Chicago Board of Trade

**Dennis A. Dutterer**
President and
Chief Executive Officer

RECEIVED
COMMENT C.F.T.C.
'00 AUG 15 AM 9 49

August 7, 2000

00-22
(25)

BY E-MAIL AND CERTIFIED MAIL

RECEIVED C.F.T.C.
RECORDS SECTION

OFFICE OF THE SECRETARIAT
'00 AUG 14 AM 8
RECEIVED
C.F.T.C.

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

Re: Proposed Rules Concerning Intermediaries – 65 Fed. Reg. 39008 (June 22, 2000)

The Chicago Board of Trade ("CBOT®" or "Exchange") is pleased to offer its comments on the Commission's "Proposed Rules Concerning Intermediaries." The Exchange appreciates the Commission's efforts to further the regulatory reform process through its proposals regarding the intermediation of futures and options transactions, in conjunction with its proposals concerning multilateral transaction execution facilities and clearing.

The Commission has noted that under its proposed new regulatory structure, intermediaries of transactions conducted on Exempt Multilateral Transaction Facilities ("Exempt MTEFs") would only be subject to the antifraud and antimanipulation provisions of the Commodity Exchange Act ("Act"). The Commission has further indicated that intermediaries involved in transactions conducted on or subject to the rules of a recognized futures exchange ("RFE") or a recognized derivatives transaction facility ("DTF") would be subject to a more comprehensive, but streamlined, regulatory framework in accordance with certain basic Core Principles. The Commission specifically proposes to distinguish certain of the requirements which apply to intermediaries, depending upon whether they are dealing with institutional or non-institutional customers, and to make use of Statements of Acceptable Practices.

The Commission acknowledges that different levels of safeguards are appropriate, depending upon the types of instruments, and the nature of the customers and markets involved. However, unlike the proposal relating to the framework for multilateral transaction execution facilities, the Commission has not recommended replacing prescriptive rules with Core Principles.

Rather, the Commission has indicated that it has identified eight Core Principles that it believes are fundamental with regard to the conduct of intermediaries, and it has proposed specific amendments to its existing rules in light of the Core Principles. The Core Principles relate to registration, fitness of registrants, financial requirements, risk disclosure, trading standards, supervision of personnel, large position reporting requirements, and recordkeeping. The CBOT addresses certain of the Commission's proposals below.

141 W. Jackson Boulevard
Chicago, Illinois 60604-2994
312 435-3602
Fax: 312 341-3392

A. Core Principle One: Registration

1. Definition of the Term "Principal"

The Commission proposes to amend its definition of "principals" for purposes of its registration rules and its rules applicable to commodity pool operators and commodity trading advisors. The CBOT agrees that the Commission should modify its definition to ensure that only those individuals who actually have a controlling influence over activities subject to regulation by the Commission are considered to be principals.

2. Special Procedures Available to Firms Subject to Securities or Banking Regulation

The Commission's Core Principle with regard to registration requires that, absent an exemption, any person or entity intermediating a transaction on an RFE or a DTF must be registered in the appropriate capacity with the Commission. The Commission proposes to simplify registration as an FCM or IB for certain persons that conduct business solely for institutional customers on a DTF. These modified registration requirements would apply to applicants that are registered with the Securities and Exchange Commission in a similar registration category or are authorized by a federal banking authority to perform similar functions. Such applicants could be registered as an FCM or an IB upon filing an appropriate notice and certification with the NFA while avoiding the need to file CFTC registration forms and fingerprints. In addition, the sales personnel employed by these firms would not be required to be registered or listed in any way, and would not be subject to any testing or training requirements, although such salespersons and their firms would remain subject to antifraud provisions.

The Commission further proposes to exempt such "passported" registrants, which only service institutional customers trading on a DTF, from any requirement that they meet the Commission's minimum financial requirements. Rather, the Commission would rely upon such registrants' meeting the financial requirements imposed by their primary regulators and by the relevant DTF. The Commission would continue to require that similar intermediaries that are not registered with another regulator remain subject to the Commission's minimum financial requirements.

The Commission currently requires that firms that are registered with other financial agencies and regulators make application for registration with the Commission in the same manner as firms that are not dually registered. In addition, the Commission requires that FCMs or IBs that are securities brokers and dealers meet the greater of the Commission's or the SEC's financial requirements.

The proposed amendments would ease the entry of firms registered with other financial authorities into the business conducted on DTFs, while potentially resulting in lesser governmentally-imposed financial requirements than under current rules. However, the DTF itself would remain free to impose whatever financial requirements it deemed appropriate. Therefore, the CBOT believes that these reforms would be beneficial to the industry.

