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Chicago Board of Trade

COMMENT

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

Re: Regulatory Reinvention – 66 Fed. Reg. 14262 (March 9, 2001)

The Chicago Board of Trade ("CBOT®" or "Exchange") is pleased to offer its comments on the Commodity Futures Trading Commission's ("Commission" or "CFTC") re-proposed rules to implement the Commodity Futures Modernization Act of 2000 ("CFMA") and the Commission's new regulatory framework, as it applies to trading facilities.

The Exchange commends the Commission for its efforts that led to the passage of the CFMA, and its prompt response to this landmark legislation. The CFMA, and the Commission's proposed implementing regulatory framework, substantially alter the regulatory landscape, without sacrificing the integrity of the marketplace or important customer protections. Section 2 of the CFMA cited multiple Congressional purposes for the new statute including "to transform the role of the Commodity Futures Trading Commission to oversight of the futures markets . . . and to enhance the competitive position of United States financial institutions and financial markets." The Commission's proposed new regulatory framework is designed to help to achieve those objectives. Indeed, the new framework recognizes that the public interests served by futures trading are best served "through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission." Section 3(b) of the Commodity Exchange Act ("Act"). The new statutory focal point for assessing self-regulation will be the broad flexible core principles that registered entities under the Act must meet. Significantly, Congress specified that a board of trade, like the CBOT, ". . . shall have reasonable discretion in establishing the manner in which it complies with the core principles." Section 5(d)(1) of the Act.

The Commission had previously promulgated final rules establishing the new regulatory framework on December 13, 2000. As a result of the passage of the CFMA, the Commission withdrew most of its final rules so that it could determine their consistency with the legislation. The Commission has now reproposed its rules, with conforming features, to implement the CFMA. The Exchange offers the following comments on certain specifics of the Commission's reproposed regulations.

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New contracts, rules, and rule amendments

The CBOT applauds the Commission's proposal to allow designated contract markets (and derivatives transaction execution facilities ("DTFs")) to implement immediately new rules and trade new products, while retaining the option of applying for Commission approval at any time thereafter. In this way, these markets will not be placed at a competitive disadvantage by having to delay the launch of new products or the effectiveness of new rules, in order to seek the added comfort of CFTC approval. The Exchange also appreciates the Commission's efforts to streamline the review procedures by providing that qualifying rules that are voluntarily submitted for review would be eligible for review and approval in 45 days.

However, the CBOT notes that the Commission may have created an unintended consequence of its proposed amendments in one area. Specifically, proposed Rule 38.4(b) provides that any rule or rule amendment that would, for a delivery month having open interest, materially change a term or condition of a futures or options contract in an enumerated agricultural commodity, must be submitted for prior review and approval under proposed Rule 40.4. Rule 40.4, in turn, refers to the procedures set forth in proposed Rule 40.5. Rule 40.5, as proposed, provides for a 45-day review, with the possibility that the Commission will extend the review period for an additional 45 days. Paragraph (f) of proposed Rule 40.5 provides for expedited approval, but only at the discretion of the Commission.

Although Section 5c(c)(2)(C) of the Commodity Exchange Act ("Act") sets a deadline of 90 days where prior approval is requested, under the fast-track review provisions of current Rule 1.41(b), rules that relate to the terms and conditions of futures and options contracts (including contracts involving enumerated agricultural commodities) must be approved within 45 days, with the possibility of a 30-day extension. Therefore, proposed Rule 40.5 grants the Commission the ability to extend the review period for 15 days longer than the current rule. The CBOT requests that the Commission modify proposed Rule 40.5 to at least make the time periods consistent with current Rule 1.41(b).

The Exchange supports the Commission's proposal, in Rule 40.4, to exempt from the requirement of prior approval, certain non-material changes to the terms or conditions of enumerated agricultural contracts that have open interest. The CBOT urges the Commission to add the listing of additional futures delivery months to its enumeration of such non-material changes. Listing additional delivery months should be considered a non-material change since a newly listed delivery month does not have open interest and trades under identical terms and conditions as delivery months with open interest.

