 6: $9.2 Million Increase by Object Class

Crosswalk From FY 2000 to FY 2001

	FY 2000 Estimate	FY 2001 Request	Change
Budget Authority ($000)	$62,761	$72,000	$9,239
Full-Time Equivalents (FTEs)	561	621	+60

Explanation of Change	FTEs	Dollars ($000)
Increases: (Adjustments to FY 2000 Base)		
To provide for full funding of the FTE ceiling of 621	+60	$3,532
To provide for annualization of estimated Jan. 2000 4.94% pay increase		444
To provide for estimated January 2001 3.7% pay increase		956
To provide for within-grade increases		324
To provide for increased costs of benefits		1,681
To provide for increased costs in other non-personnel services		2,302
Travel/Transportation ($152)		
Space Rental ($370)		
Communications/Utilities ($-162)		
Supplies/Printing ($48)		
ADP-Systems Analysis & Programming ($911)		
Equipment ($633)		
All Other (Maintenance, Transcription Svcs, Training, Tenant Alterations, etc.) ($350)		
Total Increases	**+60**	**$9,239**

Table 1: Crosswalk from FY 2000 to FY 2001

CFTC Mission Statement and Agency Goals

Mission Statement

The mission of the Commodity Futures Trading Commission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity futures and options, and to foster open, competitive and financially sound commodity futures and option markets.

Goal One
Protect the economic functions of the commodity futures and option markets.
Outcome Objectives
1. Foster futures and option markets that accurately reflect the forces of supply and demand for the underlying commodity and are free of disruptive activity.
2. Oversee markets which can be used effectively by producers, processors, financial institutions, and other firms for the purposes of price discovery and risk shifting.

Goal Two
Protect market users and the public.
Outcome Objectives
1. Promote compliance with, and deter violations of, federal commodities laws.
2. Require commodities professionals to meet high standards.
3. Provide a forum for effectively and expeditiously handling customer complaints against persons or firms registered under the Commodity Exchange Act.

Goal Three
Foster open, competitive and financially sound markets.
Outcome Objectives
1. Ensure sound financial practices of clearing organizations and firms holding customer funds.
2. Promote and enhance effective self-regulation of the commodity futures and option markets.
3. Facilitate the continued development of an effective, flexible regulatory environment responsive to evolving market conditions.
4. Promote markets free of trade practice abuses.

Breakout of $72.0 Million Budget Estimate

By Agency Goal

. . . . the $72.0 Million Budget is allocated among the agency's three Strategic Goals as follows . . . .

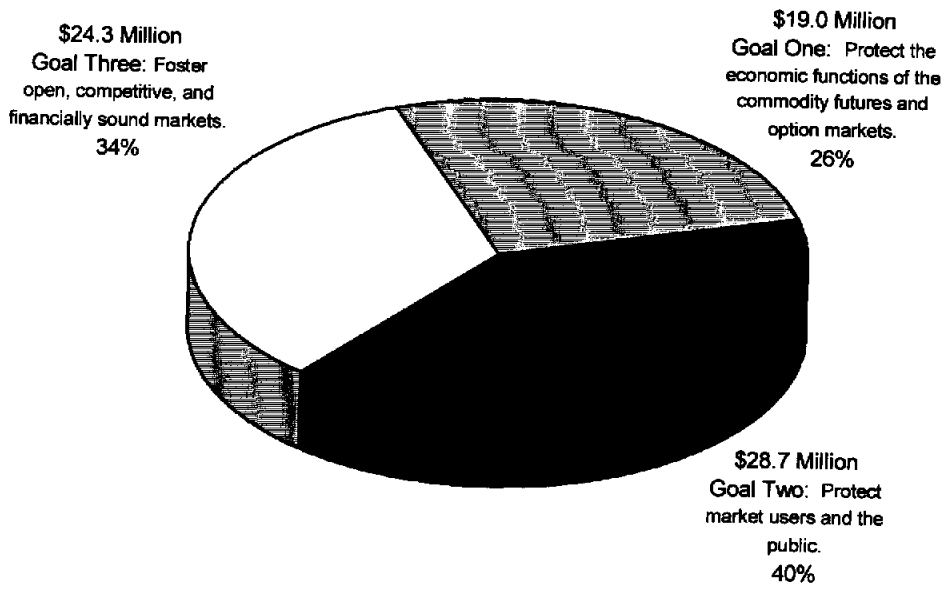

Figure 7: $72.0 Million Budget Estimate by Agency Goal

Breakout of Requested $9.2 Million Increase

By Agency Goal

. . . . the requested $9.2 Million increase is allocated among the agency's three Strategic Goals as follows . . . .

