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July 14, 2003

BY ELECTRONIC MAIL AND AIR COURIER

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

Re: CME/CBOT Common Clearing Link Rule Submission

Dear Ms. Webb:

We are writing on behalf of our client, the Board of Trade Clearing Corporation (the "Clearing Corporation"), in response to the Commission's request for comments on the Rules submitted to the Commission for its approval by the Chicago Board of Trade ("CBOT") and Chicago Mercantile Exchange ("CME") in relation to their so-called Common Clearing Link. The Clearing Corporation is the only party that is obligated to ensure the performance of the futures and option contracts that are proposed to be transferred from the Clearing Corporation to the CME. The Clearing Corporation, therefore, has a vital interest in this subject.

I. SUMMARY

Proposed CBOT Regulation 701.01 (which some have aptly described as the "follow-the-shepherd" rule) would require the clearing members of the CBOT – in other words, all of the members of the Clearing Corporation – to heed the instructions of the CBOT:

> **Transfer of Open Positions to Clearing Services Provider** - Each clearing member shall comply in all respects with any statement of policy or other notice issued by the Exchange to the procedures and processes that must be followed to effectuate the transfer of open positions to any Clearing Services Provider.

For the reasons that follow, the Clearing Corporation urges the Commission carefully to consider the ramifications of CBOT Regulation 701.01:

- Section 5c(3) of the Commodity Exchange Act (the "Act") directs the Commission to approve a rule of a contract market "*unless* the Commission finds that the ... new rule or rule amendment would violate this Act." (emphasis added)
    - Regulation 701.01 would appear to be inconsistent with the CBOT's duty, under Section 5(d)(18)(1) of the Act, to avoid adopting any rules or taking any actions that result in any unreasonable restraints of trade.
    - Regulation 701.01 similarly would appear to be inconsistent with the CBOT's duty, under Section 5(d)(18)(2), to avoid imposing any material anticompetitive burden on trading on the CBOT.
- Regulation 701.01 would require clearing members to breach their contracts with the Clearing Corporation. The CBOT has no authority to do so, and the Commission should not give its imprimatur to what would be a profoundly significant – and wholly inappropriate –precedent.
- Regulation 701.01 constitutes an after-the-fact change in the terms and conditions of the contracts made on the CBOT.
- The CBOT submission does not comply with the substantive requirements of Commission Regulation 40.5, relating to the submission of rules for Commission approval.
- The procedures that have been employed by the Commission to elicit public comment are not reasonable.[1]

II. REGULATION 701.01 WOULD APPEAR TO VIOLATE SECTION 5(D)(18) OF THE ACT

The requirement that all clearing members transfer their positions to the CME is facially inconsistent with the requirements of Sections 5(d)(18)(1) and (2), which require the CBOT to avoid adopting any rules or taking any actions that result in any unreasonable restraints of trade or that impose any material anticompetitive burden on trading on the CBOT.

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[1] Our comments are directed solely to proposed CBOT Regulation 701.01. The Commission should know that we would likely have additional comments on the other rules that have been submitted by the CBOT and CME but have not commented on those other rules because of the limited opportunity that has been provided for public comment.

CBOT Regulation 701.01 would force clearing members – who have made trades in contemplation of their being guaranteed by the Clearing Corporation – to move their positions to the CME. The difficulty with the CBOT proposal is that it would results in an apparent "tying" arrangement: "[T]he essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product [existing positions] to force the buyer into the purchase of a tied product [CME clearing services] that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms." *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 464 n.9 (1992) (quoting *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 12 (1984)). Such arrangements are *per se* violations of the Sherman Act without regard to a consideration of their reasonableness. *United States v. Topco Associates, Inc.*, 405 U.S. 596, 607 (1972). Regulation 701.01, therefore, would result in an "unreasonable restraint of trade" and impose "material anticompetitive burdens" within the meaning of Sections 5d(18)(1) and (2) of the Act.

III. REGULATION 701.01 WOULD REQUIRE CLEARING MEMBERS TO BREACH THEIR CONTRACTS WITH THE CLEARING CORPORATION

The CBOT's designation of the CME as its new clearinghouse *on a going-forward basis* is not the subject of this letter. In other words, we express no view as to whether the CBOT should instruct its members that trades made on or after a given date must be submitted to the CME. Rather, we wish to focus the Commission's attention on whether an exchange may require its members are to terminate their *existing clearinghouse contracts*, against their will and without the permission or consent of that clearinghouse.