The CBOT also supports the proposal to allow certain types of rule amendments to be made, without certification, if a weekly summary notice of such rule changes is provided to the Commission, and to allow other types of rule amendments to be made without any notice to the Commission.

Proposed Rule 40.6 would permit the Commission to stay the effectiveness of a rule implemented by a designated contract market, during the pendency of a proceeding for filing a false certification or a proceeding to alter or amend the rule. Section 8a(7) of the Act does not reference a stay. Rather, it grants the Commission the authority to alter or supplement the rules of a registered entity, if it has first made a written request to the entity to make such changes on its own, and if after an opportunity for hearing, it determines that the changes have not been made, and the changes are necessary or appropriate.

The CBOT believes that it is unnecessary and potentially detrimental for the Commission to retain the authority to stay the effectiveness of a rule. A designated contract market will view Commission initiation of proceedings to alter an exchange rule as a very serious matter. As a result, a designated contract market can be expected to decide with due deliberation whether or not to suspend operation of the rule voluntarily, taking into account the Commission's grounds for initiating the proceeding, and the potential implications to its markets, based on its extensive market knowledge and the input of market users. Moreover, suspension of a designated contract market's rule by agency action, during a proceeding to alter it, could be disruptive to the marketplace. Indeed, after a hearing, the Commission may find that the changes requested by the Commission are not necessary or appropriate, but the damage caused by a stay will already have been done. Accordingly, the CBOT asks the Commission to delete the stay provision in proposed Rule 40.6.

Section 22(b) of the Act authorizes private rights of action against registered entities, and their officers, directors, committee members, and employees, alleging any failure to enforce these entities' rules, or any violations of the Act or Commission rules in enforcing these entities' rules. Section 22(b) further provides that such private rights of action are the exclusive remedy under the Act, and that a finding of bad faith is required in order to recover damages. The Exchange requests the Commission to confirm that rules of a registered entity that are certified, and not formally approved by the Commission, do not alter any applicable defenses to a private right of action brought under Section 22(b) of the Act.

DTFs

Floor brokers and floor traders

The Commission has proposed to include floor traders and floor brokers whose trading obligations are guaranteed by a futures commission merchant ("FCM"), and who are trading for their own accounts, within the definition of eligible commercial entities, pursuant to Section 1a(11)(C) of the Act. The CBOT applauds the Commission's recognition that such persons are appropriate participants in a commercials-only DTF.

The Commission has requested comment regarding whether there are functional counterparts to floor brokers and floor traders in an electronic market which should likewise be included within the definition of eligible commercial entities. The CBOT's experience with its a/c/e electronic trading platform, as well as with its previous Project A system, confirms that there are functional counterparts to floor brokers and floor traders, who trade for their own accounts, in the electronic environment. Some of these individuals have previously traded, or concurrently trade, on the floor of the Exchange and are registered with the Commission. Other exchange members, who have not been required to register because they only execute transactions for their own accounts on the electronic system are, nevertheless, the functional equivalents of floor traders. All of these individuals' personal trades are guaranteed by their clearing FCMs and their activities are subject to trade practice and disciplinary rules of the Exchange. Such exchange members, whether or not required to register as floor brokers or floor traders, should be defined as eligible commercial entities.

Enumerated agricultural commodities

Section 5(e)(2) of the Act permits the Commission, on application, and after notice and public comment and opportunity for hearing, to prescribe rules permitting the offer and sale of futures and options contracts on enumerated agricultural commodities on a DTF. In the Commission's Federal Register release, it indicated that consistent with this Section, it would determine in a future rulemaking whether those agricultural commodities should be eligible for trading on a DTF. The Commission further noted that it had reserved a paragraph in proposed Rule 37.3 for this purpose. The CBOT appreciates and strongly supports the Commission's expressed intention to initiate such a rulemaking.

