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September 30, 2004

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

Re: SRO Governance
69 F.R. 32326 (June 9, 2004)

COMMENT

Dear Ms. Webb:

The Board of Trade of the City of Chicago, Inc. ("CBOT®" or "Exchange") appreciates the opportunity to respond to the Commodity Futures Trading Commission's ("Commission") request for comments regarding self-regulatory organization ("SRO") governance and self-regulation in connection with the Commission's study of self-regulation in the futures industry ("SRO Study").

Introduction

Recognizing the importance of futures industry self-regulation, and the Commission's obligation to foster and maintain market integrity, the Commission initiated its SRO Study in order to review the roles, responsibilities, and capabilities of SROs in the context of market changes. The Commission has issued the current Request for Comments, based on its belief that SRO governance can substantially impact key aspects of self-regulation, and in light of the increased national attention that has been given to SRO governance issues.

As the Commission noted in it proposing Federal Register release, the competitive environment and futures industry business models are evolving rapidly. These trends began prior to the adoption of the Commodity Futures Modernization Act of 2000 ("CFMA"), and have been further facilitated by that landmark legislation and the Commission's implementing regulations. Both Congress and the Commission have wisely replaced "one-size-fits-all" regulation with a core principle approach, in recognition of the flexibility needed by U.S. futures markets to compete in the world economy, and in recognition of the success of self-regulation, under Commission oversight, in the domestic futures industry.

The CFMA sets forth eighteen Core Principles that are applicable to all designated contract markets ("DCMs")[1], regardless of their corporate forms, with the exception of one that is only applicable to mutually owned contract markets. Section 5(d) of the Commodity Exchange Act ("CEA"). The Commission has adopted detailed guidance on compliance with these Core Principles in Appendix B to Part 38 of its Regulations. In addition, as DCMs have demutualized, they have become subject to additional requirements of corporate law, the Securities and Exchange Commission, and any listing securities exchange, as applicable.

The CBOT strongly believes that there is no need for Congress to adopt any additional Core Principles, or for the Commission to adopt any new rules or prescriptive guidance, with respect to Board composition, regulatory structure, disciplinary committees, conflicts of interest, or any other governance matters. The Core Principles that currently govern DCMs already address, among other things, governance fitness standards, conflicts of interest, and composition of boards of mutually owned contract markets, as well as competitive, open, and efficient markets, monitoring of trading, financial integrity, and protection of market participants.

Despite the speculation of some futures industry participants that it might occur, there has been no evidence that the trend toward for-profit exchanges, or changes in the competitive environment, have led to any decrease in the effectiveness of self-regulation. To the contrary, as more DCMs have entered the business, there is a real competitive incentive for all DCMs to attempt to distinguish themselves on the basis of their integrity, the efficiency of their markets, and their fairness to customers. In particular, it would be contrary to any DCM's own business interests and, if it is demutualized, the interests of its shareholders, to allow its integrity to be compromised by conflicts of interest in its decision-making.

Self-regulation has been a cornerstone of the regulatory structure for U.S. futures markets for many years. Under the oversight of the Commission, DCMs have long shown the ability to effectively regulate their own members through the establishment and enforcement of rules and regulations that are designed to ensure market integrity and protect customers. This has been accomplished through various forms of exchange ownership, governance models, and regulatory structures.

The Commission has a long history of effectively exercising its oversight responsibilities, in part, through its staff's performance of regular exchange rule enforcement reviews. Since the passage of the CFMA, Commission staff has continued to conduct such reviews to ensure that DCMs remain in compliance with the Core Principles. Over the years, these reviews have resulted in ongoing, constructive dialogue between Commission staff

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[1] In its comment letter, the CBOT has addressed the issues presented by the Commission from the perspective of a designated contract market, as they apply to designated contract markets. The Exchange has not attempted to specifically discuss the governance of designated clearing organizations or registered futures associations (except in response to Question 15).

and staff of the exchanges, which has served to enhance the effectiveness of exchange self-regulatory programs. The CBOT welcomes the continuation of such dialogue and cooperation.

