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The Options Clearing Corporation
440 South LaSalle Street, Suite 2400
Chicago, Illinois 60605-1050

William H. Navin
Executive Vice President and General Counsel
312.322.1817
Fax: 312.322.2693
email: wnavin@theocc.com

COMMENT

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BY FEDERAL EXPRESS

Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581
Attn: Office of the Secretariat

Re: Comment on Proposed Part 39 of the Commission's Rules Relating to Clearing Organizations

Ladies and Gentlemen:

I am writing on behalf of The Options Clearing Corporation ("OCC") and its wholly owned subsidiary, The Intermarket Clearing Corporation ("ICC"), in response to the Commission's recent release entitled "A New Regulatory Framework for Clearing Organizations" (the "Clearing Release").[1] In general, we commend the Commission and its staff on your efforts to make regulation of the futures markets more flexible and less burdensome to innovation. We do, however, have two specific comments with respect to the Clearing Release.

Priority in an Insolvency Proceeding of Claims Arising from Cross-Margining Accounts. In the "Report of the Commodity Futures Trading Commission Staff Task Force" published in February of this year, the staff included a list of "Core Principles for Recognition of Clearing Organizations." Item F. 4. b. in that list suggested that a recognized clearing organization should have in place rules "regarding priority of: . . . Where, appropriate, accounts of customers that do not participate in specialized margin reduction programs (such as cross margining) or trading links with other exchanges over accounts of customers that do participate in such programs." As previously discussed in a telephone conference with the Commission staff, OCC and ICC are opposed to discrimination against participants in cross-margining by forcing them to subordinate their claims in any way in the event of the insolvency of the clearing firm carrying their accounts. In that telephone conversation, the staff indicated to us that the

[1] 65 Fed. Reg. 39027 (June 22, 2000).

inclusion of this provision in the list of Core Principles reflected only that priority rules favoring customers who do not participate in cross-margining have been imposed by the Commission and remain in effect. The staff indicated that the inclusion of the statement in the Core Principles did not reflect a renewed determination that such provisions would be a required feature of future cross-margining proposals. The statement was merely intended to require a clearing organization proposing a cross-margining program to address the question of whether or not such a priority rule would be appropriate.

We note that, in the present Clearing Release, a modified list of Core Principles is set forth as Appendix A to proposed Part 39 of the Commission's regulations, which would establish a new regulatory framework for clearing organizations. Core Principle 6 as currently proposed states, in pertinent part, that applicants for recognition as a clearing organization should describe or document "Rules and procedures regarding priority of customer accounts over proprietary accounts of intermediary members or participants and where applicable, in the context of other programs, such as specialized margin reduction programs like cross-margining or trading links with other exchanges." We assume that the inclusion of this provision once again does not reflect a determination by the Commission or its staff that such a priority rule would be required in a cross-margining proposal. Nevertheless, we would like to take this opportunity to state that we are not aware of any circumstances in which it would be appropriate to require participants in a cross-margining arrangement to subordinate their claims to the claims of other customers. Indeed, as we have previously indicated, we believe that the subordination requirements in existing cross-margining programs are inappropriate.[2]

The rationale for the subordination requirement in existing cross-margining programs was not articulated by the Commission staff in the orders imposing the requirement. However, it is our understanding that the requirement arose from the general concern at the time the first non-proprietary cross-margining programs were approved that there might be greater risk of default by cross-margining customers and that, in the event of such a default, there might be greater risk that cross-margined accounts would be undercollateralized. The reasoning may have been that those customers who are not getting the benefits of cross-margining through

[2] At the time non-proprietary cross-margining programs were originally proposed, the Commission required that "market professionals," which is the only class of customers presently permitted to have cross-margining accounts, subordinate their claims arising from such accounts to the claims of "public customers." *See*, for example, the Commission's Order dated December 3, 1991, 56 F.R. 61406. Later, the Commission adopted Appendix B to its Part 190 Rules in order to specify the priority of claims arising from cross-margining accounts. *See* Proposed Rules dated December 28, 1993, 58 F.R. 68580. While Appendix B mitigated the harshness of the original subordination requirement, it still places cross-margining participants at a disadvantage to other customers in a clearing member liquidation.

reduced margin should not be exposed to its presumed risks. Even if one accepted that concept, however, it would at most argue for a completely separate pool of funds from which cross-margining claims would be satisfied. In contrast, the Commission's current Appendix B to Part 190 treats cross-margining funds as a separate pool only in those circumstances where to do so would result in greater loss to cross-margining participants.

