06-04
(21)

COMMENT

NEW YORK
BOARD OF TRADE

September 6, 2006

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

RE: 17 CFR Part 38; Proposed Acceptable Practices for compliance with Section 5(d)(15) of the Commodity Exchange Act, Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations, July 7, 2006

Dear Ms. Donovan:

The Board of Trade of the City of New York, Inc. ("NYBOT®" or the "Exchange") hereby submits its comments in response to the proposed Acceptable Practices for Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations published by the Commodity Futures Trading Commission ("CFTC" or the "Commission") in the Federal Register on July 7, 2006 (the "Proposal"). 71 FR38740 (July 7, 2006).

As explained below, we have three main recommendations. First, we believe that the Acceptable Practices should not be presented as a "model" for exchanges to adopt, but instead should serve as examples of ways to meet the requirements of Core Principle 15, Conflicts of Interest. Second, NYBOT urges the CFTC to eliminate the proposed Acceptable Practice that exchanges should have governing boards and executive committees composed of at least 50% public members and to make the qualifications for public members less formulaic. There is no evidence that the 50% public member benchmark is needed and, for some exchanges, it would cause undue burdens and diminish diversity of representation on governing boards. Finally, while a regulatory oversight committee ("ROC") is an appropriate way to reinforce impartiality in exchange self-regulation, a ROC should not be charged with managerial duties and overseeing daily market regulation functions. We therefore offer some modifications to make this clear.

General Comments

Recognizing that exchanges differ in many ways, including size, structure, institutional history, and products traded, the Commodity Futures Modernization Act of 2000 ("CFMA") eliminated prescriptive rules and replaced them with 18 Core Principles, giving exchanges flexibility to identify the appropriate means for meeting each of the Principles. The intent of these changes is declared in section 2 of the CFMA, as follows:

> (2) to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the Commodity Exchange Act; [and]
> (3) to transform the role of the Commodity Futures Trading Commission to oversight of the futures markets.

Therefore, the nature of regulation was changed, emphasizing the exchanges' role as frontline self-regulatory organizations (SROs), while placing greater emphasis on the CFTC's oversight responsibilities. As an example, exchanges are required to have affirmative compliance programs, but there is no one model or specific rules that must be followed. The CFTC staff periodically conducts rule enforcement reviews of each exchange to determine how well its compliance program deters and detects rule violations and disciplines offenders. If problem areas are identified, the CFTC requires changes and improvements and can penalize an exchange for laxity in its compliance functions.

During the SRO Review which led to the Proposal, the success of this regulatory framework was confirmed. As the CFTC Proposal notes, participants confirmed "that regulation works best when conducted close to the markets by individuals with market-specific expertise." The SRO Review did not indicate that the types of conflicts and scope of rule enforcement lapses cited on securities exchanges have been found on futures exchanges. Nor did it suggest that the board composition, commercial functions, or demutualized ownership structures of exchanges are impeding their exercise of self-regulatory duties. Thus, we are not aware of any showing that regulatory standards have been compromised.

In the absence of strong , empirical evidence that exchanges' current methods for minimizing conflicts of interest are not working and recognizing that exchanges have developed different approaches to address the potential for conflicts, we urge caution in the establishment of the Acceptable Practices for Core Principle 15. While not the exclusive means for meeting Core Principle 15, these Acceptable Practices are presented as a "safe harbor" for compliance, e.g. if an exchange fulfills all of the listed requirements the CFTC will consider it in compliance with the Core Principle. Therefore, the Acceptable Practices should be limited to those that clearly fulfill the intent of Core Principle 15, do not potentially interfere with other legitimate interests of the exchanges and are not unnecessarily prescriptive or burdensome. We do not believe the CFTC's Proposal meets these tests.

We therefore recommend that the Acceptable Practices be changed in several ways. As a first step, the statement, "Acceptable Practices for minimizing conflicts of interest shall include the following elements:" should be changed to, "Acceptable Practices for minimizing conflicts of interest may include some or all of the following elements:" In addition, unproven and problematic models or benchmarks should be eliminated or modified, as described in the comments below on board composition and regulatory oversight committees.