The Exchange strongly believes that the Commission can effectively address any shortcomings in a DCM's performance of its self-regulatory responsibilities, whether resulting from governance issues, or from any other factors, on a case-by-case basis, through such Core Principle compliance reviews. Moreover, if the Commission concludes that a DCM is unable or unwilling to comply with any applicable Core Principles, the Commission is authorized to revoke the designation of that DCM. Section 5e of the CEA.

Against this backdrop, the CBOT addresses the specific questions posed by the Commission below.

Board Composition

1. **What is the appropriate composition of SRO boards to best protect the public interest and serve SROs' needs? What market participant communities should be represented and how should representation be allocated among those communities (*e.g.*, quotas, volume-based)? Should the composition of SRO boards be different for the various types of SROs (*e.g.*, DCM or DCO)?**

The CBOT does not believe that there can be a one-size-fits-all definition of the appropriate composition of SRO boards and how representation should be allocated. The appropriate composition and allocation may depend on many factors, including whether the SRO is mutually owned or demutualized; if demutualized, whether it is solely owned by members, or whether its shareholders include members of the public; and the nature of the market and its participants. Core Principle 16 simply requires that a mutually owned DCM ensure that the composition of its governing board "reflects market participants." Section 5(d)(16) of the CEA.

Generally, an SRO board[2] should include SRO members, market participants, and directors who are defined as non-member directors, public directors, or independent directors. If the SRO has been the subject of a public offering, the definition of "independent directors", and their percentage composition requirements will be determined by the requirements of the listing securities exchange, as well as the SRO's own Articles of Incorporation and Bylaws. For example, the New York Stock Exchange

[2] The CBOT notes that some SROs are organized as subsidiaries of holding companies. The Exchange's discussion of the issues raised by the Commission in its Request for Comments does not distinguish between such SROs and their parent holding companies, but treats the consolidated parent-subsidiary organizations as the SRO.

("NYSE") requires that listed companies have a majority of independent directors, as defined in Section 303A, paragraph 2, of the NYSE's Listed Company Manual.

2. **How and by whom should SRO boards be nominated and elected? Should each community nominate and/or elect its representatives to the board? What nomination and election procedures are necessary to ensure the independence of independent directors?**

As with the composition of SRO boards, the manner in which such boards should be nominated and elected may vary, depending upon whether an SRO is mutually owned, owned by member-shareholders, or owned in part by the public. While it may be appropriate for a mutually-owned SRO to have a nominating committee made up exclusively of members, the NYSE, for example, requires that the nominating committees of listed companies must be composed entirely of independent directors.

Regardless of the corporate form of an SRO, there should be a procedure for members or shareholders to suggest candidates for nomination to the nominating committee. In addition, there should be a procedure for members who have voting privileges, or stockholders, to nominate individuals who have not been nominated or recommended for nomination by the nominating committee, subject to any appropriate notice requirements or other conditions.

A mutually owned SRO should be permitted to restrict the categories of members who are permitted to vote for directors to those categories that are represented on the Board. Each mutually owned exchange should have the flexibility to determine whether a voting membership category should elect its own representatives to the Board, or whether such members should be permitted to vote for directors from other membership categories. Even if an SRO were publicly owned, it would remain appropriate, if the SRO so chose, to restrict voting for member-directors to members only.

The Board of Directors itself should be permitted to elect the public directors of a mutually owned SRO, after receiving nominations for such directors from the nominating committee. However, if an SRO is demutualized, whether it is owned exclusively by members, or is publicly-owned, all shareholders should be entitled to vote for independent directors in proportion to the number of shares that each holds.

Prior to the election of independent directors of a demutualized SRO, the nominating committee should make determinations regarding the independence of potential candidates, and the Board should make such determinations on an ongoing basis. For example, Section 303A of the NYSE's Listed Company Manual, paragraph 2(a), states that "[n]o director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company . . . ."

3. **Should SRO boards include independent directors and, if so, what level of representation should they have? What are appropriate definitions of**

"independent director" and "public director?" Should all independent directors be public directors? Can SRO members be considered independent? Is the New York Stock Exchange's definition of independent, i.e., independence from the exchange's management, members, and member organizations, an appropriate model for the futures industry?

