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**KANSAS CITY
BOARD OF TRADE**

RECORDS SECTION

August 30, 2006

SENT VIA E-MAIL
secretary@cftc.gov

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

COMMENT

2006 AUG 30 PM 1:43
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RE: Regulatory Governance; 71 FR 38740 (July 7, 2006) ("Release")

Dear Ms. Donovan:

The Kansas City Board of Trade ("KCBT") submits the following comments in response to the Commission's proposed acceptable practices for safe harbor compliance with Section 5(d)(15) of the Commodity Exchange Act ("CEAct") (Core Principle 15) pertaining to conflicts of interest in self-regulatory organizations, which was posted for public comment on July 7, 2006. (These comments are in addition to those previously submitted for the record on September 20, 2004 and January 17, 2006 respectively.)

For the reasons detailed below, KCBT believes the proposed acceptable practices should not be applied to mutually-owned exchanges such as KCBT, which have not undergone the types of changes or challenges cited in the Release as giving rise to the proposal. Applying the acceptable practices to a mutually owned exchange would present a significant burden to efficient exchange operations that cannot be justified as necessary or appropriate to effectuate the purposes of the CEAct, including § 5(d)(15). Moreover, the proposal is contrary to the governance standards of Core Principle 16 which applies to the KCBT as a mutually-owned exchange. Therefore, the KCBT hereby requests that the Commission make explicit that the aforementioned practices for compliance with Core Principle 15 do not apply to mutually-owned exchanges such as KCBT.¹

¹ The Commission's acknowledgement in the Release that "exchanges may choose not to comply with the proposed Acceptable Practices for Core Principle 15" (71 FE 38744) provides no real comfort. The detailed, proscriptive nature of the proposal, combined with the proposed acceptable practices language that "Acceptable Practices for minimizing conflicts of interest shall include..." (emphasis added) and use of terms in the Release such as "every exchange" and "all exchanges" evidences a pre-disposition to hold all exchanges to these standards.

None of the criteria the Commission cites as justification for the necessity of such acceptable practices is applicable to KCBT, namely: 1) increasing competition between exchanges, both domestic and foreign; 2) changing ownership structures; 3) evolving business models; and 4) transformation to a publicly traded stock company. As a lower volume, single-product exchange, KCBT faces unique challenges that necessitate the proper construction and implementation of its regulatory responsibilities. A smaller exchange cannot afford to allow or even give the appearance of condoning practices that are contrary to the best interests of the marketplace and market participants. To do so would invite devastating results to the future of the exchange as a going concern. KCBT has always taken very seriously its regulatory responsibilities and has rigorously developed programs and procedures designed to ensure the highest level of market integrity; it exercises the utmost diligence to ensure that its regulatory decision making is conducted with that objective in mind. The results of these efforts are supported by current and past CFTC rule enforcement review reports. Simply put, KCBT has experienced no “problem” in the history of this Commission which would warrant imposing such drastic acceptable principles. The following details our concerns more fully.

Initially, we note that Section 5(d)(15) of the CEAct (“Core Principle 15”) requires exchanges to “minimize” – not eliminate – “conflicts of interest in the decision making process.” (Emphasis added.) Congress’ choice of “minimize” was knowing and deliberate. It recognizes that exchange governance could be free from even the perception of a conflict by filling governance positions with those totally devoid of any connection to the marketplace whatsoever, and rejects that approach. Given that exchanges are self regulatory organizations, such conflict “purity” would necessarily lead to the major decisions regarding the operation of our vital national futures markets being made by those with no expertise in such decision making and no vested interest in the long-term best interest of these national markets. Hence, neither Congress, nor (until now) this Commission, has ever seriously considered such extreme (and potentially counter-productive) requirements.

Instead, what has always been sought and, to date, achieved is a balance between reputable, conflict-free directors and knowledgeable ones who are committed to the integrity and long-term best interests of the marketplaces which form an integral part of their professional existence. Because maintenance of a futures marketplace is an intricate art, not an exact science, capable exchange governance has traditionally come first and foremost from market participants of all sorts, not just exchange members. Thus, in those (few) times of great market stress – from Black Monday and 9/11 to 1979 Silver and 1989 Soybean markets – America’s futures exchanges have distinguished themselves for both the efficiency and integrity with which market crises were dealt.

But such expertise is not common or fungible. Brilliant bankers are rarely knowledgeable about potential market manipulations and expertise in operating a successful public corporation carries with it no experience in maintaining and fostering futures markets. Thus, knowledgeable “public” governors are few and far between.

Therefore, requiring an exchange governing board to be comprised of fifty percent public directors may be a sound practice for Enron, but it is regulatory over-kill and an invitation to disaster for governing our nation's complex futures markets. This is evidenced by the proposal's contradiction of Core Principle 16 (CEAct § 5(d)16) which requires a mutually-owned Exchange (such as the KCBT) to constitute its governing board to "... reflect market participants." Thus, existing Core Principles recognize the imperative need for vested expertise in board governance; yet, the proposal tips this balance disproportionately in favor of governors without market expertise, however otherwise qualified they may be. Perhaps there is a need beyond NYSE listing requirements for public perception to have more public directors for those exchanges which are de-mutualized, publicly listed companies, but not for mutually owned exchanges with lesser volume. Significantly increasing public directors will only dilute the requisite market expertise on the governing board and create an imbalance among all the other necessary diverse market participants (such as floor traders, brokers, FCMs, commercials, funds and proprietary trading firms).