By their nature, futures contracts and options on futures contracts are executory. Each such contract remains in effect until offset or exercised, settled in cash, or assigned to another clearing member for the making or taking of delivery. The Clearing Corporation is a party to each contract that it accepts for clearance and, under the rules of the Clearing Corporation and the CBOT (which are part of the terms of all such contracts), neither the Clearing Corporation nor a clearing member is at liberty to repudiate its obligations thereunder.[2]

That the open positions of clearing members and their customers will be closed at the Clearing Corporation and reopened at the CME may appear to be innocuous. The CME Clearing

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[2] At present, all futures contracts and options on futures contracts traded on or subject to the rules of the CBOT must be submitted to the Clearing Corporation for clearing. Upon acceptance of the transaction by the Clearing Corporation, the contract between the original parties is extinguished and, in place of that contract, two new contracts come into existence through a novation. More specifically, the Clearing Corporation interposes itself between the original parties, substituting itself as the seller to the purchasing clearing member and the buyer from the selling clearing member, under terms identical to those in the original transaction. If, as a result of substitution, a clearing member has bought such a contract from or sold such a contract to the Clearing Corporation and thereafter enters into an opposite transaction (*e.g*, a purchase followed by a sale), the second transaction will, if accepted for clearance, be deemed *pro tanto* to be a settlement or adjustment of the prior transaction. The clearing member is then liable to pay any loss to, and entitled to collect any gain from, the Clearing Corporation.

House Division is generally regarded as one of the top two futures clearinghouses in the United States. Moreover, it would certainly be more expedient if all positions (both old and new) were housed in a single clearinghouse. Mere convenience, however, does not justify wresting these contracts away from the Clearing Corporation. Perhaps most fundamentally, mere convenience can never be sufficient justification for a change in the terms of the contracts between a clearinghouse and its members. Those contracts embody an agreed set of understandings and risks that have been undertaken by the clearinghouse.[3]

It is admittedly convenient to refer to the contracts traded on the CBOT as "CBOT contracts." That nomenclature should not be allowed to obscure the fact that while the CBOT may establish the terms of and provide the facilities for the trading of futures contracts and options on futures contracts, it is the Clearing Corporation – and *not* the CBOT – that is the "buyer to every clearing member seller and the seller to every clearing member buyer."

We are unaware of any provision of Illinois statutory or common law, or any relevant equitable principle, that would permit the CBOT or any other person (other than a bankruptcy trustee, receiver or similar authority) who is not a party to the contracts between the Clearing Corporation and its members unilaterally to compel the abrogation of those valid and binding contractual agreements. *A fortiori*, the CBOT has no power to require the Clearing Corporation to transfer the contracts to which it is party (*i.e.*, the open interest) to the CME.

Recognizing that it has no power to do so, the CBOT has submitted Regulation 701.01 to the Commission and asked the Commission for its imprimatur. The Clearing Corporation believes that Commission approval of Regulation 701.01 would result in a "taking" under the Fifth Amendment to the Constitution, because the Commission would be approving an arrangement whereby the CBOT would be in a position to compel members of the Clearing Corporation to breach the more than 16 million futures and option contracts that are outstanding between the Clearing Corporation and its members. The Clearing Corporation has no objection if one of its members wishes to terminate that relationship with respect to CBOT products. In those circumstances, the Clearing Corporation is prepared to relinquish its rights and facilitate the transfer of that member's positions to the CME. Proposed Regulation 701.01, however, would permit the CBOT to *require* clearing members to make such a change, even if they would prefer not to do so.

The Clearing Corporation has a valid property interest in its contracts with its members. Commission approval of the proposed arrangement will effectively cause the redistribution of the Clearing Corporation's property to the CME. The Supreme Court has repeatedly acknowledged

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[3] By way of illustration, no one would seriously suggest that a contract market could unilaterally change the size of contracts that have already been traded, or shorten (or lengthen) the periods for delivery, without the consent of the clearinghouse. In like fashion, we cannot imagine that the Commission would be indifferent to a move by the CBOT to force its members to clear all of their business through one of the smaller and less well-capitalized clearinghouses.