SRO boards should include some independent directors, as discussed in response to Question 1. However, the Exchange does not believe that it is appropriate for the Commission to mandate their level of participation. Indeed, as noted by the Commission, when Congress adopted the CFMA, it repealed former Section 5a of the CEA, which had explicitly required that at least 20% of the directors of a contract market must be non-members. Former Section 5a(a)(14)(B) of the CEA. Therefore, it appeared to be Congress' intent that DCMs should determine for themselves the appropriate percentage of independent director representation on their boards.

The Commission should not impose a single definition of "independent directors" on all SROs, but should permit each SRO to develop its own specific standards. The appropriate definition may depend, in part, on whether the SRO is mutually owned or demutualized, and on any relevant corporate law or listing standards. For example, if a publicly traded SRO is listed on the NYSE, it must comply with the NYSE's stringent requirements for independent directors of listed companies, which require independence from management, as set forth in Section 303A of its Listed Company Manual, Section 2. It may be appropriate for a mutually owned SRO to require that its public directors be non-members, as does the NYSE. However, the CBOT does not believe that members cannot serve as independent directors of a demutualized SRO.

The CBOT is aware that the Futures Industry Association ("FIA") has suggested, in its June 8, 2004 Position Paper, that the definition of independent director should require that such directors not be currently "active in the industry." This proposal is overly broad. The CBOT believes that current definitions are adequate, and that such an extreme definition would unnecessarily exclude potential directors who may have no relationship with members, member firms, or management, as applicable, but who do have valuable expertise.

Regulatory Structure

4. **Are the governance standards applicable to listed companies sufficient for futures exchanges or their listed parent companies? Or, given that futures exchanges are not typical corporations in that they bear self-regulatory responsibilities, should they adopt higher governance standards, particularly with respect to self-regulatory activities? Please explain.**

The governance standards applicable to listed companies are generally more than sufficient for publicly owned futures exchanges or their listed parent companies. However, individual exchanges may choose to adopt additional procedures that they

believe will enhance the performance of their self-regulatory functions. The implementation of any such procedures should be left to the discretion of the particular SRO.

The FIA, in its June 8, 2004 Position Paper, has raised the specter of *potential* conflicts of interest, the *possibility* that exchanges can abuse their SRO responsibilities, and *appearances* of bias, in recommending the imposition of certain new SRO governance standards. However, it has not cited any specific instance of an actual conflict, abuse, or bias affecting any SRO action or causing any failure to act that might justify any new prescriptive requirements.

5. **Should SROs' regulatory functions be overseen by a body that is internal to the SRO, but independent of management, members, and business functions? If so, what specific functions should fall within its purview (*e.g.*, regulatory budget; personnel decisions; compensation of regulatory staff; compliance and disciplinary programs; other aspects of self-regulation)?**

An SRO should provide for the review of its regulatory functions on an ongoing basis. However, each SRO should have the flexibility to determine the manner in which it will do so. As discussed above, all exchanges are subject to the relevant Core Principles identified in the CEA. Among other things, DCMs must monitor and enforce compliance with their rules (Core Principle 2), monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process (Core Principle 4), and establish and enforce rules to protect market participants from abusive practices committed by their agents (Core Principle 12). Sections 5(d)(2), 5(d)(4) and 5(d)(12) of the CEA.

Section 5(d)(1) of the CEA states that a DCM ". . . shall have reasonable discretion in establishing the manner in which it complies with the core principles." Therefore, how any particular SRO determines and reviews its regulatory budget, and makes decisions regarding personnel, compensation of regulatory staff, and compliance and disciplinary programs should be determined by the SRO. As previously noted, Commission staff has a long history of reviewing the effectiveness of SROs' regulatory programs in its periodic rule enforcement reviews, and it can be expected to continue to do so in the context of reviewing SROs' compliance with the CEA's Core Principles. Such rule enforcement reviews have repeatedly found that the CBOT and other SROs have adequate regulatory programs. Moreover, in light of the fact that the Commission has the authority to revoke the contract market designation of any DCM that fails to comply with the Core Principles, DCMs have a strong incentive to effectively fulfill their self-regulatory responsibilities.