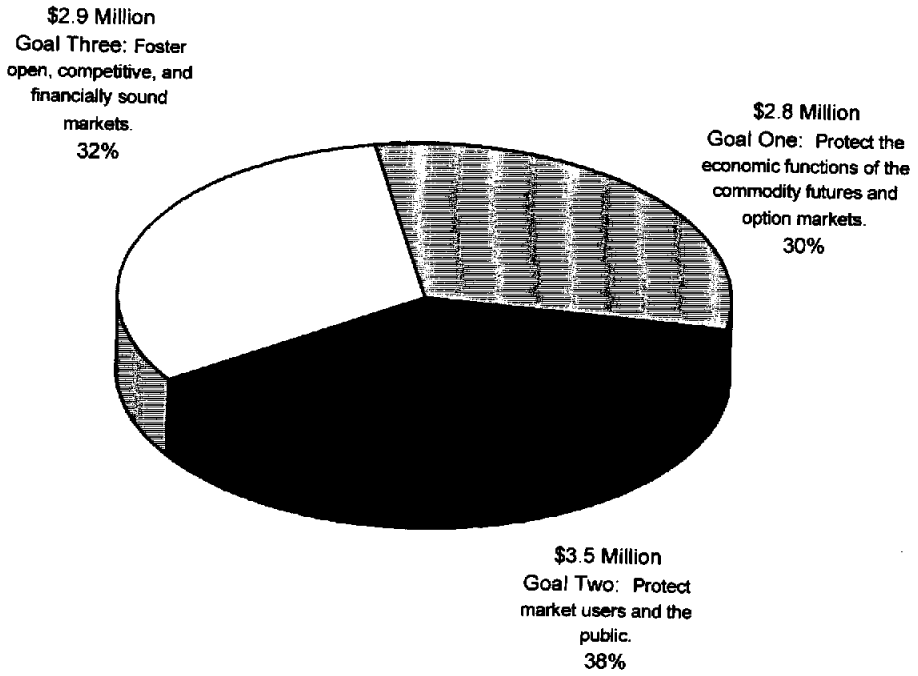

Figure 8: $9.2 Million Increase by Agency Goal

Ranking of Commission Outcome Objectives

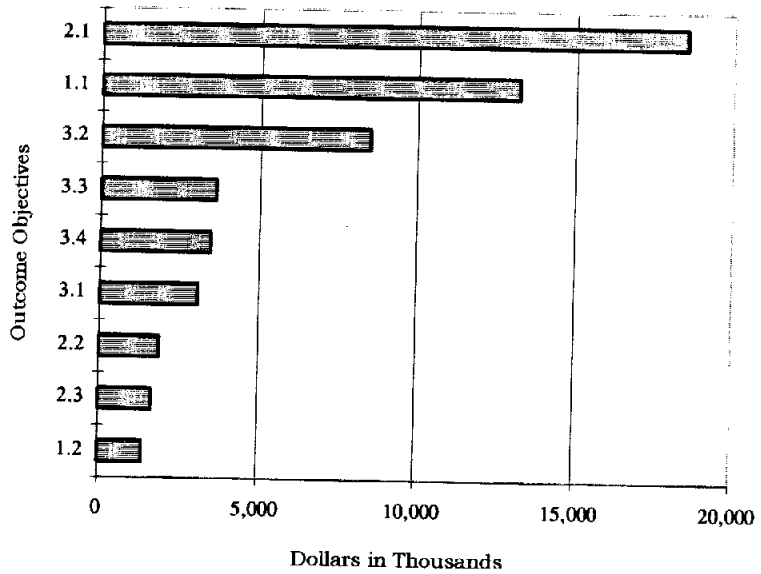

Table 2: Outcome Objectives by Dollars Budgeted

	Outcome Objective
2.1 [1/]	Promote compliance with, and deter violations of, federal commodities laws.
1.1	Foster futures and option markets that accurately reflect the forces of supply and demand for the underlying commodity and are free of disruptive activity.
3.2	Promote and enhance effective self-regulation of the commodity futures and and option markets.
3.3	Facilitate the continued development of an effective, flexible regulatory environment responsive to evolving market conditions.
3.4	Promote markets free of trade practice abuses.
3.1	Ensure sound financial practices of clearing organizations and firms holding customer funds.
2.2	Require commodities professionals to meet high standards.
2.3	Provide a forum for effectively and expeditiously handling customer complaints against persons or firms registered under the Commodity Exchange Act.
1.2	Oversee markets which can be used effectively by producers, processors, financial institutions, and other firms for the purposes of price discovery and risk shifting.

[1/] Denotes Goal Two, Outcome Objective One. (See page 9.)

Significant Developments in the Past Year

Enforcement

The primary goal of the Enforcement program is to police futures markets for conduct that violates the Commodity Exchange Act (CEA or the Act) or Commission regulations. Such misconduct undermines the integrity of the markets and the confidence of market participants. The Enforcement staff always look for new ways to enhance their ability to detect and deter wrongdoing. In FY 1999, Enforcement staff recommended that the Commission take important actions using novel substantive and procedural approaches. The following matters are examples of significant developments in FY 1999:

- *Copper Manipulation*. In May 1999, the Commission filed a one-count administrative complaint against Global Minerals and Metals Corporation (Global); Global's president and chief executive officer R. David Campbell; and Global's chief copper trader, Carl Alm. The complaint alleged that the respondents manipulated, cornered, and attempted to manipulate and attempted to corner the copper market in late 1995. The complaint also named Merrill Lynch & Co. Inc. (Merrill Lynch), Merrill Lynch International Inc. (Merrill International), and Merrill Lynch, Pierce, Fenner and Smith (Brokers & Dealers) Limited of London, England (Merrill (B&D)) (collectively referred to as the Merrill Lynch respondents), and alleged that these respondents aided and abetted Global, Campbell, and Alm in the worldwide copper market manipulation and attempted manipulation. Specifically, the complaint alleged that between October and December 1995, Global, Campbell, and Alm, together with Sumitomo Corporation of Japan, manipulated and attempted to manipulate upward the worldwide price of copper and copper futures contracts in violation of the Act. According to the complaint, the manipulation of copper prices was the culmination of a long and deliberate scheme by Campbell and Sumitomo's former chief copper trader, Yasuo Hamanaka (Hamanaka), to acquire large market positions and liquidate them at distorted and artificially high prices. The CFTC alleged that Global, Campbell, and Alm, among other things: acquired and maintained a dominant and controlling position in London Metal Exchange (LME) warehouse stocks of copper and thereafter withheld substantially all or a large percentage of that copper from the market; purchased and held massive and unneeded long copper futures contract positions; and engaged in an elaborate scheme of deception and false statements, which fostered the manipulation. As a result of their conduct, the complaint alleged that the prices of copper futures contracts, copper spread price differentials, and the prices of cash or physical copper, both in the US and abroad, reached artificially high levels. *In re Global Minerals & Metals Corp., et al.*, CFTC Docket No. 99-11 (CFTC filed May 20, 1999).