Retail participation

The CBOT continues to believe that retail participation on DTFs should not be limited to persons who trade through FCMs that have a minimum of $20,000,000 in net capital. The CBOT seriously questions whether a specific level of net capital may reasonably be viewed as a proxy for providing effective customer protections and risk management. Many firms that have less than $20 million in net capital have unblemished records of compliance with all applicable sales practice requirements and financial rules. Those firms should not be discriminated against by precluding them from competing with larger firms for the business of retail market participants that want to trade on a DTF. The CBOT urges the Commission to reconsider exercising its exemptive authority under Section 4(c) of the Act to modify this requirement. The Exchange also encourages the Commission to address this issue in its forthcoming reproposal of rules relating to intermediaries under the new regulatory framework.

Exempt securities

Proposed Rule 37.3 identifies the commodities eligible to be traded on a DTF. The Commission has determined that the commodities that qualify under the requirements of Section 5a(b)(2)(A) through (C) of the Act include the commodities defined as "excluded commodities" in Section 1a(13) of the Act, including exempt securities. The CBOT believes that it is appropriate that futures and options on exempt securities be permitted to trade on a DTF.

The Commission has noted that the CFMA imposes no specific limitations or requirements for exempt securities to trade on a DTF, and it has requested comment on whether additional regulatory requirements, such as large trader reporting, should be imposed as a condition for such trading on a DTF. The CBOT has found large trader reporting to be a useful tool for monitoring trading of futures and options on exempt securities, as well as other commodities. Therefore, the Exchange might choose to require some type of large trader reporting, if it elects to operate a DTF in the future. However, the CBOT believes that individual DTFs should be granted flexibility with regard to the form, levels, and timing of any such reporting since such markets may vary with regard to the nature of the market participants and the extent of intermediation.

Designated contract markets

Disciplinary authority

Proposed Rule 38.3 sets forth the procedures for designation by application. Section (b) of that rule provides guidance regarding an application for designation. Rule 38.3(b)(3), as proposed, states that:

> [t]he designation criterion to enforce disciplinary procedures under section 5(b)(6) of the Act may be satisfied by an organized exchange or a trading facility with respect to non-member participants of the contract market by expelling or by denying future access to such a person found to have violated the contract market's rules;

The Commission has proposed similar guidance with respect to Core Principle 2 of Section 5(d) of the Act in Appendix B to Part 38 for designated contract markets.

Traditionally, futures exchanges have been membership organizations, non-members have not had direct access to these markets, and these exchanges have not had the jurisdiction to impose or enforce any restrictions on indirect access. In this regard, it should be noted that Section 5(b)(6) of the Act requires a board of trade to establish and enforce disciplinary procedures that authorize the discipline, suspension, or expulsion of "members or market participants" that violate such rules. The use of the word "or" in the statute appears to provide an alternative for a market that does not have members.

The Commission should clarify that it is not intending to impose any new requirements upon markets that have membership structures, and that its guidance regarding denying access would only apply to persons having direct access.

Monitoring of trading

Core Principle 4 of Section 5(d) of the Act requires a designated contract market to monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process. This is a very important function that the Exchange performs today. The Commission has provided guidance with regard to compliance with this core principle in Appendix B to Part 38, in subparagraph (b)(3), by stating that "[t]o assess traders' activity and potential power in a market, at a minimum, every contract market should have routine access to the positions and trading done by the members of its clearing facility."

The CBOT recognizes that the role of independent clearing organizations is changing, and a clearing organization may clear transactions for multiple markets. Therefore, "members of its clearing facility" may be a larger universe of entities than just those that participate in a particular designated contract market. The Commission may wish to clarify that such access by a contract market should only relate to positions and trading done by participants in that market. However, it is crucial to the performance of a contract market's trade monitoring function that it retains such access without any restrictions or any special showing of need.