Currently, at the CBOT, the President of the Exchange recommends compensation levels for regulatory (and other) employees to a Board-level Human Resources Committee. Subject to levels specified by the Board, the Human Resources Committee approves the salaries of the officers that supervise the regulatory staff (and other officers). The

Committee, together with the President, approves the salaries of non-officer employees, including those of the regulatory staff.

The officers responsible for the CBOT's Office of Investigations and Audits ("OIA") recommend the self-regulatory budget to the Office of the President of the CBOT which, in turn, recommends this and all other department budgets to a Board-level Finance Committee. The Finance Committee reviews and recommends these budgets to the Board of Directors, which has the ultimate approval authority.

The CBOT's Regulatory Compliance Committee, which is made up of three Board members, as well as the chairmen of the Arbitration, Business Conduct, Financial Compliance, Floor Conduct, Floor Governors and Membership Committees, monitors compliance policies, and reviews related proposed rule changes prior to Board consideration.

In its June 8, 2004 Position Paper, the FIA recommended that the CFTC require that a board committee of independent, non-industry directors oversee exchange regulatory functions. Some exchanges may choose to appoint such a committee. However, there is no compelling reason for the Commission to mandate such an approach. Neither the FIA, nor anyone else, has put forth any evidence that regulatory policy at the CBOT, or at any other exchange, has been improperly influenced by business interests.

The FIA also recommended that the CFTC require that exchanges institute a more formal separation between their business staff and their compliance and surveillance staff. This recommendation appears to be based on an unfounded concern that confidential information obtained by a DCM's regulatory staff might be shared with, and used by, its business staff to further the competitive interests of the DCM. The FIA has not cited a single instance of any such alleged use of confidential information. On the contrary, the CBOT, for example, in its role as the designated self-regulatory organization ("DSRO") for a number of futures commission merchants, maintains strict confidentiality of their routine financial filings submitted to the Exchange's Audit and Financial Surveillance staff, as well as all documentation and findings relating to its audits of such firms.

It is reasonable to expect that a DCM's regulatory staff will not be supervised by its business staff. However, the issue of the separation between the business side and the regulatory side is not as clear-cut as it may appear. For example, when the CBOT's business staff is designing new contracts, particularly if they have novel features, it is essential for the regulatory staff to participate in the analysis of whether particular terms and conditions of the proposed contracts comply with Commission and/or Exchange regulations. The same consultation is necessary when the business staff is exploring different methods of trade execution that may be offered for particular contracts. Similarly, coordination is required between the business staff and the Exchange's Registrar's Office, which resides in OIA, when firms seek to become delivery facilities for physical commodity contracts.

Market integrity and good business are inextricably linked. A DCM that allows the fairness of its marketplace to be compromised by narrow business interests will lose its business, through a loss of customer confidence, and perhaps ultimately, a revocation of its designation by the Commission if it fails to comply with relevant Core Principles.

6. **Please address whether any rule enforcement, disciplinary, or other functions currently performed by exchanges should be performed instead by an independent regulatory services provider.**

Both Congress and the Commission have recognized that regulatory services may be effectively performed by exchanges themselves or by a third party regulatory services provider. Section 5(b)(6) of the CEA; Appendix B to Part 38 of the Commission's Regulations.[3] This flexibility should be retained, so that each exchange may determine the most appropriate and effective venue for performing its self-regulatory services.

The CBOT strongly believes that rule enforcement, disciplinary and related functions can be, and are, effectively performed by exchanges. The CBOT's OIA has successfully conducted trade practice surveillance, market surveillance, and audits and financial surveillance for many years. Commission staff has recognized the adequacy of CBOT surveillance and disciplinary programs in a number of rule enforcement reviews, and has praised the effectiveness of the Exchange's sophisticated electronic trade practice surveillance system. See, *e.g.*, Rule Enforcement Review of the Chicago Board of Trade, Division of Trading and Markets, June 30, 2000, pages 15 and 17.