In June 1999, the Commission issued an order accepting the offer of settlement of Merrill (B&D) and Merrill International. Without admitting or denying the allegations of the complaint or the findings contained in the order, Merrill (B&D) and Merrill International consented to the entry of the order, which found that they aided and abetted violations of the anti-manipulation provisions of the Act during the fourth quarter of 1995. More specifically, the order found that the firms aided and abetted the manipulators (Sumitomo Corporation of Japan and others) in at least the following ways: by providing more than one-half billion dollars of credit and finance to the manipulators; by providing trading facilities, accounts, and trading capacity through which the manipulators acquired their dominant position in a combination of futures contracts and warehouse stocks, and through which the manipulators sold or lent a small portion of their holdings at artificially high absolute prices and artificially high backward-dated spread price differentials; and by providing trading advice, which the manipulators used in the execution of their strategy of withholding their copper from the market. The order stated that Merrill (B&D) and Merrill International possessed the requisite knowledge and intent to find that they aided and abetted the manipulators' violations. In addition, the order found that Merrill (B&D) benefited from the manipulation by providing financing, trading facilities, and credit to the manipulators, and by earning profits through its proprietary trading. The CFTC ordered the companies to pay a civil monetary penalty of $15 million and to cease and desist from further violations of the Act, as charged. The settlement also requires the Merrill Lynch respondents to cooperate with the CFTC in proceedings and any investigations related to this matter, and dismisses the action as to Merrill Lynch & Co., Inc. The case against Global is ongoing. *In re Global Minerals & Metals Corp., et al.*, CFTC Docket No. 99-11, Order Making Findings And Imposing Remedial Sanctions As To Respondents Merrill Lynch, Pierce, Fenner & Smith (Brokers & Dealers), Ltd. And Merrill Lynch International, Inc., and Dismissing The Proceedings As To Respondent Merrill Lynch & Co., Inc. (CFTC entered June 30, 1999).

- *Supervision and Compliance*. In May 1999, the Commission issued an order, simultaneously instituting and settling an administrative proceeding naming Refco, Inc., a registered futures commission merchant (FCM). According to the order, the matter arose out of trade allocations by a registered introducing broker (IB). The order states that, from at least January 1995 through December 1995, the IB typically placed orders for thousands of US Treasury bond futures and options contracts per day for his customers through Refco, and the IB placed a substantial number of such orders without providing account identification to Refco. After the orders were executed, according to the order, the IB assigned those trades to customer accounts, directing posi-

tions as the IB chose, and sometimes moved trades between accounts after trades had been assigned and cleared. The order finds that Refco failed to: 1) comply with Commission regulations regarding order-taking and recordkeeping in handling customer orders; 2) administer a proper supervisory system; and 3) investigate indications of improper handling of trades. Refco consented to issuance of the order without admitting or denying the findings.

The CFTC ordered the company to cease and desist from further violations of those provisions of the CEA and to pay a total of $7 million, of which $6 million will be paid immediately as a civil monetary penalty. The remaining $1 million will be used to fund a study of issues associated with order transmission and entry procedures for exchange-traded futures and options and the diligent supervision of the order transmission and entry process by commodity professionals. The study, the first of its kind in the futures industry, will be overseen by representatives of the National Futures Association (NFA) and the Futures Industry Institute (FII), among others. The order also requires Refco to conduct an internal study to review and make recommendations concerning its compliance policies and procedures related to its handling of trades by its trading floor and back office personnel as may be necessary to conform such procedures to the requirements of the CEA, CFTC regulations and exchange rules and to prevent recurrence of the type of conduct discussed in the order. *In re Refco, Inc.*, CFTC Docket 99-12 (CFTC filed May 24, 1999).

- *Fraudulent Internet Solicitations*. In FY 1999, the Commission also demonstrated its ability and commitment to respond when new methods, such as the Internet and "spam" e-mail, are used as the means to cheat or defraud the public. Such methods pose a new threat because they enable malefactors to solicit business fraudulently from millions of people quickly and cheaply. With use of the Internet and e-mail growing, the Commission has brought its first action to address the use of mass marketing via e-mail, known as "spamming," to defraud retail customers. In the case captioned *In re Dunhill Financial Group, Inc., et al.*, CFTC Docket No. 99-7 (CFTC filed March 4, 1999), the Commission filed a four-count administrative action against Dunhill Financial Group, Inc. (Dunhill), Dunhill's sales manager Mark Hutcherson, Dunhill's compliance officer Kevin Jackam, New Millennium Promotions (NMP), and two NMP employees, Michael Thomas and Forrest Dayton, Jr. The complaint charged that Dunhill, a registered IB, and Dunhill's registered associated persons (APs), Hutcherson and Jackam, violated the anti-fraud provisions of the Act and Commission regulations by fraudulently soliciting prospective customers to open accounts to trade options on commodity futures contracts. The complaint also charged NMP with operating as an unregistered IB of Dunhill. Thomas and Dayton were charged with failing to register as APs of NMP. The com-

plaint alleged that NMP solicited customers over the Internet on Dunhill's behalf by sending unsolicited bulk e-mail in return for a fee paid by Dunhill for generating a list of prospective customers. The complaint also alleged that, from October 1995 through the filing of the complaint, Dunhill, Hutcherson, and Jackam made false and misleading statements regarding the likelihood of profit, risk of loss and amount of commissions involved in the trading of commodity options. Specifically, they led customers to believe that customers who purchase options on futures contracts would profit from seasonal and other existing and known supply and demand forces that affect the prices of certain commodities in the cash market. These misrepresentations were allegedly made in advertisements over the Internet, on the radio, in promotional materials sent to customers, and in direct telephone solicitations of prospective customers. As alleged in the complaint, at least 91.4 percent of the customer accounts opened by Dunhill from October 1995 through September 1998 lost money, and that total net losses, including commissions, were in excess of $9.3 million.