Qualified, knowledgeable public directors are difficult enough to find and have agree to serve. However, to more than double the number necessary to meet core principles would require an exchange to dilute the necessary resources of expertise so vital to exchange governance. Absent compelling reasons – not presented here – we should not so endanger our national marketplaces.

This is even more compelling given that the cited bases for the proposed acceptable practices bear no relation to the KCBT. The proposal cites "changing ownership structures" as one predicate for these changes. However, KCBT (and other exchanges) have not changed their ownership structure; KCBT remains the same non-public, mutually-owned entity that it has been over its history. Neither is KCBT a for-profit limited liability company. Thus, this motivation is inapplicable to KCBT (and other mutually-owned exchanges).

As for "increasing competition" and/or "evolving business models," neither of these factors has bearing on the operation of KCBT's markets; they remain vital and largely unchanged. Consequently, radical, deleterious governance changes would be imposed by the proposal for no justifiable reason. As to the Release's observation that SRO functions face "the possibility" that they "may be marginalized by potentially conflicting commercial interests," that is not applicable to KCBT and its markets. The studies cited to support such a concern admittedly focus not only on de-mutualized exchanges, which KCBT is not, but also securities exchanges/markets, which KCBT is not. Simply because the NYSE becomes public and international is no justification for burdensome, counter-production regulation of the KCBT. Given that no "problem situations" at futures exchanges are cited in the proposal, "fixing" that which is not broken with draconian requirements swings the balance of SRO regulation way too far toward perception rather than practical necessity.²

² The proposal that exchange disciplinary committees be composed of at least one public member is currently in place at many exchanges and proven not to be onerous or counterproductive. Thus, KCBT has no objection to this portion of the proposed acceptable practices.

The proposed Regulatory Oversight Committee (“ROC”) requirements also present significant problems. First, it requires the ROC to be comprised solely of public directors, who almost universally would lack sufficient experience and expertise to provide meaningful oversight of exchanges’ intricate SRO functions. Exchange regulatory programs are highly specialized, and to function well must be administered by highly skilled and experienced exchange personnel. Moreover, much of the proposal (such as number and compensation of regulatory officers and staff as well as hiring and termination) represents a level of authority contrary to commonly accepted corporate management best practices by taking management functions from management and vesting them as Directors’ responsibilities. To have a Board committee charged with a general, annual review of exchange regulatory practices may be desirable in a de-mutualized, public exchange. But to require Directors to usurp management responsibilities is contrary to sound corporate management and constitutes form over substance given the typical Director’s lack of expertise over such detailed regulation in a futures exchange. The proposal should be limited to one of general, annual oversight. Indeed, even conceptually the ROC proposal seems particularly unnecessary given that the Release acknowledges that “SRO Review has found no indication of widespread inadequacy in exchange disciplinary committees.” (Release @ p. 29).

Regarding the definition of public director (irrespective of the requisite percentage on the Board), that definition must include those members leasing their seats or otherwise “marginally” involved in trading at the particular exchange in order to ensure an available pool of potential public directors sufficiently knowledgeable about futures markets such that their advice and oversight is meaningful and constructive. [The proposals should also be expanded to include as public directors those who have exchange membership at exchanges other than where they serve as a director as well as holders of corporate memberships whose firms likely conduct business at multiple exchanges.]

Overall, the proposal seeks to remedy problems which do not exist (at least at the KCBT) by means which exceed the balance required by core Principles and the intention of the 2000 amendments to the CEAct. Those amendments rejected rigid, “bright-line” requirements for exchange governance in favor of broad, core principles with flexibility and diversity regarding compliance. These proposals swing that balance far too much in favor of rigid, arbitrary requirements when there is no demonstrable need for such action. There is no history of recent futures exchange governance abuse such as that at Enron, etc., which spawned Sarbanes Oxley, most certainly not at the KCBT. Existing conflict of interest rules have worked well and, if more is required of de-mutualized, public exchanges (which KCBT is not), NYSE listing requirements and Delaware/corporate law governance have dealt with those issues sufficiently.

Instead of these proposals, we urge the Commission to give deference to Congressional policies underlying Core Principle 16 which directly covers exchange governance (or mutually-owned exchanges) and its existing requirement that futures exchanges’ governing boards be comprised of “market participants.” This provides the necessary experience and expertise to achieve meaningful governance; conflicts issues are well-served by existing standards.

If the Commission insists on merging Core Principle 15 conflicts requirements with § 16 governance issues, it should adopt acceptable practices which expressly recognize that these bright-line rigid proposals are not applicable to non-public, lower volume exchanges such as the KCBT. By so doing, the Commission will be providing the flexibility required by the 2000 CEAct amendments in dealing with lower volume, non-public exchanges.

Respectfully submitted,



Jeff C. Borchardt
President and CEO