The regulatory services that are provided by exchanges encompass much more than the investigation and prosecution of potential trade practice or market abuses, and the performance of audits and financial reviews. The regulatory staff of an exchange is in a unique position to develop relationships with the exchange's members and member firms, which offer opportunities for education, answering questions, and preventing violations from occurring through increasing the membership's awareness of the exchange's rules and regulations. Moreover, an exchange is in the best position to interpret its own rules.

One of the essential functions of a DCM's market surveillance staff is the surveillance of expiring futures contracts to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process, in compliance with Core Principle 4. Section 5(d)(4)

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[3] Section 5(b)(6) of the CEA (Designation Criterion 6 for DCMs) states that "[t]he board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties." In its discussion of Core Principles 2 (Compliance with Rules) and 4 (Monitoring of Trading), Sections 5(d)(2) and 5(d)(4) of the CEA, in Appendix B to Part 38 of the Commission's Regulations, the Commission indicated that trade practice surveillance and market surveillance could be carried out either by a designated contract market itself or through a delegation of the relevant function to a third party.

of the CEA. This surveillance process can involve frequent meetings with the exchange committee that has the responsibility for monitoring expirations, and numerous letters and phone calls between the market surveillance staff and large participants who remain in the market during the delivery period. Exchanges' market surveillance staffs have an opportunity to become very familiar with their own market participants in this manner, and in turn, can effectively coordinate with Commission staff who are responsible for the Commission's own market surveillance efforts.

The staff of an exchange that conducts its own audits and financial surveillance becomes very familiar with member firms' accounting staffs, internal controls and other procedures and financial positions based on frequent routine interaction, including audits, regular financial surveillance, and the routine surveillance of the potential financial impact of large trader positions. An exchange's audit and financial surveillance staff, which has developed relationships with member firms through such regular contact, is frequently aware of developing problems, and is in a position to respond by intensifying its monitoring efforts and requiring increased reporting to the exchange. An exchange's audit and financial surveillance staff is also keenly aware of the impact that one member firm's financial problems may have on the exchange's clearing house and other member firms and their customers, and is strongly motivated to attempt to ensure that such consequences do not occur. The CBOT believes that the performance of these functions by exchange staffs has resulted in the impressive record of the industry in averting or minimizing the impact of financial failures.

There are also important benefits to be gained by an exchange that maintains its own investigative staff. Particularly, in the case of an open outcry market, such an investigative staff is in a position to act very quickly, because it has immediate access to brokers and traders on the floor. Members who are the subjects of investigations may be more likely to cooperate with the exchange's own investigators than those of a third party, because they are more likely to know them, and because they are strongly motivated to maintain their trading privileges and reputations at the exchange. Similarly, other exchange members are more likely to file a complaint with the exchange's own investigative staff. At the CBOT, the investigative staff also spends time on the trading floor, monitoring trading at various opens, closes, and expirations, and is frequently consulted about the Exchange's trading rules and regulations by members who wish to avoid taking actions that could violate those provisions.

Exchanges also can effectively provide a forum for disciplinary proceedings resulting from rule violations that lead to prompt and effective disciplinary action. Disciplinary committees that include representatives of the various categories of members who appear before them have the insight necessary to perceive violations and their consequences, and impose appropriate penalties. For example, floor brokers, floor traders, and FCM representatives who are familiar with trading practices and floor broker recordkeeping requirements, are in a unique position to quickly recognize how a floor broker may have mishandled a customer order and how his actions may be revealed by his trade documentation. Moreover, other floor brokers and exchange members are motivated to

mete out appropriate discipline that will correct the behavior of the violator, and maintain the integrity of the exchange, because the actions of the one reflect on all.

C. Forms of Ownership

7. What impact do varying business models have on SROs' self-regulatory behavior? Consider for-profit/not-for-profit, member-owned/shareholder owned, and publicly traded/privately held business models.