- *Fraudulent Trade Allocation*. In December 1998, the Commission filed a three-count administrative complaint against Kyler F. Lunman II, his company, Hold-Trade, Inc. (also known as Hold Trade, Ltd.) (Hold-Trade) and Steven G. Soule, a former employee of Coastal Corporation (Coastal). The complaint was amended on February 4, 1999 to add as a respondent Robert C. Rossi, the principal owner and manager of Refined Energy Executions, Inc. and Refine Executions, Inc. (collectively, Refined) which provided Coastal with floor broker (FB) services on the New York Mercantile Exchange (NYMEX). The complaint alleged that, from September 1993 through December 1994, the respondents defrauded Coastal by misappropriating its energy futures trades and wrongfully allocating them to accounts they controlled. Specifically, the complaint alleged that Soule, as the Coastal employee responsible for entering its energy futures orders to the floor of the NYMEX, allocated, with the assistance of one of Refined's telephone clerks, profitable Coastal trades to futures trading accounts owned or controlled by respondents Lunman and Hold-Trade who distributed the profits among the members of the scheme. *In re Soule, et al.*, CFTC Docket No. 99-4 (CFTC filed December 22, 1998, amended February 4, 1999).

- *Part 14 Debarments*. In October 1998, the Commission entered an order instituting proceedings, making findings, and imposing sanctions on Anatoly Osadchy, also known as Anthony Osadchy, who the Commission found had engaged in unprofessional conduct within the meaning of Commission Regulation 14.8(c) in connection with his audit of an IB. In the order, which accepted an offer of settlement in which Osadchy neither accepted nor denied the findings, the CFTC specifically found that Osadchy failed to follow Generally Accepted Accounting Standards by, among other things: failing to maintain adequate training and profi-

ciency as an auditor; failing to educate himself regarding an IB's business, even though he had never audited a registrant; failing to employ adequate audit procedures to find potential fraud, errors, or irregularities in the financial statements; and by opening an active trading account with the IB and therefore failing to maintain his required professional independence. As part of the settlement, the Commission ordered Osadchy permanently denied the privilege of practicing or appearing before the Commission and ordered respondent to comply with his undertaking not to apply to the Commission for reinstatement. *In re Osadchy*, CFTC Docket No. 99-2 (CFTC filed October 29, 1998).

Commission's Task Force on Regulatory Reform

The Commission has undertaken a broad review of its regulations and their effect on the competitiveness and efficiency of derivatives markets. Over the past decade, there have been significant advances in the development and use of derivative instruments, including futures and option contracts, as well as in the trading platforms on which these instruments are executed. In an effort to ensure that the regulatory scheme under which these contracts are traded remains current, the Commission has undertaken a broad review of its rules with the intention of eliminating obsolete rules and streamlining and coordinating regulations across markets. The Commission anticipates completing its review in early 2000.

Regulatory Reform

The CFTC has been engaged in a comprehensive regulatory reform effort designed to update, modernize, and streamline its regulations in order to improve markets and protect market participants. This effort has included:

- *Bunched Orders*. Adoption of new Commission Rule 1.35(a-1)(5) which allows post-execution allocation of bunched orders. This new rule eliminates the need for customer account identifiers on order tickets thereby permitting account managers to allocate the fills at the end of a day. Pursuant to this, the Chicago Board of Trade (CBT) and the Chicago Mercantile Exchange (CME) have submitted proposed rules which the Commission has allowed into effect. (October 1998)

- *EFS Transactions*. Approval of the NYMEX proposal to adopt new Rule 6.21A, which authorizes the noncompetitive exchange of futures contracts for qualifying swap agreements (EFS transactions) pursuant to the terms and conditions of a three-year pilot program. (January 1999)

- *Block Trading*. Issuance of an *Advisory on Alternative Execution, or Block Trading, Procedures for the Futures Industry*, whereby the

Commission will consider contract market proposals to adopt alternative execution procedures for large size or other types of orders on a case-by-case basis under a flexible approach to the requirements of the CEA and Commission regulations. The advisory enables each contract market to retain its discretion to permit alternative execution procedures and to have the ability to develop procedures that reflect the particular characteristics and needs of its individual markets and market participants. (June 1999)

- *Disciplinary Notices*. Delegation to NFA certain regulatory responsibilities associated with Commission Regulation 9.11. The Commission has issued an advisory informing the exchanges that they can directly file Regulation 9.11 disciplinary notices with NFA, either electronically or in writing, rather than with the Commission. In this vein, the Commission has also issued an order delegating to NFA the duty to collect, process, and maintain Regulation 9.11 notices submitted by exchanges.

- *Foreign Advisors and Disclosures*. Adoption of amendments to Commission Rules 30.5 and 30.6. Amended Rule 30.5 permits a foreign person acting in the capacity of an IB, commodity trading advisor (CTA) or commodity pool operator (CPO) who deals with US customers to obtain an exemption from registration in certain circumstances. To obtain a Rule 30.5 exemption, the person must file a petition for exemption with and receive confirmation from the NFA. The Commission also amended the disclosure requirements of Rule 30.6 to "level the playing field" between CTAs and CPOs trading domestic products and CTAs and CPOs trading foreign futures and options. Under amended Rule 30.6, CTAs and CPOs must provide similar disclosures to clients or participants regardless of whether they trade on domestic or foreign markets. Amended Rule 30.6 also decreases the amount of disclosure to be provided to sophisticated investors. Pursuant to a Delegation Order issued concurrently with the rule amendments, the Commission authorized NFA to review the disclosure documents filed pursuant to Rule 30.6.

- *Temporary Licenses*. Adoption of rule amendments and approval of related NFA rules to permit NFA to issue temporary licenses (TLs) to certain applicants for registration as APs, FBs, floor traders (FTs), and guaranteed IBs despite a "yes" answer to a disciplinary question.