Whatever the merits of the Commission's concerns might have been at the time these provisions were imposed, OCC believes that there is no longer any justification for them. The clearing organizations and the Commission have had more than ten years of successful experience with cross-margining. There is no basis in that experience to believe that cross-margining accounts involve any greater risks than other accounts. On the contrary, cross-margining is intended to reduce risk and has been endorsed by several reports relating to risk reduction in the financial system.[3] Indeed, the evidence is that cross-margining accounts, to the extent that they have been utilized, have worked as anticipated and have decreased systemic risk by sharply reducing the excessive demands on liquidity that can arise from high market volatility. Given this experience, it is our view that cross-margining programs should be encouraged as an effective risk-management tool and not discouraged by placing cross-margining participants at a disadvantage in a clearing member liquidation. OCC has already had discussions with the Commission staff regarding a proposed pilot program to expand cross-margining to include accounts of certain institutions and other qualified customers. Imposing any type of subordination or other discriminatory provision would likely prevent many institutional customers from participating in this program.

Chairman Rainer has stated that the Commission's proper role should be to encourage the development of market efficiency, competition, technological advances, and the reduction of systemic risk through netting and other clearing arrangements.[4] According to the Chairman, major deregulation of the financial futures markets should be part of those efforts and would redound to the benefit of the markets and customers as a whole. To achieve these goals, the Chairman has stated that the Commission must examine and regulate "products, entities and exchanges" on a "rational basis," without being "bound by tradition." No rule or regulation should "escape scrutiny" as the Commission develops and encourages the reduction of systemic risk through industry initiatives. Our present comment is consistent with the Chairman's goals while not involving any departure from basic Commission policies of customer protection.

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[3] *See, for example,* Interim Report of The Working Group on Financial Markets at p. 10 and Appendix D, pp. 10-11 (May 1988); Report of the Presidential Task Force on Market Mechanisms at pp. 65-66 (January 1988).

[4] See Remarks of William J. Rainer, Chairman, Commodity Futures Trading Commission, 22nd Annual Chicago-Kent College of Law Derivatives and Commodities Law Institute, Chicago, Illinois, October 28, 1999.

RCO Status of The Intermarket Clearing Corporation. Our second comment relates to the "grandfathering" of certain clearing organizations as "Recognized Clearing Organizations" ("RCOs") under the new Part 39 rules without going through the application process. The Clearing Release states that, "To be recognized as an RCO, an entity must have already been clearing nondormant contracts on a U.S. designated contract market as of January 1, 2000 or must apply to the Commission for recognition." Under this standard, ICC would be required to apply for RCO status because on the specified date, and subsequent to that time, the contract markets for which ICC is the clearing organization have not had open interest or active trading in any of their products. Notwithstanding the foregoing, ICC was on that date, and remains, fully prepared both operationally and in terms of regulatory compliance, to clear transactions in futures contracts in accordance with its rules.

ICC has maintained its clearing systems, rules and banking and other arrangements in place and has the continued capacity to resume its clearing functions at any time. Moreover, ICC would be obligated to its participant exchanges, AMEX Commodities Corporation and Philadelphia Board of Trade, to clear their trades if they should resume active trading in any contracts for which they are the designated contract markets. In addition, ICC has recently been engaged in discussions with other markets for which ICC may in the future clear transactions in products subject to the Commission's jurisdiction. The Commission staff is familiar with ICC's rules and its operations, and ICC meets the conditions for recognition as an RCO as set forth in proposed Part 39 of the Commission's rules. We believe that no purpose would be served in requiring ICC to apply for RCO status under these circumstances.

In a telephone conversation between ICC's outside counsel and a member of the Commission staff, counsel was informed that the Commission staff was not aware at the time the Clearing Release was drafted that ICC would not meet the requirement for RCO status. The staff member stated that this was an entirely unintended result and she thought that something could be done to avoid this unintended effect.[5] We would very much appreciate the Commission's support in this regard.

[5] Telephone conversation between Lois Gregory and James McDaniel on August 4, 2000.

We thank you for your time and consideration of our views. If you have questions or would like to discuss these comments with us, please contact our outside counsel, James R. McDaniel, at (312) 853-2665.

Very truly yours,

William H. Navin

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JRM:dt

cc: Lois J. Gregory

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