Issues common to designated contract markets and DTFs

Dissemination of market information

Proposed Rule 38.3 sets forth the procedures for designation of a contract market by application. Rule 38.3(b)(2) states that the designation criterion under Section 5(b)(3) of the Act that requires fair and equitable trading rules, includes "fair, equitable and timely availability to market participants of information regarding prices, bids and offers." This language is mirrored in the Application Guidance contained in the Commission's proposed Appendix A to Part 38. Section 5(b)(3) itself does not address the availability of prices, bids and offers. Neither does Section 5(d) of the Act listing the core principles for designated contract markets, nor proposed Appendix B to Part 38, which provides guidance on compliance with such core principles. In footnote 7 of the Federal Register release, the Commission stated that the requirement might be satisfied by making such information available to traders through commercial vendors.

Proposed Rule 37.6(d)(iii), and the Guidance set forth in proposed Appendix B to Part 37, also state that the core principle applicable to DTFs regarding disclosure of general information includes providing information regarding prices, bids and offers to market participants on a fair, equitable and timely basis. Such a requirement does not appear in

Section 5a of the Act which addresses the criteria for registration and the core principles applicable to DTFs.

In the final rules that were adopted by the Commission on December 13, 2000, and subsequently withdrawn in light of the enactment of the CFMA, the core principle of transparency applicable to designated contract markets was defined to include "[p]rovid[ing] market participants on a fair, equitable and timely basis information regarding, as appropriate to the market, prices, bids and offers,. . . ." Regulation 38.4(g)(emphasis added).

In the newly proposed rules the "appropriate to the market" language has been removed. While it may be expected that an electronic market would be able to routinely capture and disseminate bids and offers entered into the trading system, as well as execution prices, it is difficult for an open outcry market to do the same. To date, it has not been the practice of the CBOT to report all bids and offers. In order to do so, additional pit reporting staff would have to be employed, and costly technological enhancements would have to be made. The CBOT asks that the Commission reinsert the "appropriate to the market" language and make it clear that a new requirement is not now being imposed upon open outcry markets. Indeed, if the Commission meant to impose such a new requirement, it would be placing open outcry exchanges at a competitive disadvantage to electronic exchanges, a result that the CBOT does not believe the Commission intended.

Fitness standards

Section 5(d)(14) of the Act addresses the core principle of governance fitness standards for designated contract markets. It requires a board of trade to establish and enforce appropriate fitness standards for directors, members of disciplinary committees, members of the market, and "any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph)." A similar core principle is included in Section 5a(d)(6) which is applicable to DTFs. Proposed Rule 38.3(b)(4), addressing this core principle for governance fitness standards, states that:

> [t]he requirement to establish appropriate minimum fitness standards for participants in a facility having direct access to the facility under the core principle on fitness pursuant to section 5(d)(14) of the Act includes natural persons that directly or indirectly have greater than a ten percent ownership interest in the facility.

Similar language appears in proposed Rule 37.6(d)(v) regarding compliance with the core principle applicable to DTFs.

It is clear in the statute that fitness standards only apply to persons who are themselves, or are affiliated with, directors, disciplinary committee members, members, and other persons with direct access to the facility. The Commission's proposed rule goes a step

further than is required by the Act by including natural persons that directly or indirectly have greater than a ten percent ownership interest in the facility.

In footnote 8 of the Federal Register release, the Commission stated that proposed Rule 38.3(b)(4) relating to the core principle on fitness standards "applies to natural persons with greater than a ten percent ownership interest in the facility or in its owners." This footnote is in conflict with proposed Rules 38.3(b)(4) and 37.6(d)(v), in that the language of these proposed rules requires that the natural person himself have greater than a ten percent ownership interest in the facility, either directly or indirectly. According to the language of the footnote, fitness standards could apply to a person who had greater than a ten percent ownership interest in an owner of the facility, which in turn had greater than a ten percent ownership interest in the facility. That individual, therefore, may only indirectly own greater than a one percent interest in the facility. It does not appear that the Commission intended this implication of its footnote.