- *Administrative Process*. Improvement of the fairness and efficiency of the administrative process by adopting: 1) new rules to establish a specific procedure for filing requests for no-action, exemptive, and interpretative letters to give structure to the process; 2) new rules to provide greater guidance to requesters and make the process more transparent to all interested parties; and

3) amendments to CFTC Part 10 rules, which update procedures in administrative enforcement actions brought under the Act.

- *Performance Data and Disclosure for CTAs*. Proposed amendments to Part 4 of the Commission's rules concerning the documentation, computation, and disclosure of CTA past performance information. The rules would simplify the recordkeeping and computational requirements for CTAs who accept partially funded client accounts while providing for meaningful and focused disclosure to clients regarding the past performance of the CTA and the risks attendant upon trading on a partially funded basis.

- *Risk-Based Capital*. Review of the impact of risk-based capital rules of the CME, CBT, and the Board of Trade Clearing Corporation (BOTCC) on capital requirements of CME and CBT clearing members. These rules were the first risk-based capital rules approved by the Commission in FY 1998. The new rules amended existing capital rules by requiring CME and CBT clearing members to maintain adjusted net capital in excess of the greater of the following: 1) minimum dollar balances established by the applicable exchange or clearing organization; 2) regulatory capital requirements set by the Commission or the US Securities and Exchange Commission (SEC); or 3) risk-based capital computations.

Innovative New Markets

In FY 1999, the Commission reviewed and approved 73 applications for new futures and option contracts, 30 of which were submitted and approved under fast-track procedures. Several of the approved contracts represent innovative approaches designed to meet specialized hedging needs of producers and firms. For example, the Commission approved weather-related futures and option contracts submitted by the CME based on heating degree days and cooling degree days for 10 cities. These contracts, the first approved relating to weather-related data, were specifically designed to deal with the unique hedging needs of firms exposed to risk arising from temperature variations. Also, the Commission approved futures and option contracts submitted by the Commodity Exchange, Inc. (COMEX), Division of the NYMEX based on aluminum produced throughout the world, as well as various dairy and regional electricity contracts.

International Regulatory Cooperation

- *Hedge Funds*. Actions involving responding to events in the financial markets related to the activities of hedge funds and other highly leveraged institutions dominated a significant part of Commission activities in the International Organization of Securities Commissions (IOSCO). The Technical Committee organized

a task force to consider recommendations that would strengthen risk management processes, improve information flows and identify areas where it may be advisable to cooperate with other interested international parties, such as the Basle Banking Committee. Commission staff, working through the working parties on secondary markets and market intermediaries, respectively, continued to play an active role in these developments.

- *"Best Practices."* The Commission also is actively engaged in the IOSCO Task Force on the implementation of the IOSCO report *Objectives and Principles of Securities Regulation* (Core Principles) that were adopted last year as a statement of international "best practices." The Commission has been participating in drafting groups that are preparing surveys for a high-level self assessment on the extent to which the Core Principles have been implemented.

- *Year 2000 Preparedness*. The Commission also actively contributed to IOSCO's activities to address challenges posed by the Year 2000 problem, including the development of a draft statement on Year 2000 testing and contingency planning.

- *Electronic Markets*. Responding to the increasing development of cross-border electronic markets, IOSCO also has initiated work on examining the status of regulation of electronic markets and the need for revisions to IOSCO's 1990 statement of regulatory principles. The Commission actively participates in this effort.

- *Over-the-Counter Derivatives*. In 1999, the Commission completed the report, *Survey of the Regulation of Over-the-Counter Derivatives Transactions,* which examined the regulatory regimes in 16 jurisdictions across Europe, Asia and North and South America. The survey was undertaken to support the Commission's inquiries into the over-the-counter (OTC) markets and was intended to serve as a resource to make existing requirements more accessible and to facilitate further study of the treatment of OTC derivatives. In this regard, copies of the report were provided to the President's Working Group and to members of the IOSCO Technical Committee.

Agricultural Trade Options

- *New Regulatory Scheme*. Effective June 15, 1998, the Commission removed the longstanding ban on agricultural trade options. Despite these rules going into effect, no one had applied for registration as an agricultural trade option merchant (ATOM). Consequently, in response to additional industry input, the Commission found it appropriate in December 1999 to amend its agricultural trade option rules in order to stimulate interest in these instruments. The amended rules, which permit greater flexibility

in the offer and sale of agricultural trade options, went into effect on February 2, 2000.

- *History*. Agricultural options (both on- and off-exchange) were traded in the US at least from the mid-1800s until the 1930s. However, concerns about fraudulent sales practices, failures to perform OTC obligations, and the use of exchange-traded options to manipulate the prices of agricultural commodities prompted numerous industry and government efforts to limit or eliminate trading in agricultural options. In 1936, Congress banned all sales of options on certain agricultural commodities listed in the Act. The Commission permitted exchange trading in options on agricultural futures in 1984. There have been deep divisions within the agricultural community on whether the ban on off-exchange agricultural options should be lifted. Opponents of lifting the ban have expressed concerns over possible fraudulent activity and suggested that such contracts might result in confusion in the producer community. Others wish the Commission would permit use of trade options in the agricultural sector.

- *Public Meetings & Comment*. The Commission and its staff conducted numerous meetings with representatives of agricultural interests focusing on areas of concern in the program rules. Agricultural trade options were also discussed at meetings of the Agricultural Advisory Committee on August 12, 1998 and on April 21, 1999. In particular, some observers suggested that certain provisions of the final rules discourage participation, and agricultural trade options would be offered more readily if the rules were modified.

- *Proposed Rule Amendments*. Based in part on those views, the Commission published a notice of proposed rulemaking in the *Federal Register* on August 31, 1999 that proposed a number of significant amendments to its agricultural trade option rules. These proposed changes were to allow more flexibility in the types of options that can be offered, to streamline the reporting and disclosure requirements, and generally to bring the rules more in line with practices in the cash markets.