Board and Executive Committee Composition; "Public" Director Defined

To comply with the proposed Acceptable Practices an exchange would be required to elect a governing board composed of at least 50% public directors. Executive committees, or similarly empowered bodies, would also be required to have 50% public members. A "public member" is defined as an individual found by the governing board to have no material relationship with the contract market that could affect the independent judgment of the member.[1] The Proposal also disqualifies potential public members who fall into certain enumerated categories.

The 50% public member requirement for boards and executive committees is arbitrary, is not used by any exchange and does not address any identifiable finding of conflict of interest. It will cause unacceptable trade-offs for some exchanges, such as less diversity and expertise among board members. For some exchanges, such as NYBOT, which are not large and provide minimal compensation to board members, it will be very difficult to attract adequate numbers of qualified public members.

The CFTC Proposal states that during the SRO Review "most participants agreed on the benefits of including 'public' directors on exchange boards." However, very few participants recommended a specific level. In fact, a preponderance of participants testified during the SRO Review that diversity on the board is most important as it creates checks and balances and provides expertise from a variety of perspectives. The public members of NYBOT's Board strongly endorse this view and have filed a separate comment letter regarding the Proposal, which is submitted herewith. The 50% proposal would interfere with an exchange's ability to maintain diversity on its board, including adequate representation of commercial interests and other market users.

Regulatory oversight duties of the board are a critical part of their fiduciary responsibilities to the exchange, but, at the same time, expertise is needed in the underlying commodities to assure market integrity for the businesses and individuals who rely on the markets for price discovery and risk management. Therefore, a cornerstone of futures self-regulation has been assuring sufficient representation from commercial interests on governing boards. Because underlying commodities have distinct commercial characteristics, NYBOT

[1] The Proposal refers to "directors," but at NYBOT board members are called the "governors." Thus, in this letter we use the more generic "board members" and "governing board."

assures representation on its board of at least one representative from each of the agricultural commodities traded.

As Commissioner Hatfield observed in his statement accompanying the CFTC Proposal, 50% public members is more restrictive than the board composition rule in place prior to enactment of the CFMA. At that time, the exchanges were required to have meaningful representation on their boards from six different categories of members and market users to assure diversity of representation. Specific composition requirements were in place for two of the categories: 20% for non-members and 10% for commercial users of the commodities traded on the particular exchange. According to Core Principle 16, mutually owned exchanges, such as NYBOT, are still required to maintain board diversity, but without specific composition targets, while demutualized exchanges are not so required.

NYBOT currently meets the previous board composition requirements for public members and, therefore, with a 25-member board, 5 are public members. To meet the proposed 50% public member level, without reducing the number of members from commercial interests (such as agricultural and financial firms that produce, use or sell the underlying commodities), futures commissions merchants and other market users, NYBOT would have to increase its board to 40 members by adding 15 new public directors. Besides the obvious difficulty of finding 15 more qualified public members who are willing to take on extensive duties such as serving on the ROC, a forty-member board is not workable as a governing body. Thus, in order to meet the proposed 50% benchmark for public members, diversity of representation on NYBOT's board would have to be sacrificed and the number of representatives from remaining categories would have to be reduced. For example, the four positions dedicated to futures commission merchants that serve differing roles in NYBOT markets might be reduced to one position. Even taking drastic steps such as this would leave the Exchange with an insufficient number of public members if the 50% standard is adopted, thus placing NYBOT in a position where it could not take advantage of the safe harbor while other exchanges would be able to do so.

No underlying problems have been identified to justify this extreme change in policy. One of the reasons cited by the CFTC is that it would address the "perception" that governing boards of demutualized exchanges could be unduly influenced by profit-driven motives. Instead, however, the 50% benchmark would more likely create burdens for exchanges that are owned by public companies, as they must meet a variety of other governance requirements, without providing any measurable safeguards against conflicts of interest. Moreover, while the Proposal suggests that to maximize profits demutualized exchanges may decide to dedicate fewer resources to regulatory activities, it is at least equally possible they would want to build public confidence through a well-financed regulatory program.

