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STATEMENT OF THE

BOARD OF TRADE CLEARING CORPORATION

BEFORE

THE COMMODITY FUTURES TRADING COMMISSION

REGULATORY REINVENTION HEARINGS

JUNE 28, 2000

Chairman Rainer and members of the Commission, this statement is submitted on behalf of the Board of Trade Clearing Corporation ("BOTCC" or the "Clearing Corporation"). The Clearing Corporation appreciates this opportunity to appear here today to make its views known regarding the Commission's regulatory reform initiative.

BOTCC is the world's largest fully independent futures and options clearinghouse and the only futures clearinghouse that is rated "AAA" by Standard & Poor's. Day in and day out, the Clearing Corporation compares the data that is submitted by its members, matches the resulting trades, collects and disburses original and variation ("mark-to-market") margin payments through a network of banks, and provides an ironclad guarantee of performance for every trade that is accepted by it for clearing. BOTCC, which was formed in 1925, currently serves as the clearing organization for the Chicago Board of Trade and the MidAmerica Commodity Exchange, has in the past provided trade processing services for the New York Cotton Exchange and the Commodity Clearing Corporation, and has entered into an agreement to serve as the clearing organization for the Merchants' Exchange of St. Louis. The Clearing Corporation is or has been a party to cross-border, inter-exchange trading links and a variety of cross-margining and common banking arrangements with other futures and securities clearinghouses.

At the outset, the Clearing Corporation wishes to commend the Commission for taking steps to modernize and transform the regulatory structure that is administered by the Commission. The Commission's proposal for a new regulatory framework has the potential to promote innovation, enhance legal certainty, and improve the ability of firms that are or may be subject to regulation by the Commission to compete effectively with their foreign counterparts and with companies doing business in the over-the-counter markets. The Commission also is to be commended for recognizing the vital importance of clearing facilities to the organized markets and for taking steps to ensure that clearing organizations are afforded appropriate recognition under the new regulatory framework.

The Clearing Corporation nonetheless has profound reservations regarding certain aspects of the Commission's proposal:

The Part 39 Requirements Are Overbroad.

The Commission is proposing a fundamental realignment of the regulatory scheme applicable to futures exchanges and other boards of trade to enable them to respond more effectively to competitive challenges. In particular, the Commission has stated its intention to replace the "one-size-fits-all" model it currently has in place with broad, flexible "core principles" that would apply in varying degrees to three tiers of markets: regulated futures exchanges, derivatives transaction facilities and exempt multilateral transaction facilities. In like fashion, the Commission has stated its intention to simplify and streamline the regulation of intermediaries by providing them with greater flexibility in numerous areas that are now the subject of prescriptive Commission regulations.

It surely cannot have escaped the Commission's attention that the Commodity Exchange Act and the Commission's Regulations are focused narrowly in their application to clearing organizations.[1/] It is, therefore, surprising that the Commission is now proposing to impose an array of new responsibilities on the clearinghouses. That these obligations are being imposed under the guise of "core principles" does not change their effect – clearing organizations will be made subject to far greater regulatory compliance burdens than at any time in the past.

The clearinghouses have an admirable record of safety and soundness. The Board of Trade Clearing Corporation has in its history cleared more than one billion contracts, but has never failed to perform its obligations to its clearing members, in full and on time. BOTCC's sterling record is attributable to numerous factors, including its strict membership standards and risk management practices. BOTCC's success in this area is also attributable, in no small part, to its ability to respond flexibly, promptly and appropriately to a member firm's insolvency and to other

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1/ With the exception of Sections 4d(2) (segregation), 4g (recordkeeping) and 5a(a)(12) (rule review), the Act does not prescribe express requirements for clearing organizations. The Commission historically has been similarly restrained in its approach and has focused its attention on those aspects of the clearing process that, in its considered judgment, necessitated its regulatory involvement – the "early warning" requirements applicable to member firms (Regulation 1.12); certain of the customer funds segregation requirements (Regulations 1.20, 1.25, 1.26, 1.27 and 1.29); the maintenance of a "trade register" (Regulation 1.35(e)); review of clearing organization rules (Regulation 1.41); and restrictions on the use of "inside information" (Regulation 1.59), on service on a clearing organization's governing board and committees (Regulation 1.63) and on voting by interested members of the board or committees (Regulation 1.69). Taken together, these provisions of the Act and Regulations provide core protections to the markets and market users, consistent with the Commission's role as an oversight regulator.