- *Rule Amendments*. After carefully considering the comments, the Commission published a notice of final rulemaking in the *Federal Register* on December 6, 1999, amending its agricultural trade option rules. These amended rules were effective on February 2, 2000. In particular, the rules now permit cash settlement and offset or cancellation of agricultural trade options. Under the prior rules, an agricultural trade option, if exercised, had to result in physical delivery of the underlying commodity. These amended rules give parties greater flexibility to settle an option through financial means. The amendments also streamlined the registration requirements for ATOMs and their sales agents in several respects including removing the training requirement for

those sales agents. Changes to the rules also revised the required disclosure statements and streamlined and reduced overall reporting and recordkeeping requirements. Commission staff briefed the public on the amended rules during the latest meeting of the Agricultural Advisory Committee on December 8, 1999.

Chicago Board of Trade Wheat Delivery Rules

- *CBT Survey and Task Force*. In December 1996, the Commission directed the CBT to complete its consideration of possible changes to its wheat contract. The CBT responded with a status report and stated that it would conduct a market research effort to determine whether a broader review of the contract should be undertaken. In August 1997, the CBT conducted a survey of wheat futures contract users to identify desirable changes in contract terms. In January 1998, the Business Development and Marketing Committee of the CBT formed a wheat task force to review the survey results and recommend contract changes to the CBT's Board of Directors. In August 1998, the CBT Board of Directors approved the task force's recommendations and, on October 14, 1998, the membership approved those amendments. The CBT submitted those amendments to the Commission for its review on October 21, 1998.

- *Amendments to the Wheat Contract*. The CBT proposed amendments were designed to enhance its regulatory oversight of the wheat contract. Specifically, the CBT proposed to amend its wheat contract: 1) by reducing the 600-contract spot-month speculative position limit during the last five trading days in the March contract to 350 contracts and in the May contract to 220 contracts; 2) by changing the locational price differential for delivery of wheat at Toledo from a two-cent-per-bushel discount to par and for delivery at St. Louis from an 8-cent-per-bushel premium to a 10-cent-per-bushel premium; 3) by changing the quality price differential for delivery of US No. 1 grade northern spring wheat from par to a premium of three cents per bushel and for US No. 2 grade northern spring wheat from a one-cent-per-bushel discount to par; 4) by requiring regular warehouse or shipping station operators at Chicago and St. Louis to give preference to orders to load out wheat for futures delivery over their cash commitments; 5) by deleting provisions relating to in-loading of wheat at regular warehouses in Chicago and St. Louis; and 6) by changing the last trading day of the contract to the business day prior to the 15th calendar day of the month and the last delivery day to the seventh business day following the last trading day.

- *Public Comment*. The Commission requested public comment on the exchange rule amendments raising a number of specific issues for response, including whether under the proposed amendments deliverable supplies would be sufficient to prevent or diminish price

manipulation, market congestion, or the abnormal movement of such commodity in interstate commerce. The Commission also requested comment on the likely effect on deliverable supplies which might result from the increasing concentration of control over delivery facilities.

- *Rule Amendments*. The Commission approved these rule amendments under section 5a(a)(12) of the Act on January 25, 1999. The Commission noted, however, that the amendments did not address the fundamental issues raised by the Commission in its notice and are unlikely to provide a long-term solution to increasing deliverable supplies of wheat during the months of March and May, when deliverable supplies of wheat are lowest. In light of the incomplete nature of the response of the CBT to the problems identified by the Commission in the notice and the difficulty in forecasting deliverable supplies, the Commission directed the CBT to report on the experience with deliveries and expiration performance in the wheat futures contract on an annual basis for a five-year period after contract expirations begin under the revised terms. These reports, in light of existing, and possible further, increases to concentration in the ownership of delivery facilities should include an analysis of whether increased concentration unduly restricts deliverable supply or contributes to congestion or threatened manipulation of the contract.

Chicago Board of Trade Soybean Oil Delivery Rules

In December 1998, the CBT submitted for Commission approval proposed amendments to its soybean oil futures contract. The proposed amendments would: 1) increase to 10 cents per hundredweight (cwt.) from five cents per cwt. the amount by which the contract's locational price differentials for nonpar delivery points may be adjusted under existing rules providing for automatic adjustment of such differentials on an annual basis; 2) establish a maximum limit on the number of warehouse receipts that may be issued for delivery by individual regular warehouses, equal to 30 times the registered daily load-out rate for rail cars at the facility; and 3) require that operators of regular warehouses not located on Class I railroads pay the switching and/or freight costs to the nearest Class I railroad interchange point if requested in writing by the taker of delivery (Class I railroad amendment). The proposed amendments generally become effective with respect to existing contract months commencing with the January 2000 contract month and to all newly listed contract months.

The Commission approved these amendments in June 1999, concluding that they are not inconsistent with the requirements of the CEA or the policies and regulations of the Commission. However, the Commission reminded the CBT of its obligation to maintain delivery terms that conform to Guideline No. 1 and the policy of the

Commission on locational price differentials. In particular, the Commission reminded the CBT of its obligation to monitor locational price differentials of the contract and, if appropriate, take steps to assure that the futures delivery value of soybean oil in each delivery territory reflects the cash market value of soybean oil at each regular warehouse located within such territories. The Commission advised the CBT to monitor carefully the operation of the proposed Class I railroad amendment to assure that it does not serve as an impediment to delivery on the futures contract.