The nature of an SRO's business model, *i.e.*, whether it is for-profit or not-for-profit, member owned or shareholder owned, or publicly traded or privately held, may impact its governance model and committee structure. However, it should not affect an SRO's self-regulatory behavior. All SROs that are DCMs, whatever their business models, are obligated to comply with the same Core Principles set forth in Section 5(d) of the CEA, with the exception of Core Principle 16, Section 5(d)(16), which specifically requires a mutually owned contract market to ensure that the composition of its governing board "reflects market participants". Those Core Principles require all such SROs to provide a competitive, open and efficient market, to monitor trading to prevent manipulation and price distortion, and to enforce rules that preserve the financial integrity of the market, protect customer funds, and protect participants from abuse of their orders. No SRO could continue to function as such if its business model allowed it to compromise its commitment or ability to fulfill its self-regulatory responsibilities. Moreover, regardless of the nature of an SRO's business model, effective self-regulation is in its own best interests and those of its members, shareholders, if any, and customers.

8. More specifically, is an SRO subject to new influences in the performance of its self-regulatory functions when it converts from a member-owned, not-for-profit organization to a publicly traded, for-profit company? Might a for-profit, publicly traded SRO attempt to attract volume or increase its profits through lax self-regulation? Or, is it more likely that the SRO will seek to protect its brand and add value through effective self-regulation?

A publicly traded, for-profit SRO does not have any motivation to seek to attract volume or increase its profits through lax self-regulation. To the contrary, it is "good business" to maintain the integrity of the exchange. Potential participants will be drawn to a market that will treat them fairly, and on which they are likely to obtain prices that are determined by the fundamentals of the particular commodities and the liquidity of the market, rather than being affected by abusive or manipulative practices. As it pursues its intention to become demutualized and potentially a publicly held company, the CBOT recognizes that a continued emphasis on market integrity is ultimately its strongest marketing tool.

D. Disciplinary Committees

9. How should SRO disciplinary committees be structured so as to ensure both expertise and impartiality?

Designation Criteria 3 and 6, and Core Principles 2 and 12 all address requirements that DCMs enforce their rules and/or maintain effective disciplinary procedures. Sections 5(b)(3), 5(b)(6), 5(d)(2) and 5(d)(12) of the CEA. None of these Designation Criteria or Core Principles even require that an SRO fulfill its disciplinary responsibilities through a committee mechanism, much less mandate how any such committees should be structured.

The CBOT believes that any SRO that enforces its rules through disciplinary committees should be able to determine for itself how such committees should be structured so as to ensure expertise and impartiality. Moreover, there is not just one structure that will fulfill these goals. Some SROs may choose to have disciplinary committees that consist solely of members of the SRO, and others may choose to have one or more non-members serve on such a committee. Moreover, some may choose to have non-member representation on a case-by-case basis, depending on the nature of the particular matter under consideration. Finally, an SRO's determination of the appropriate composition of any particular disciplinary committee may depend on the nature of the matters handled by that committee.

The CBOT believes that it is important that its disciplinary committees contain both expertise and impartiality, and that these two qualities are not mutually exclusive. Only members serve on the Exchange's Floor Governors and Business Conduct Committees, subject to defined processes to minimize conflicts of interest. Each of these committees consider matters that require a detailed knowledge of either trading practices and related recordkeeping, or member firm back office procedures. Therefore, the Exchange includes members who have such knowledge on these committees, as well as representatives of diverse membership interests in order to ensure fairness.

Prior to the effectiveness of the CFMA, the CBOT included non-members on the Floor Governors and Business Conduct Committees, on a case-by-case basis, under the circumstances specified in Commission Regulation 1.64(c)(1)[4]. However, the Exchange found that more often than not, although these individuals generally had some knowledge of the futures industry, they did not have sufficient expertise to independently draw conclusions about the matters in issue, and they simply deferred to the Exchange members on the relevant committee.

In order to ensure sufficient expertise, the CBOT's Financial Compliance Committee is made up of "qualified individuals, whether members or non-member employees of member firms." CBOT Rule 551.00. This provision permits individuals who have

[4] As a result of the passage of the CFMA, the Commission now exempts DCMs from the application of Regulation 1.64, pursuant to Commission Regulation 38.2

knowledge of futures-related accounting requirements and practices of member firms to serve on this committee, whether or not they hold their firms' memberships in their own names.