However, the Exchange believes that the requirements for registration and minimum financial requirements for intermediaries should be consistent between RFEs and DTFs. Therefore, firms and individuals that conduct transactions on an RFE for institutional customers should be subject to the same requirements as firms and individuals that conduct transactions for institutional customers on a DTF. If the nature of the entity or individual intermediating the transaction and the nature of the customer determines the need for any particular requirement, whether the transaction facility is a DTF or an RFE is irrelevant.

The Commission has indicated that although it is not proposing changes to its minimum net capital requirements with respect to FCMs at this time, it is considering permitting the application of risk-based net capital requirements in the future. The Commission further stated that it desires input regarding the most effective approach in this regard. The industry has been urging the Commission to adopt a risk-based capital approach for many years, and the CBOT applauds the Commission's expressed willingness to consider doing so. The CBOT believes the Commission should adopt and implement a specific time-table for considering and approving risk-based capital rules.

The Exchange notes that the CBOT, the Board of Trade Clearing Corporation ("BOTCC"), and the Chicago Mercantile Exchange ("CME"), adopted a risk-based capital requirement at the clearing organization level as of January 1, 1998. This coordinated risk-based capital requirement is based upon customer and noncustomer risk margin/performance bond requirements. The CBOT believes that this is a proper method for setting a risk-based capital requirement, and member firms have now had an opportunity to become familiar with, and to develop the systems for complying with, such a requirement. Currently, the percentages are set at 8% of customer and 4% of noncustomer risk maintenance margin/performance bond requirements. The CBOT, BOTCC, and the CME have monitored and will continue to monitor these levels to determine their effectiveness and their overall effect on member firms. In fact, the percentage applicable to customers was previously reduced from 10% to 8% based upon such an analysis. These entities will continue to consider whether these percentages remain appropriate. The Commission should allow exchanges and clearing organizations the flexibility to apply risk-based net capital requirements to FCMs which intermediate business thereon, and to determine the best methodology for doing so. Thus, for example, exchanges and clearing organizations should remain free to continue to examine how risk-based capital requirements might address issues such as concentration risk or proprietary risk, as well as the ongoing effectiveness of the percentages discussed above.

3. Standard Application Procedures for FCMs and IBs

The Commission has proposed to eliminate its requirement that applicants for registration as FCMs or non-guaranteed IBs provide certified financial statements with their registration applications. Instead, the Commission would permit such applicants to file an unaudited financial report that reflects compliance with the relevant minimum capital requirements. A firm that did so would be subject to an on-site review within six months of registration by the firm's DSRO, or a conference between staff of the firm and the DSRO within that time frame. The Commission stated that this procedure is modeled on similar procedures in the securities industry. The Commission further indicated that it would not require an applicant that did file a certified financial statement to be subject to a six-month review, although a DSRO may review its member firms at any time.

The Exchange believes that there are important benefits to be gained by having access to certified financial statements, prior to a new FCM becoming qualified to begin doing customer business. However, such requirements may originate with the relevant exchange as a matter of private self-regulation. CBOT Regulations require that FCMs that will handle customer business must submit certified financial reports to the Exchange in connection with their membership applications. Certified financial reports are not required from membership applicants that are IBs handling customers' business on a disclosed basis or firms clearing house trades only.

All newly-registered member FCMs are currently reviewed by the CBOT within three months after beginning to deal with customers, pursuant to CFTC guidelines. If the CFTC were to adopt a six month time frame, the Exchange believes that the six months should be calculated from the time when the FCM begins customer business, rather than six months from the time of registration.

B. <u>Core Principles Two and Six: Fitness and Supervision</u>

1. <u>Proficiency Testing and Ethics Training for Individual Registrants</u>

The Commission has proposed to delete current CFTC Rule 3.34, which sets forth specific requirements for initial and periodic subsequent ethics training for all CFTC registrants, and to replace it with a Statement of Acceptable Practices which would serve as a "safe harbor." Unlike Rule 3.34, the Statement of Acceptable Practices permits a great deal of flexibility with regard to who may provide the ethics training, the content of the training, and the timing of the training. The door would be left open for DSROs to establish any specific requirements that they deem appropriate for their own members. The Exchange wholeheartedly supports the Commission's efforts to attempt to avoid micromanagement in this area.

2. <u>Reforms Relating to Statutory Disqualification From Registration</u>

The Commission recently amended its guidance to NFA regarding the treatment of self-regulatory organization disciplinary actions in determining whether "other good cause" exists to affect the registrations of floor brokers and floor traders. The Commission has stated its intent to publish both its 1997 guidance letter, and its April 13, 2000 revisions as an accompanying statement when it publishes final rules. The CBOT was heartened by the Commission's April 13, 2000 amended guidance, which in large part, addressed the concerns which had been expressed by the Exchange, and the entire Joint Compliance Committee, for some time. The CBOT agrees that these guidance letters should be published.