Electronic Trading Developments

The Commission is faced with an increasing number of important issues concerning the impact of technological changes on methods of transacting business on futures exchanges. The Commission has before it three different issues related to developments in electronic trading:

- *Foreign Boards of Trade Automated Trading Systems in the US.* On March 16, 1999, the Commission issued proposed rules concerning access through automated trading systems (computer terminals and automated order routing systems (AORS)) in the US to foreign boards of trade. The Commission received in excess of 50 written comments on the proposed rules and held a roundtable discussion during the comment period. In light of substantial comment suggesting that the issues involved needed to be explored further and the Commission's own reconsideration of these issues, on June 2, 1999, the Commission withdrew the proposed rules and instructed the staff to begin immediately to process no-action requests from foreign boards of trade seeking to place trading terminals in the US. The Commission also committed simultaneously to initiate processes to address comparative regulatory levels between US and foreign electronic systems so as not to provide one with a competitive advantage and to proceed expeditiously toward adoption of rules and/or guidelines. A no-action letter was issued to the London International Financial Futures and Options Exchange (LIFFE) in July, 1999. No-action letters were issued in August 1999 to Eurex (Germany), Marché à Terme International de France (MATIF) as well as the Sydney Futures Exchange and New Zealand Futures and Options Exchange, which jointly operates the Sydney Computerized Overnight Market (SYCOM) system. No-action letters were issued ot the International Petroleum Exchange (IPE) in November 1999 and to the Singapore International Monetary Exchange (SIMEX) in December 1999. A supplemental no-action letter was also issued to LIFFE in December 1999. As of the end of January 2000, there are pending no-action requests from the OM Exchange in the UK (OMLX), the Hong Kong Futures Exchange, and Eurex (Switzerland). The Global Markets Advisory Committee (GMAC) has pursued the regulatory parity issue and presented a report to

the Commission with recommendations following discussion at a meeting on July 21, 1999.

- *Cantor Financial Futures Exchange (CFFE).* CFFE is a designated contract market and is a joint venture between Cantor Fitzgerald, an interdealer-broker in the US Treasury securities market, and the New York Cotton Exchange (NYCE) division of the New York Board of Trade (NYBT), a designated contract market. The Commission has allowed rules to go into effect that enable certain classes of exchange members to enter orders directly into the order-matching system of the exchange via terminals provided by the exchange. The Commission also has allowed into effect CFFE rules that permit the exchange to operate a trading facility in London. Lastly, the Commission allowed into effect a market maker program which provided for transaction fee waivers to participants who provide minimum levels of liquidity.

- *Internet and Electronic Contract Market Applicants.* Commission staff are reviewing the application of FutureCom, Ltd. (FutureCom), a Texas limited partnership owned by the Texas Beef Group, for designation as a new contract market for the automated Internet-based trading of cash-settled live cattle and options contracts. FutureCom is unique in that it would be the first totally Internet-based futures or securities exchange and every member would be its own clearing member. Full margin for an order would have to be deposited with FutureCom before the order was accepted by the system and margin levels and position limits would be tied directly to the creditworthiness of the member. FutureCom would operate on a for-profit basis. Commission staff concluded a second on-site visit to verify certain aspects of FutureCom's operations and participated in mock trading. At the request of Commission staff, FutureCom obtained a third party review of its trading system. In January 2000, Commission staff informed FutureCom by letter that staff had received materials addressing outstanding issues, including the testing of the system, and have an adequate record in support of the FutureCom proposal. Commission staff are actively working to complete the Commission's review of the FutureCom application.

Proprietary Cross-Margining

In June 1999, the Commission gave approval to New York Clearing Corporation (NYCC) to establish a proprietary cross-margining program with Government Securities Clearing Corporation (GSCC) for the cross-margining of US Treasury futures contracts traded at CFFE with cash US Treasury securities cleared through GSCC. The NYCC-GSCC program differs from previous cross-margining programs because each clearing organization would maintain its own separate account of the proprietary positions an funds subject to cross-margining. Each clearing organization calculates the margin

savings to the participating clearing members and is guaranteed the sum of those amounts by the other clearing organization. Previous cross-margining arrangements involved each participating clearing organization possessing a joint perfected security interest and lien in the joint account which holds the cross-margined positions and supporting funds.

Over-the-Counter Derivatives and Hedge Funds

The Commission participated in, and wrote several sections of, the President's Working Group on Financial Market's study, *Hedge Funds, Leverage, and the Lessons of Long Term Capital Management.* It also participated in the working group's study on the OTC derivatives market. The Commission also is working with international organizations and foreign regulators to develop coordinated regulatory approaches that address issues related to trading of OTC derivatives including issues related to systemic risk. Of particular importance is the work of the Commission with the IOSCO which, through a specially created task force and its working parties, is addressing questions related to adequate regulation of hedge funds, appropriate disclosure concerning trading of OTC derivatives of the banks and securities firms, international coordination of derivatives regulations and other matters. The Commission also designed, and compiled the results of, an international survey of regulations governing OTC derivative activity.

Streamlining of Contract Market Designation Applications

Following the successful implementation of fast-track designation and rule change procedures in FY 1997 to reduce significantly Commission review times for contracts submitted under fast-track procedures, the Commission sought to streamline further its review procedures. On June 1, 1999, the Commission adopted rules to reduce the filing burdens of the exchanges when exchanges seek approval of new contracts. The Commission revised its Guideline No. 1 from narrative information requirements to abbreviated forms and checklists. Exchanges also may substitute analyses prepared by third parties for analyses prepared by exchange staff exclusively for the Commission. The Commission also reduced the fees exchanges must submit with their designation applications and created a new, lower fee structure for a single submission of a series of futures and option contracts based on a common index.

In addition, on July 27, 1999, the Commission published in the *Federal Register* a proposal to modify its rules regarding the listing of contracts without prior approval. On November 26, 1999, in response to industry comments, the Commission issued final rules to permit exchanges to list commodity futures or option contracts for trading without Commission approval of the contract or its terms and conditions. This new listing procedure, adopted as an alterna-

tive to regular or fast-track procedures for contract market designation, was in response to concerns of representatives of US exchanges that the ability to list contracts more quickly than currently possible is necessary for them to meet competitive challenges by foreign exchanges and over-the-counter markets.