In its June 8, 2004 Position Paper, the FIA expressed its concern that the current composition of exchange disciplinary committees may create an appearance of bias. However, the FIA can cite no instances where a respondent or a customer demonstrated that the composition of a disciplinary committee resulted in an unfair conclusion.

10. Please address whether SRO disciplinary committees should have independent, non-SRO member chairs and/or committee membership. Should the level of representation for independent, non-SRO members vary according to the type of disciplinary case?

Each SRO should determine for itself whether any of its disciplinary committees should have non-member chairpersons or committee members, and if so, the appropriate level of representation for any particular case. These issues are more fully discussed in the response to Question 9 above.

11. How and by whom should SRO disciplinary committees be appointed? Should the terms of committee members be limited? Please explain.

The manner in which the members of disciplinary committees are appointed, by whom, and for how long should be determined by each SRO. The members of the CBOT's disciplinary committees, as well as all of its other member committees, are appointed by the Chairman of the Board, with the approval of the Board, for terms that are defined in the Exchange's rules. The CBOT does not limit the number of terms that any committee member may serve, and believes that SROs should have the flexibility to reappoint members to disciplinary committees who have gained increasing levels of expertise through prior committee service.

E. <u>Other Issues</u>

12. What additional information, if any, should SROs make available to the public to increase transparency with respect to their governance and regulatory structures (e.g., board member affiliations; regulatory staffing and budget; disciplinary committee membership and affiliations, etc.)?

Each SRO should have the discretion to determine what additional information it will make available to the public with respect to its governance and regulatory structures, in addition to that which is already required by existing law. For example, exchanges that plan to engage in an offering of shares, whether only to members, or to the public, are required to disclose information regarding the compensation of directors and the extent of their stock ownership, as well as certain business relationships, in their SEC registration statements.

The CBOT makes the names and affiliations of its Board members available on its website. More detailed information has been provided about each Board member, his/her affiliation, membership status, length of service, and committee memberships, in Amendment No. 8 to the Form S-4 Registration Statement for CBOT Holdings, Inc., filed with the SEC on September 30, 2004, pursuant to relevant SEC requirements. The Exchange also makes the names of disciplinary committee members available to the public, by posting their names on the Exchange's website at the time when they are appointed, and thereafter, at any time, upon request. Other information available on the CBOT website includes the Exchange's Rules and Regulations, biographical sketches of the Exchange's top management, and the most recent certified annual report.

In particular, the CBOT does not believe that there is any need for the details of regulatory staffing and budgets to be made available to the public. Section 8c(a)(2) of the CEA requires an exchange to make public the results of its disciplinary actions, which the CBOT does through the National Futures Association's internet-accessible database, but prohibits an exchange from disclosing the evidence underlying its disciplinary actions to the public. Commission staff routinely reviews the effectiveness of exchanges' disciplinary programs in its rule enforcement or Core Principle compliance reviews, and information about a particular DCM's disciplinary committee members, staffing and budget is readily available to the Commission, if its staff requests such information, as it often does.

13. Would additional core principles for SROs help to clarify their responsibilities with respect to governance, or would regulatory guidance be more appropriate.

The CBOT strongly believes that there is no need for any additional Core Principles related to SRO governance, nor is there a need for any additional regulatory guidance, other than that which has historically and effectively been offered by the Commission. Core Principles 14, 15, and 16 already address governance fitness standards, conflicts of interest, and composition of boards of mutually owned contract markets, respectively. Sections 5(d)(14), 5(d)(15), and 5(d)(16) of the CEA. Moreover, demutualized exchanges are also subject to the corporate law of their jurisdictions of incorporation, SEC regulations, and if publicly owned, the requirements of their listing securities exchanges. Because there is no one-size-fits-all business model for futures exchanges, any attempt to adopt additional core principles, or to develop further regulatory guidance, would be ineffective, inappropriate, and unduly prescriptive.

14. What steps should be taken to manage or eliminate conflicts of interest involving SRO board and disciplinary committee members?