C. Core Principle Three: Financial Requirements

1. Trading by Non-Institutional Customers on DTFs

The Commission has proposed that trading on DTFs be permitted in specified commodities, or for trading in any commodity, other than the agricultural commodities listed in section 1a(3) of the Act, if such trading is done only by institutional customers or commercial entities.

The Commission has also proposed to permit an FCM to transact business on a DTF for non-institutional customers if: (1) it is a clearing member of at least one designated contract market or RFE, and (2) it has a minimum adjusted net capital of at least $20 million.

The Commission has not suggested any basis for its unfounded assumption that trading on a DTF would pose any greater risks to retail customers than would trading on an RFE. Moreover, as discussed in detail in the CBOT's separate comment letter on the Proposed Rules Concerning A New Regulatory Framework for Multilateral Transaction Execution Facilities, 65 Fed. Reg. 38986 (June 22, 2000), a specific level of net capital may not reasonably be viewed as a proxy for providing effective customer protections. A super-capital requirement would unfairly discriminate against smaller FCMs which otherwise meet the CFTC's minimum capital requirements and which have proven their ability to comply with sales practice requirements and to preserve the safety of customer funds. The Exchange notes that on the CFTC's report entitled "Selected FCM Financial Data from Reports Filed by March 31, 2000," only 85 out of 203 FCMs had at least $20,000,000 in adjusted net capital. Therefore, more than half of the registered FCMs would be excluded from intermediating such transactions, based upon such a super-capital requirement.

There is simply no justification for any special capital requirement for FCMs that handle non-institutional customer business on a DTF. Any FCM that is registered has been found to be fit to conduct transactions for retail customers. In addition, any clearing FCM is subject to constant risk monitoring by its clearing organization. Moreover, as discussed in the Exchange's companion comment letter referenced above, the proposed $20 million requirement is arbitrary and inconsistent with other regulations.

However, if the Commission decides to retain a net capital threshold, it should consider an alternative means by which an FCM may qualify to handle retail customer business which should be reasonably related to the Commission's customer protection and sales practice concerns. Specifically, the Exchange has proposed that the Commission consider permitting any registered FCM to transact non-institutional customer business on a DTF, if the firm: (1) has been registered as an FCM for at least 3 years, and (2) has not been found, by a governmental or self-regulatory authority, to have committed any sales practice violations against retail customers during the past 3 years. Any firm that is found to have committed such a violation could be suspended for one year from handling accounts for retail customers on a DTF. This proposal would allow more FCMs to offer their services to non-institutional DTF customers, without unjustly discriminating against FCMs which may not have $20 million in capital, but which have strong records of customer protection.

2. Segregation of Funds

The Commission has stated its belief that segregation of customer funds should continue to be required for the funds of all customers trading on an RFE and the funds of all non-institutional customers trading on a DTF. However, it is considering whether to permit other customers to "opt out" of segregation. The CBOT notes that for a long time segregation of customer funds has been a bedrock principle of customer protection in the U.S. and can be presumed to have attracted customers to U.S. markets. As the Commission has indicated, there are a number of important issues that must be carefully reviewed before any specific rule changes can be considered in this area, and many of these issues require further study. One of the primary concerns would be the fact that under current bankruptcy law, a customer who opted out of segregation would lose the substantial degree of legal certainty under the Bankruptcy Code and the Commission's bankruptcy rules that he currently enjoys.

In addition, the Commission must adopt a risk-based capital requirement before it considers permitting any customers to opt out of segregation. The Exchange generally believes that a risk-based capital requirement is more appropriate than a capital requirement that is based upon a percentage of segregated funds. However, it is even more imperative, if any given firm's capital requirement could decrease based upon the current formula simply because some customers' funds were not segregated.

The Commission has noted that some industry participants have suggested that the Commission permit FCMs to maintain, in the same customer segregated account, various instruments, including OTC derivatives, equity securities, and other cash market positions, as well as the funds used to secure or margin such products and positions. The Commission further expressed its view that it has the flexibility under the Act to modify its requirements in this regard. The Commission indicated that it has previously permitted futures and securities options to be held in the same segregated account pursuant to cross-margining arrangements. The CBOT agrees that there may be circumstances where it may be beneficial to permit other instruments to be held in the segregated account as long as the balances related to the different types of instruments are clearly identified and distinguished on the customers' account statements. In addition, further consideration must be given to the bankruptcy treatment of such an account.

3. Investment of Customer Funds

The Commission has proposed to amend Rule 1.25 to expand the types of instruments in which FCMs and clearing organizations are permitted to invest segregated cash. The Commission has noted that currently, the only permitted investments include obligations of the U.S., general obligations of a State or political subdivision thereof, or obligations fully guaranteed as to principal and interest by the U.S.