developments in the markets. The Clearing Corporation, therefore, is apprehensive about any new regulatory regime that would inhibit its ability to respond as necessary to the exigencies of the marketplace and urges the Commission to evaluate carefully whether it is necessary or appropriate to engraft a new layer of regulation on the futures clearinghouses.

The Board of Trade Clearing Corporation respectfully suggests that to the extent that the Commission continues to believe that additional across-the-board regulation (as opposed to case-by-case remedial action) is warranted, any new rules should be directed toward new clearing organizations that seek to provide clearing services for existing futures exchanges or for over-the-counter derivatives or exempt multilateral transaction facilities that have not previously had the benefit of clearing arrangements.

The Part 39 "Core Principles" Are Unduly Prescriptive.

The level of specificity envisioned by Part 39 and, in particular, Appendix A goes far beyond anything that is required currently by the Commission's regulations, is wholly inconsistent with the Commission's intention to transform itself into an "oversight regulator" and, most importantly, has the potential to inhibit the flexibility and adaptability that enables the clearinghouses successfully to manage risk.

The fourteen core principles for clearinghouses, and the accompanying nine pages of "guidance" provided by Appendix A, are far more intrusive and detailed than anything that now applies to clearing organizations. (To cite one of the more extreme examples, proposed Appendix A to Part 39 specifies that testing of a clearinghouse's automated systems be performed by "an independent third-party professional that is a certified member of the Information Systems Audit and Control Association.") The Commission should have no illusions: While characterized as "broad" and "flexible," there can be little doubt that the "core principles" will take on the force of law, and that all clearinghouses – applicants for recognition and existing clearinghouses alike – will be required either to affirmatively demonstrate their compliance or satisfy the Commission's staff that one or more of the principles should not apply.

In light of the foregoing, we urge the Commission to re-evaluate the applicability of the core principles. As a first step, the Commission should recognize that not all of the core principles will be applicable to all clearing organizations and to all products. Similarly, we would urge the Commission to emphasize that the "guidance" to applicants provided by Appendix A is simply that and is not a checklist of steps that need to be taken in all cases.

The Commission's Proposal Would Inappropriately Expand the Scope of the Act and Regulations.

Proposed Regulation 39.5 would, for the first time, make clearinghouses subject to various provisions of the Act and Regulations that simply do not – and should not – apply to clearing organizations. For example, the incorporation by reference of Section 4i of the Act (relating to speculative position limits) and Commission Regulation 1.38 (relating to the execution of transactions other than by open outcry), is particularly problematic because their inclusion in Regulation 39.5 implies that a clearing organization is somehow responsible for enforcement of these requirements.

This is not a trivial matter. Holding a clearinghouse accountable for acts or omissions that have nothing whatsoever to do with the trade matching and credit enhancement functions that are provided by a clearing facility unnecessarily and inappropriately creates the potential for liability, in enforcement proceedings and in private civil litigation brought under Section 22 of the Act, for conduct that was never previously thought to be actionable. The clearinghouses should not be made subject to these requirements without a careful and thorough evaluation of their relevance and the consequences of their applicability to a regulated clearinghouse.