that laws and other governmental actions redistributing property from one private party to another can be "takings" under the Fifth Amendment. *See, e.g., Eastern Enters. v. Apfel*, 524 U.S. 498, 523 (1998) ("'It is against all reason and justice' to presume that the legislature has been entrusted with the power to enact 'a law that takes property from A and gives its to B'"); *id.* at 542-543 (Kennedy, J., concurring) ("our regulatory takings analysis recognizes a taking may occur when property . . . is transferred to other private parties"); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1004-1005 (1984) ("It has never been the rule that only governmental acquisition or destruction of the property of an individual constitutes a taking."); *United States v. Security Industrial Bank*, 459 U.S. 70, 78 (1982) (Takings Clause protects against "a general economic regulation which in effect transfers the property interest from a private [party] to a private [party]"). The Court has analyzed such laws under the multi-factored test typically applied to land use cases and first set out in *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104 (1978). *See Eastern Enters.*, 524 U.S. at 529-537 (applying *Penn Central* factors to strike down provision in Coal Industry Retiree Health Benefit Act requiring plaintiff to fund health plan for miners, including miners who had been employed by other, now defunct, mine companies decades earlier); *Ruckelshaus*, 467 U.S. at 1055, 1010-1013 (applying *Penn Central* test and finding that federal law allowing authorities to use and disclose plaintiff's trade secrets was a taking).

Under this test, courts consider three factors: (1) the law's "economic impact" on the property owner; (2) the degree of interference with the owner's "distinct investment-backed expectations"; and (3) "the character of the governmental action." *Penn Central*, 438 U.S. at 124. The proposed arrangement would clearly have an economic impact upon the Clearing Corporation.[4] Governmental action here would be particularly egregious: The CBOT is requesting that the Commission interfere with the competitive process by forbidding members from determining whether, in the interest of safety, they prefer to leave their existing positions with the Clearing Corporation until they are offset or expire.

Commission approval of such an arrangement would serve no valid public purpose and would thus violate the "public use" requirement of the Takings Clause of the Fifth Amendment. "[T]he Constitution forbids even a compensated taking of property when executed for no reason

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[4] It is a mistake to conclude that the Clearing Corporation has no interest in the contracts between it and its clearing members. First, the Clearing Corporation will be deprived of clearing fee revenues if the positions it carries are forced off its books without being closed out through the normal process. Second, and of far greater potential import, the Clearing Corporation is at risk of being dragged into expensive and time-consuming litigation if customers or clearing members bring suit to recover damages caused by this transfer. In this regard, the Commission should be aware that the Clearing Corporation will *require* – and not merely "expect," as the CBOT seeks to characterize it in its self-certified "Statement of Policy Relating to the Procedures for the Transfer of Open Interest" – exculpations and indemnifications from the CBOT, the CME and all clearing members who transfer their accounts (for themselves and their customers). In essence, the Clearing Corporation will require, as a condition of cooperating with the transfer of positions to the CME, that the CBOT, CME and clearing members hold the Clearing Corporation harmless and indemnify it for all costs, losses, damages and expense associated with this forced transfer.

other than to confer a private benefit on a particular private party. A purely private taking could not withstand the scrutiny of the public use requirement; it would serve no legitimate purpose of government and would thus be void." *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229, 245 (1984). *See also Thompson v. Consolidated Gas Corp.*, 300 U.S. 55, 80 (1937) ("[O]ne person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid."); *Porter v. DiBlasio*, 93 F.3d 301, 310 (7th Cir. 1996) ("The Constitution forbids a taking executed for no other reason than to confer a private benefit on a particular private party"). "It is overwhelmingly clear from more than a century of precedent that the government violates the Constitution when it takes private property for private use." *Armendariz v. Penman*, 75 F.3d 1311, 1320 (9th Cir. 1996). Such takings also violate the Due Process Clause, because they are not "rationally related to legitimate government interests." *Washington v. Glucksberg*, 521 U.S. 702, 728 (1997).

There is no legitimate public purpose in transferring the Clearing Corporation's property interest in the existing contracts to its competitor (the CME) and there is no legitimate public purpose in forbidding members from maintaining a clearing relationship with the Clearing Corporation. Such a scheme is designed solely to benefit the CBOT and CME and is, therefore, unlawful.

IV. REGULATION 701.01 CONSTITUTES AN AFTER-THE-FACT CHANGE IN THE TERMS AND CONDITIONS OF THE CONTRACTS MADE ON THE CBOT.