The CBOT agrees with the Commission's premise that an expansion of the list of permitted investments could benefit FCMs, clearing organizations and their customers, through possible increased yields, without negatively affecting the safety of customer funds.

The Commission has specifically proposed to include as permitted investments: (1) obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by certain banks; (3) commercial paper; (4) corporate notes; and (5) interests in money market mutual funds. In addition, the Commission has proposed to allow all permitted investments to be bought and sold pursuant to agreements for resale or repurchase.

The Commission has proposed to include certain additional requirements, in order to minimize the credit risk, volatility risk and liquidity risk that this expanded list of permitted investments may entail. These requirements address ratings, average time-to-maturity, concentration limits, specific prohibitions against particular types of instruments, and recordkeeping.

The CBOT agrees that permitted investments should include the obligations of U.S. agencies such as the Federal National Mortgage Association, the Federal Farm Credit Bank, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank. The Exchange also agrees that the Commission should permit investments in Investment Grade commercial paper, certificates of deposit, corporate notes and money market mutual funds. However, the Exchange recommends that the Commission also establish guidelines with regard to the marketability of these instruments. The Exchange believes that segregated funds should only be invested in instruments for which there are available quotes or valuations and a likelihood that such instruments can be liquidated within a reasonable time. In addition, the Exchange notes that although FCMs would be permitted to invest segregated funds in these additional instruments, individual clearing organizations may not allow all of these instruments to be posted for margin purposes.

The Exchange recommends that the Commission consider stating a specific period of time within which an FCM must replace a downgraded investment with an acceptable investment, rather than permitting an FCM to continue to hold the investment subject to a reduced valuation for segregation purposes. This approach would permit FCMs to continue to recognize the current market value of the instrument during that limited time window, without risking possible errors in calculating the proposed 20% reduction in value.

The Exchange supports the Commission's proposal to replace Division of Trading and Markets Financial and Segregation Interpretation No. 2-1 with a rule permitting repurchase transactions, deleting the 180-day cap on the time-to-maturity of collateral subject to reverse repurchase agreements, and adding the Depository Trust Corporation as a permitted depository for securities.

The Commission has also proposed to eliminate the requirement that an FCM obtain a written segregation acknowledgment from clearing organizations, as long as such clearing organizations have adopted and submitted to the Commission rules providing for segregation, in order to codify a three year old staff no-action letter. The CBOT supports this proposal.

D. <u>Core Principle Four: Risk Disclosure and Account Statements</u>

The Commission has proposed to streamline the account opening process by permitting certain required disclosures to be included in a customer agreement, and acknowledged through a "single signature," rather than the multiple signatures that are currently required. The CBOT is in favor of the Commission's effort to simplify the account opening and disclosure process.

E. <u>Core Principle Five: Trading Standards</u>

The Commission is proposing to retain the requirements of Rules 155.1, 155.3, and 155.4 with regard to the intermediation of trades at contract markets, RFEs, and DTFs (non-institutional customers only). For intermediation of trades for institutional customers at DTFs, the Commission has proposed replacing these rules with a general standard of practice that would simply prohibit misuse of the knowledge of any institutional customer's order. In general, the Exchange believes that prescriptive rules regarding trading practices should be replaced with Core Principles or standards of practice for all participants in all markets, so that the individual market remains responsible for detailed customer protection requirements.[1]

F. <u>Core Principle Seven: Reporting Requirements</u>

The Commission has proposed to subject intermediaries transacting business on DTFs to large trader reporting requirements only by special call. In general, the CBOT believes

---

[1] Although not related to intermediaries, the Commission has proposed to amend Rule 155.5, which contains the dual trading prohibition, to make it applicable to contract markets and recognized futures exchanges. Therefore, the prohibition would not apply to DTFs. There is no justification for this distinction between RFEs and DTFs. The Exchange believes that a dual trading prohibition is no longer necessary for either type of market given the tremendous advances in the audit trails and the electronic surveillance capabilities of U.S. markets since the 1992 legislation which introduced the prohibition.

that the Commission should permit individual markets to require large trader reporting, as they deem necessary, in keeping with the principles of self-regulation. All large trader reporting to the Commission should be done pursuant to special call, without drawing any unnecessary distinctions between DTFs and RFEs.

Conclusion

The CBOT appreciates the Commission's efforts to revise its rules with regard to intermediaries, in conjunction with its proposed new regulatory structure. This undertaking comes at a crucial time because of the rapidly changing nature of the industry and its international environment. The Exchange believes that the Commission can best fulfill its responsibilities as an oversight regulator by relying to the maximum extent possible on Core Principles and Statements of Acceptable Practices, while allowing individual multilateral transaction execution facilities to adopt the specific requirements most applicable to their markets.

We would be happy to discuss our comments with Commission staff at its convenience.

Respectfully submitted,

Dennis Dutterer,
Interim President and
Chief Executive Officer