More generally, the Commission should clarify what is meant by "direct access to the facility." Automated order routing systems may enable numerous customers to send their orders directly to a trading floor or to an electronic trading system. Such trades may be intermediated and/or guaranteed by a clearing FCM. The CBOT does not believe that the Commission intended to require markets to impose fitness requirements on such customers.

Compliance with core principles

Proposed Rule 38.5 requires a designated contract market to comply with a Commission request to demonstrate that it is in compliance with one or more core principles. Appendix B to Part 38 (applicable to designated contract markets) and Appendix B to Part 37 (applicable to DTFs), also state the authority of the Commission to require such a demonstration by these registered entities. The Commission indicated, in footnote 10 to its Federal Register release, that such requests for information provide an informal fact-finding mechanism that would provide the CFTC with the information it may need under the more formal procedures contained in Section 5c(d) of the Act. That Section details the Commission's authority to take certain actions to enforce compliance with a core principle, but only if it determines that there is substantial evidence that a designated contract market or a DTF is violating such a core principle. The Exchange appreciates the Commission's expressed intent to explore more informal methods of resolving issues relating to compliance with core principles before utilizing more formal mechanisms.

Arbitration

The CFMA removed, among other things, the Act's previous detailed requirements regarding exchange arbitration proceedings in former Section 5a(11), and replaced them with a core principle that designated contract markets "establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries." (Section 5(d)(13) of the Act).

The Commission has, therefore, proposed to delete Part 180 of its rules, and to repropose its withdrawn Rule 166.5. However, the only part of reproposed Rule 166.5 that is necessitated by the CFMA is the provision allowing a registered FCM to require an eligible contract participant to enter into an agreement waiving the right to file a CFTC reparations proceeding, as a condition to doing business with that FCM. As the Commission itself noted, the CFMA is silent as to whether pre-dispute arbitration agreements must be entered into voluntarily but the Commission has nevertheless retained its previous requirement of voluntariness.

In its proposed Appendix B to Part 38, the Commission has provided guidance with regard to acceptable practices which replace the more detailed requirements of Part 180, and has stated that a designated contract market should make such dispute resolution procedures available to a customer on a voluntary basis. This guidance does not address whether or not an FCM may require a customer to sign a pre-dispute arbitration agreement. It merely refers to the provision of one possible, but non-exclusive, dispute resolution forum. The Commission may wish to re-examine its voluntariness requirement in light of recent contrary developments in the securities arena.

Antifraud rule for retail foreign exchange transactions

The Commission has proposed a new antifraud provision in Rule 1.1 to address fraud in, or in connection with, retail foreign exchange transactions. Section 2(5) of the CFMA stated that one of the purposes of the statute was to clarify the CFTC's jurisdiction over otherwise unregulated retail foreign exchange transactions and bucket shops. Prior to the enactment of the CFMA, some courts had held that the Commission did not have jurisdiction over such transactions. The CBOT supports the Commission's proposal to implement the clarified statutory authority granted to the CFTC by the CFMA. Rule 1.1 addresses a regulatory gap with regard to such unregulated entities. It does not replace the applicability of any existing antifraud rule, and Section 2(c)(2)(C) of the Act makes it clear that FCMs and their affiliates remain subject to the general anti-fraud and anti-manipulation provisions of the Act in connection with retail foreign exchange transactions. The Commission should also make it clear that these foreign exchange transactions would be illegal unless they are executed on a designated contract market or a DTF.

Conclusion

The Exchange greatly appreciates the spearheading role that the Commission has played in the reinvention of the regulatory framework applicable to markets. This monumental effort was designed to permit U.S. markets to remain competitive in the fast-paced and

constantly evolving world economy. The Exchange looks forward to continuing to work with the Commission to effectuate and implement this significant regulatory relief. We would be happy to discuss our comments with Commission staff at its convenience.

Respectfully submitted,

David J. Vitale
President and Chief Executive Officer