As the foregoing makes clear, the CBOT does not have the authority to abrogate the contracts that have been made between the Clearing Corporation and its members. The difficulties posed by the CBOT's submission of Regulation 701.01 would be diminished if the CBOT maintained and operated its own clearinghouse (like the Clearing House Divisions of the CME and the New York Mercantile Exchange). That is not the case here, however. Even if we were to hypothesize a scenario where the CBOT operated its own clearinghouse, it still could not effect such a transfer absent the adoption of a binding rule that announced prospectively – *before trades are made and positions are established* – that it may in the future transfer positions to another clearinghouse. Absent such a prospective rule, the CBOT does simply not have the authority, in the absence of an emergency situation, to force the open positions of its members and their customers to be liquidated at the Clearing Corporation and re-established at the CME.[5]

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[5] Core Principle 6 of Section 5(d) of the Act and the Commission's explication thereof in Appendix B to Part 38 of the Regulations ("Appendix B") make clear that such a drastic measure may be taken by a contract market only under its emergency authority. Core Principle 6 provides that "[t]he board of trade shall adopt rules to provide for the exercise of *emergency* authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to – (a) liquidate or transfer open positions in any contract ..." (emphasis added) The Acceptable Practices provisions of Appendix B accompanying Core Principal 6 provide that "[a]s is necessary (cont'd)

V. THE CBOT SUBMISSION DOES NOT COMPLY WITH THE SUBSTANTIVE REQUIREMENTS OF COMMISSION REGULATION 40.5, RELATING TO THE SUBMISSION OF RULES FOR COMMISSION APPROVAL.

Commission Regulation 40.5 ("Voluntary Submission of Rules for Commission Review and Approval") requires that a registered entity, such as the CBOT, that is seeking the Commission's approval of a rule:

> Explain the operation, purpose, and effect of the proposed rule, including, as applicable, [(i)] a description of the anticipated benefits to market participants or others, [(ii)] any potential anticompetitive effects on market participants or others, [(iii)] how the rule fits into the registered entity's framework of self-regulation, and [(iv)] any other information which may be beneficial to the Commission in analyzing the proposed rule.

The CBOT's entire response to these requirements consisted of one sentence: "The referenced regulation is an enabling provision for the transfer of open positions from one CBOT clearing entity (a "Clearing Services Provider") to another." It is apparent that the CBOT either failed entirely to consider, or did not choose to share with the Commission, its analysis of these requirements.

Commission Regulation 40.5 further requires that a registered entity that is voluntarily seeking the Commission's approval of a rule –

> Identify any Commission regulation that the Commission may need to amend, or sections of the Act or Commission regulations that the Commission may need to interpret in order to approve or allow into effect the proposed rule. To the extent that such an amendment or interpretation is necessary to accommodate a proposed rule, the submission should

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(... cont'd)

to address perceived market threats, the contract market, among other things, should be able to ... order the liquidation or transfer of open positions." (emphasis added).

Core Principle 6 and the Acceptable Practices provide that a contract market will have the authority to cause the transfer of open positions where "necessary" in the case of an emergency or to address a perceived market threat. If a contract market normally had the power to cause such a transfer, there would have been no need for Congress to have specifically addressed the need for emergency authority in Core Principle 6. Furthermore, the limitations provided both by Congress (such authority is to be exercised "in consultation or cooperation with the Commission, where necessary and appropriate") and the Commission (such authority is to be exercised "as is necessary") make it clear that a contract market has this authority only in special circumstances. The CBOT is not facing an emergency – such as the insolvency or dissolution of its clearinghouse – that it could possibly use to justify its proposed compelled transfer of open interest against the wishes of clearing members and customers that may wish to continue to clear through the Clearing Corporation. The CBOT, therefore, would lack the authority to make such a demand, even if it operated its own clearinghouse and did not need to obtain the consent of the Clearing Corporation.

include a reasoned analysis supporting the amendment or interpretation of the Commission's regulation.

The CBOT's response to this requirement similarly consisted of a single sentence: "The CBOT has not identified any Commission regulations or sections of the Act which require interpretation or amendment in connection with this proposal." Proposed Regulation 701.01 is, on its face, inconsistent with Commission Regulation 1.38, which effectively requires all futures contracts to be made by open outcry and does not permit the ex-pit transfer of trades and positions, but the CBOT apparently did not believe it was necessary to bring this to the Commission's attention or address how this apparent inconsistency should be resolved.

VI. THE PROCEDURES THAT HAVE BEEN EMPLOYED BY THE COMMISSION TO ELICIT PUBLIC COMMENT ARE NOT REASONABLE.

The procedural schedule for considering the rules that have been submitted by the CBOT and CME deprives the Clearing Corporation of a meaningful opportunity to be heard and suggests that its views will not be considered on this vitally important matter. The Commission has afforded interested parties, such as the Clearing Corporation, only six days (July 14, 2003) from the date of its notice (July 8, 2003) to submit comments on the proposed rules.