The Clearing Corporation also wants to register its vigorous opposition to proposed Regulation 39.6. That Regulation would punish anyone who cheats or defrauds any other person or who willfully makes a false report or statement "in connection with any transaction cleared by a recognized clearing organization." Although it is difficult – if not impossible – to envision circumstances in which a clearing organization could engage in conduct that violates Regulation 39.6, our objection is not merely formal or hypertechnical. The effect of this Regulation would be the assertion of the Commission's enforcement authority over otherwise-exempt transactions simply because those transactions are submitted to clearing. We submit that this is unwise as a matter of public policy: The Commission's Part 35 and 36 Regulations would do much to enhance legal certainty by declaring that clearing does not, by itself, make an exempt transaction subject to the Commodity Exchange Act; the Commission should not undermine that objective by interposing a potentially significant impediment to the use of clearing facilities by market participants whose business affairs are otherwise outside the scope of the Act.

Part 39 Would Confer an Inappropriate Competitive Advantage on Non-Futures Clearinghouses.

The markets are converging. Market participants are demanding and receiving real-time access to the cash, futures, securities and options markets. The Clearing Corporation accordingly supports the Commission's determination to unshackle the markets and to allow market participants to adapt to rapidly changing circumstances.

The futures, cash and option markets are inextricably intertwined, with the result that every clearinghouse has a stake in the financial and operational integrity of every other clearinghouse. The Clearing Corporation accordingly has grave reservations about the wisdom of that aspect of the Commission's proposal that would exempt securities clearinghouses, banks (and bank affiliates), and foreign clearinghouses from the substantive requirements that otherwise would apply to recognized clearing organizations.

There is only a superficial resemblance between the services offered by futures and securities clearinghouses.[2/] There is even less of a resemblance between a clearinghouse and the funds transfer and netting systems that are subscribed to by banks, thrifts and trust companies. As to the proposed exemption for foreign clearinghouses, many of them operate under legal systems that are simply incompatible with the bankruptcy and other laws which govern clearing organizations in this country. It is for these reasons that the Clearing Corporation wishes to express its utmost concern regarding the Commission's apparent willingness to permit anyone to set up shop as the clearing organization for a futures market that is organized as an exempt multilateral transaction facility ("MTEF") as long as the clearing organization in question has passed muster with the Securities and Exchange Commission, is organized as or affiliated with a bank, or has been approved by foreign regulators.

The Clearing Corporation believes that this lack of operational and regulatory comparability should cause the Commission to reevaluate and withdraw this proposed exemption. The Commission should in any event be aware that futures clearinghouses will find it difficult to survive in this new competitive environment if the Commission unilaterally cedes the field to securities clearing agencies, foreign clearinghouses, and banks by giving them the right not only to clear OTC derivatives, but also to clear futures and option contracts traded on exempt MTEFs. If, as expected, trading volume in financial futures and other products migrates to exempt MTEFs, traditional futures clearing organizations will be left with declining revenues and diminished capital with which to support agricultural futures and other established products.

The Clearing Corporation, therefore, urges the Commission to reconsider this exemption.

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2/ Future trades are marked-to-market on the day after the trade, with interim variation margin collections being made on the trade date; stock trades are not settled until T+3. BOTCC and other futures clearinghouses guarantee cleared transactions upon confirmation of a "matched trade"; the National Securities Clearing Corporation guarantee does not become effective until midnight of the day that the trade is reported back to participants as having been compared.

Clearing organizations serve a vitally important role in the safe and efficient functioning of the markets.[3/] It is, after all, the clearing organizations that stand behind every trade made on the exchanges as the "seller to every buyer and buyer from every seller." Accordingly, we urge the Commission to proceed with the utmost caution before superimposing a new – and unwarranted – regulatory regime on the nation's clearinghouses.

The Board of Trade Clearing Corporation thanks you for the opportunity to express its views on this important subject. We welcome the opportunity to work with the Commission and its staff to refine this proposal and to ensure the continued integrity of the clearing system.

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3/ "Both the liquidity of exchange-traded derivatives markets and the timely completion of payments and deliveries associated with these markets are critically dependent on the financial integrity of an exchange's clearing house, in which are concentrated the credit and liquidity risks of exchange trading and the responsibility for managing those links. . . . The financial integrity of futures and options markets depends on the robustness of their arrangements for clearing and settling trades." Bank for International Settlements, *Clearing Arrangements for Exchange-Traded Derivatives* (Basle 1997).