Streamlining of Reviews of Exchange Rule Changes

The Commission reviewed its requirements for exchange submissions of proposed rule changes for Commission approval. In June 1999, the Commission proposed amendments to Rule 1.41 to increase the number of exchange rule changes that can become effective immediately and those that may go into effect within three days or ten days of submission to the Commission. The proposed procedures also will permit exchanges to reduce significantly the number of filings of rule changes they are required to make to the Commission.

In addition, in a *Federal Register* release published on November 26, 1999 (64 FR 66428), the Commission sought comment on a proposal to revise its procedures for the review of contract market rules and rule amendments. The comment period was originally scheduled to expire on January 25, 2000. Upon the request of seven agricultural organizations, the Commission has extended the comment period to February 24, 2000.

Under the proposed new Regulation 1.41(z), a contract market rule could be placed into effect on the business day after the Commission had received a submission for the rule. There would be no delay in the implementation of the rule to allow for prior Commission review. The submission for the rule would have to include: 1) the text of the rule or amendment, with redline, as applicable; 2) a brief explanation of the rule; 3) a description of any substantive opposition; and 4) a certification that the rule is not inconsistent with the Act or with Commission regulations. To ensure that a board of trade seeking initial designation as a contract market would continue to undergo detailed analysis, the process could be used only by a contract market with at least one non-dormant contract.

Speculative Limits

On May 5, 1999, the Commission published final rules that will increase the speculative position limits for the deferred delivery months for futures and option contracts on various agricultural commodities. These position limits were restricting the ability of some traders to maintain as large a position as they determined appropriate to the risk they wish to assume. The Commission determined that the markets in question had grown sufficiently in the years since the Commission last considered these position limits and that increases in the position limits were appropriate. The Commis-

sion also consolidated in one part of its regulations its various rules and policies regarding the administration of speculative position rules.

A Study of the Global Competitiveness of US Futures Markets

During FY 1999, Market Research staff examined the global competitiveness of US futures markets and found that US-based commodities exchanges are successfully competing with foreign exchanges. In fact, regulation at overseas commodities exchanges appear to be converging toward common "best practice" principles implemented by most exchanges around the world. The results of the study have been published and can be found on the Commission's Web site at the following address:

<http://www.cftc.gov/dea/compete/compete.doc>.

Year 2000 Compliance

The Commission has worked since 1994 to prepare for the Year 2000 to ensure that its own systems were Year 2000 compliant. In addition, the Commission worked with the self-regulatory organizations (SROs) to execute a comprehensive and multifaceted approach to assist the futures industry in achieving Year 2000 compliance. The actions taken include: 1) sending questionnaires to SROs and registrants; 2) specifying Year 2000 responsibilities for SROs, registrants, and auditors; 3) working with the American Institute of Certified Public Accountants (AICPA) to develop agreed-upon procedures to assess programs to ensure Year 2000 readiness; and 4) fostering testing and contingency planning preparations. The Commission worked closely with the Futures Industry Association (FIA) to achieve industry-wide testing. The Commission also participates in the President's Council on the Year 2000 Conversion, as well as other domestic and international industry groups addressing the Year 2000 problem. The Commission experienced no Year 2000-related problems.

Dual Trading

Dual trading is prohibited in an affected contract market unless an exchange files a dual trading petition that demonstrates that the exchange has a trade monitoring system capable of and used for detecting dual trading-related abuses. Once a petition is filed, application of the dual trading prohibition is suspended unless and until the petition is acted upon.

On February 26, 1999, the Commission approved an Order granting CBT a statutory dual trading exemption for the US Treasury Bond futures contract traded on its Project A trading system. That Order was amended on June 4, 1999 to include the Ten-Year US Treasury

Note futures contract traded on Project A. This is the first time the Commission has addressed the applicability of a dual trading prohibition to an electronic system and, in doing so, the Commission specifically took into account the quality of the audit trail of the system.

Commission staff completed its analysis of data submitted by CBT and CME in connection with the November 1997 proposed dual trading orders of the Commission. The Commission is formulating final dispositions on a priority basis. Commission staff are also analyzing NYMEX's dual trading petition in six affected contract markets.

Improved Clarity of Commodity Pool Disclosure Documents

The Commission adopted rule amendments and approved a related NFA rule that requires CPOs to divide their Disclosure Documents into two separate parts. These rule changes responded to concerns that prospective participants experienced difficulty focusing on the large amount of information provided in the Disclosure Documents of commodity pools filed with the Commission by CPOs. The goal of the Commission is to arrange the disclosure documents that will help investors to focus on items in relative order of importance.

Conflicts of Interest

The Commission approved new Rule 1.69, implementing the statutory directives of Section 217 of the Futures Trading Practices Act of 1992, which requires SROs to adopt rules prohibiting governing board, disciplinary committee, and oversight panel members from deliberating or voting on certain matters where the member has either a relationship with the named party in interest or a financial interest in the outcome of the matter. The final rules also amend Commission Rules 1.41 and 1.63. The final rule became effective on March 5, 1999.

Sexual Harassment Policy & Training

Sexual harassment is a problem faced by employees and employers nationwide. As a result, many organizations have taken steps to eliminate harassment in the workplace and to increase awareness of the various types and impact of inappropriate gender-based conduct.

In response to this growing concern and to highlight its commitment to equal employment opportunity, in FY 1999, the Commission adopted a new sexual harassment policy. The new policy was made available to all employees and was featured as part of Commission-sponsored sexual harassment training. During FY 1999, all Commission employees in headquarters and the regional offices attended mandatory training to review the Commission's new sexual harass-

ment policy and increase overall awareness of sexual harassment issues.

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