The Commission's press release provides no justification whatsoever for such a truncated schedule. There appears to be some sort of arbitrary deadline for Commission approval, despite the fact that the CBOT and CME were obviously in negotiations for weeks or months before they announced the signing of their Clearing Services Agreement on April 16th. What possible rationale could justify this extraordinary acceleration of the period for Commission review from 45 days (*see* Commission Regulation 40.5) to six?

This curtailment of the public's right to be heard on the significant rule changes proposed by the CBOT and CME contravenes basic principles of administrative law. Whether this proceeding is properly characterized as a "rulemaking" or, rather, as an "adjudication," the Administrative Procedure Act ("APA"), 5 U.S.C. § 551 et seq., requires that interested parties, such as the Clearing Corporation, be afforded a meaningful and adequate opportunity to be heard.

Clearly, if this proceeding were deemed a "rulemaking," the notice and procedural schedule provided by the Commission would be procedurally deficient. For one thing, the APA (and, therefore, the Federal Register Act) and the Commission's own regulations require publication of rulemaking notices in the Federal Register. *See* 5 U.S.C. § 553(b) (APA); 44 U.S.C. §1505(a)(3) (Federal Register Act, requiring publication in the Federal Register of "classes of documents that may be required so to be published by Act of Congress"); 17 CFR § 13.3. Here, however, the notice was not even published in the Federal Register, but was disseminated by press release. Moreover, both the APA and the Commission's own regulations require that the public be afforded an adequate opportunity to comment in rulemaking

proceedings. *See* 5 U.S.C. § 553(c); 17 CFR § 13.4. The Commission may be excused from this requirement when the Commission "for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedures thereon are impracticable, unnecessary, or contrary to the public interest." 5 U.S.C. § 553(b) (emphasis added); *accord*, 17 U.S.C. § 13.5(b)(2). The Commission, however, has not identified any "good cause" for radically abbreviating the comment period, and we are aware of no case law holding that, in the absence of such a showing of good cause, it is appropriate to allow only six days – and slightly more than three business days – for the submission of comments concerning a rulemaking that will affect substantive and financially significant contract rights. *Cf. Northwest Airlines, Inc. v. Goldshmidt*, 645 F.2d1309, 1320 (8th Cir. 1981) (noting that the Secretary of Transportation invoked good cause exemption to justify a seven-day comment period).

Moreover, even if the proceeding were deemed to be an "adjudication," the comment period provided by the Commission would be legally inadequate. The APA provides that, in adjudications, "[t]he agency shall give all interested parties opportunity for (1) the submission and consideration of facts, arguments, offers of settlement, or proposals of adjustment when time, the nature of the proceeding, and the public interest permit." 5 U.S.C. § 554(c)(1). The Commission has made no attempt whatsoever to explain why "time, the nature of the proceeding, and the public interest" do not permit the provision of an adequate period of time for the Clearing Corporation – which, clearly, has a significant interest in the proposed rules – to submit facts and arguments pertinent to the proposal.

In addition, the Commission's plan to vote on the rules the day after the close of the comment period makes a mockery of even the truncated opportunity for comment that the Commission has afforded. An opportunity to be heard is meaningless if there is no reasonable prospect that the comments elicited will receive genuine consideration. By setting the vote for the day after the comments are due, the Commission has foreclosed serious and reflective consideration of the comments that will be submitted in this proceeding. Thus, the procedural schedule set forth in the Commission's notice suggests a wholly unwarranted rush to judgment, not the fair, impartial, and deliberative process to which the Clearing Corporation and other interested market participants are entitled.

VII. CONCLUSION.

The CBOT proposal is profoundly troubling on several levels. *First*, it would appear to violate Section 5(d)(18) of the Act and be incapable of approval. *Second*, it would create a precedent for future conduct by the CBOT – indeed, by every exchange and clearinghouse – that allows unfettered discretion once a general authorizing rule has been approved or otherwise made effective. *Third*, it would imply that the Commission is indifferent to contract rights, and that the exchanges are free to change the terms of their contracts without the consent of a third-party clearinghouse, its members and their customers as long as it can get the Commission's blessing for whatever change it proposes to make. *Fourth*, the Commission should not allow the CBOT to disregard the requirements of Commission Regulation 40.5. *Fifth*, it is unwise, as a matter of public policy, for the Commission to countenance to such a profound and unprecedented proposal with barely a week between the date of submission and the date of its expected approval.

Sincerely,

Kenneth M. Rosenzweig

cc: Chairman James E. Newsome
Commissioner Barbara Pederson Holum
Commissioner Walter L. Lukken
Commissioner Sharon Brown-Hruska
Dennis A. Dutterer
Nancy K. Brooks