



June 17, 2002

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: National Futures Association Proposed Interpretive Notice to NFA
Compliance Rule 2-4 Regarding Broker-Dealer Best Execution
Obligations with Respect to Security Futures, Release No. 34-45720; SEC
File No. SR-NFA-2002-02

Dear Mr. Katz:

On behalf of the Steering Committee on Security Futures established jointly by the Futures Industry Association ("FIA")¹ and the Securities Industry Association ("SIA")² I am pleased to submit our comment letter in response to the captioned release regarding the National Futures Association's (the "NFA") Proposed Interpretive Notice to NFA Compliance Rule 2-4 rulemaking (the "Proposed Interpretive Notice").

FIA and SIA ("the Associations") recognize and support the efforts of NFA to ensure, through the Proposed Interpretive Notice, that NFA Compliance Rule 2-4 is construed as incorporating the flexibility necessary for NFA members to discharge the obligations established under the rule. The Associations wish to express their strong reservations, however, with respect to the application of a best execution obligation under

¹ FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is composed of approximately 50 of the largest futures commission merchants ("FCMs") in the United States, the majority of which are also registered broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international.

² SIA's members include more than 740 securities firms (including investment banks, broker-dealers, and mutual fund companies) that are active in all US and foreign markets and in all phases of corporate and public finance. The US securities industry manages the accounts of more than 80 million investors directly and indirectly through corporate, thrift and pension plans.

certain circumstances currently contemplated by the rule.

I. Absence of a Consolidated Price Reporting System.

The Associations understand that no consolidated price reporting system will be in place at the time security futures are expected to commence trading. The Associations do not believe that it is appropriate to impose a best execution obligation on NFA members under such circumstances. The Associations are aware that best execution obligations have been applicable under Self Regulatory Organization (“SRO”) rules to listed equity options in the absence of a consolidated price reporting system for listed options. The Associations nonetheless believe that, under such circumstances, there can be no realistic expectation that members will have the ability, reliably and with consistency, to ensure that they are discharging their best execution obligation where real competition exists between economically comparable security futures contracts traded in different markets. It is not appropriate to put intermediaries in such an untenable position.

II. Non-fungibility.

The Associations also understand that at least certain of the exchanges expected to list security futures contracts will **not** permit the Options Clearing Corporation to extinguish positions in their contracts against equal and offsetting positions in contracts listed on other exchanges that are otherwise economically identical. The Associations have, on numerous occasions and to no avail, expressed their view that this prohibition is potentially costly and burdensome to investors and not in the public interest.

The Associations further understand that the Commission and the Commodity Futures Trading Commission (“CFTC”) currently intend to impose an initial and maintenance margin requirement in respect of equal and offsetting positions in otherwise economically identical contracts.

The result of these circumstances is that two security futures contracts that would otherwise be economically fungible will not be fungible.³ We describe such contracts as non-fungible because, as a result of the margin requirement for equal and offsetting positions, a customer with an outstanding position in contracts listed on exchange A will **not** be economically indifferent as to whether the offsetting position is executed on exchange A (with no resulting margin requirement) or on exchange B (with an ongoing initial and maintenance margin requirement). The Associations stress that **no current**

³ The Associations note that the Commission could avoid this result in either of two ways. First, the Commission could preclude exchange rules from limiting a clearing agency’s ability to extinguish equal and offsetting positions in otherwise economically identical contracts. Alternatively, the Commission could preclude such a limitation in circumstances where the affected customer is insolvent or in default of its obligations. By allowing a clearing agency to extinguish offsetting positions under these circumstances, the Commission would effectively eliminate the liquidation risk that has lead the Commission to impose a margin requirement on equal and offsetting positions in security futures contracts that are otherwise economically identical. In that event, the Commission could eliminate the margin requirements that would cause such contracts to be non-fungible.

analogy to this situation exists with respect to any security or listed option that is subject to a best execution obligation.

Under the Proposed Interpretative Notice, a member's best execution obligation will apply in the context of contracts that "are not materially different". The Associations understand that this standard is intended to encompass non-fungible contracts of the type described above. The Associations categorically object to the application of a best execution obligation under these circumstances. The application of a best execution obligation in this context would establish an obligation that cannot be effectively discharged by NFA members and that is fundamentally inconsistent with the well-understood scope of the best execution obligation.

The Commission staff has observed on a number of occasions that the best execution obligation is an obligation to be evaluated, not on a transaction-by-transaction basis, but rather in the overall context of the trading relationship between a member and its customer.

As noted above, however, the facts necessary to evaluate the relative effective cost of execution of two non-fungible contracts are ***inherently transaction specific***. In addition, these facts include circumstances of the particular customer at the time of execution that are unrelated to market conditions. Moreover, any such evaluation would require access to data not likely to be immediately available to the executing broker and would entail the time consuming calculation of implicit margin financing costs. It is apparent on its face that any such analysis simply is not realistic and is utterly inconsistent with the equally important (and cost sensitive) investor objectives of prompt and efficient execution.

The Associations therefore believe that application of a best execution obligation to non-fungible contracts is unrealistic, inconsistent with the interests of investors, inconsistent with the traditional supra-transactional focus of the best execution obligation and is not justified by analogy to any existing application of the best execution obligation. For these reasons, the Associations strongly urge that the Proposed Interpretative Notice be modified to clarify that the best execution obligation is inapplicable to non-fungible contracts.

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The Steering Committee would be pleased to discuss the foregoing comments with staff of the Commissions at your convenience. Please feel free to contact Barbara

Wierzynski of FIA at (202) 466-5460, Jerry Quinn of SIA at (212) 618-0507, or the outside counsel for the Steering Committee, Edward Rosen of Cleary, Gottlieb, Steen & Hamilton at (212) 225-2820, if you wish additional information.

Very truly yours,

Jonathan Barton, Chairman
FIA/SIA Steering Committee on Security Futures

cc: James E. Newsome, CFTC
Daniel J. Roth, NFA