Under former Section 5a of the CEA, the Commission had adopted detailed, prescriptive requirements with respect to voting by SRO board and committee members in situations where they might have potential conflicts of interest. Commission Regulation 1.69. This

section of the CEA was repealed by the CFMA, which instead addressed potential DCM conflicts of interest in Core Principle 15, Section 5(d)(15) of the CEA. This Core Principle requires such SROs to establish and enforce rules to minimize conflicts of interest in their decision-making processes and to establish a process for resolving conflicts of interest.

The Commission exempted DCMs from the application of Regulation 1.69, pursuant to Commission Regulation 38.2, and provided guidance regarding compliance with Core Principle 15, in Appendix B to Part 38 of its Regulations. This guidance indicates that DCMs should have methods to ascertain the presence of conflicts of interest and to make decisions in the event of conflicts. The guidance also states that DCMs should provide for appropriate limitations on the use or disclosure of material, non-public information by board members, committee members, and employees.

Each SRO is in the best position to determine how to manage conflicts of interest involving its own board and disciplinary committee members. Among other things, the CBOT's Regulation 188.04, Conflicts of Interest, incorporates essential elements of the formerly applicable CFTC Regulation 1.69, while making them more workable for the Exchange. CBOT Regulation 188.01 prohibits the disclosure of material, non-public information by directors and committee members for any purpose other than the performance of their official duties. Members of the Exchange's disciplinary committees and the Board of Directors all sign Oaths of Confidentiality at time when they begin their service. The CBOT also maintains an Employee Investment Policy, which appropriately limits the ability of employees to maintain investments that could create conflicts of interest with respect to their responsibilities to the Exchange, as well as a Confidential Information Policy, which is applicable to all employees. In addition, third party consultants are required to maintain the confidentiality of information learned during their engagements, pursuant to the terms of their consulting agreements.

15. Should registered futures associations that are functioning as SROs also be subject to governance standards?

At the time when Congress amended the CEA to replace a rules-based approach with a core principle approach to the regulation of futures exchanges, it retained the detailed provisions of Section 17 of the CEA that govern registered futures associations. Sections 17(b)(5), 17(b)(11), 17(b)(12) and 17(b)(13), which address fairness in governance and the composition of such an association's board and major disciplinary committees, generally require "fair representation" by a "diversity of membership interests", and specifically require that no less than 20% of the board must be non-members or persons who are not regulated by the association. However, the CEA does not require a registered futures association to include non-members on its disciplinary committees, except "where appropriate to carry out the purposes of [Section 17 of the CEA]." Section 17(b)(13)(B). Commission Regulation 170.3 specifically requires that a registered futures association include non-members on its board and hearing panels "wherever practicable," and prohibits any single class of association members from exercising

disproportionate influence on the board or any disciplinary panel. Neither Section 17 of the CEA, nor the Commission's Part 170 Regulations, addresses conflicts of interest in the decision-making of a registered futures association. The CBOT believes that registered futures associations that are functioning as SROs should be subject to no less onerous standards than those that the Commission applies to DCMs.

Conclusion

The Commission, in its oversight function, has confirmed again and again the effectiveness of self-regulation by U.S. futures exchanges. Designated contract markets have a long-standing and continuing record of maintaining the integrity of, and protecting customers in, their markets. An increasing number of exchanges are demutualizing, and new exchanges are entering the market. In this context, every DCM can be expected to continue to examine its own governance structure and its implementation to ensure that its exchange remains in compliance with applicable Core Principles while meeting its business needs. Compliance and good business complement one another in that the success of an exchange's business is totally dependent on its market integrity and the confidence of its customers.

The CBOT is convinced that when the Commission concludes its SRO Study, it will have a firm basis to determine that there is no need for additional Core Principles, new rules or prescriptive guidance, with regard to exchange governance. The Commission has shown its continuing ability to effectively exercise its oversight responsibilities as markets have evolved, and there is no evidence that market changes over the past several years have raised any issues with respect to the fairness of Board composition and decision-making or the impartiality of exchange disciplinary processes. To the contrary, the increasing volume on U.S. exchanges (and increasing stock prices where publicly held) is testament to their customers' confidence in their market integrity.

If you have any questions about these comments, please feel free to call Anne Polaski, Assistant General Counsel, at (312) 435-3757.

Sincerely,

Bernard W. Dan