The main rationale for the 50% benchmark given in Part IV of the Federal Register notice, "Analysis and Rationale for Proposed Acceptable Practices," is that "dual regulatory and commercial roles suggest that a fifty percent 'public' board is an appropriate balance and should best enable directors to carry out their responsibilities." This implies that the half of the board that is public will assure the self-regulatory functions are carried out while the other half protects commercial interests. This is not an accurate picture of how exchange boards operate, as all of the board members have a fiduciary responsibility to the exchange and commercial interests may be more keenly aware of, and concerned about, regulatory activities than public members. No data are given to back the claim that 50% is the "appropriate balance," just a footnote quoting participants in the SRO review who commented on the importance of including public members on governing boards – a position that NYBOT took, as well. We therefore recommend that the Acceptable Practices be changed to include public membership on governance boards as one component, but without a specific percentage.

Executive Committee and Selection Process

The concept of including public members on executive committees was raised by only a few participants in the SRO review and its purpose and potential impact was not sufficiently reviewed. We fail to understand the basis for this cumbersome requirement, as executive committees are primarily involved in day-to-day operational and managerial issues, rather than developing or overseeing the exchange's regulatory policies. Moreover, imposing a requirement that half of the Executive Committee be public members will impede the exchanges in circumstances calling for prompt action. Such committees typically are small in size and quorum requirements may be difficult to meet because of the commitments that public members have to their own businesses. Thus, this aspect of the Proposal should be eliminated completely.

Finally, we are concerned about the specificity of some of the provisions regarding the selection of "public members." First, we note that while not explicitly stated in the proposed Acceptable Practices themselves, the description of the board composition practice in Part III of the Federal Register notice states that "exchanges should elect governing boards composed of at least fifty percent public directors" (italics added). This is entirely too specific a requirement to apply to all exchanges. At NYBOT, for example, public governors are identified and appointed by the board after considering the expertise, independence, reputation and public sector awareness of the candidates. It is difficult to find qualified candidates. If the selected nominees must be placed before the membership for a vote, this may discourage potential candidates. The membership may vote against a qualified nominee, making it more difficult to maintain the current level of public members. In addition, requiring the election of public members would seem to create a conflict in itself, as it creates the potential for the elected individual to become beholden to the electing constituency, especially if the position is compensated.

The qualifications for public members must also be modified to give the governing members more discretion to determine whether a potential public member may have a "material relationship" with the contract market. We suggest eliminating the $100,000 compensation test, because it is an arbitrary level that may amount to de minimis compensation in the context of that person's total compensation and income. Instead, compensation received by the candidate from the exchange or its members is an issue the governing board should consider when reviewing a potential public member.

Regulatory Oversight Committee

The establishment of a ROC, as a committee of the board and comprised of public members, is an appropriate means to minimize conflicts of interest. As we understand the Proposal, the ROC would review, oversee, and provide recommendations on compliance and market surveillance matters to the governing board, which we agree are appropriate functions. However, even though NYBOT has established a ROC comprised of its five public members, it may not be the best approach for smaller exchanges. Therefore we believe it should not be required of all exchanges. Instead, it should serve as an example of an Acceptable Practice.

In addition, we recommend a change to the draft ROC proposal. Clause (3)(B)(iv) states that the ROC will, "Supervise the contract markets' chief regulatory officer, who will report directly to the ROC." This implies that the ROC is charged with overseeing day-to-day operations and managerial functions, which is very different than "oversight responsibility" to assure the "sufficiency, effectiveness, and independence of self-regulatory functions," as stated elsewhere in the proposal. Giving the ROC a direct supervisory role would cause ambiguity in the management chain and could require public members to devote significantly more of their time to exchange matters than they are prepared to offer, ultimately diminishing the pool of qualified persons who are willing to serve. Moreover, isolating regulatory staff in an exclusive reporting chain to the ROC will deprive the exchange of regulatory staff review on, and input into, product design and other matters where their expertise is needed. Sufficient ROC support for and independence of regulatory staff can be assured by confirming that the ROC has unhindered access to regulatory staff, the resources needed to effectively carry out an exchange's regulatory program are available to the staff, and that nothing interferes with the staff's fulfillment of the program. This can be accomplished without giving the ROC managerial responsibility for the regulatory staff. Thus, we recommend that clause (3)(B)(iv) be deleted.

Disciplinary Panels

NYBOT agrees with the recommended Acceptable Practice for disciplinary panels as a practical and meaningful way to avoid conflicts of interest.

In conclusion, NYBOT believes, as suggested by Commissioner Hatfield, that "having a ROC that serves to insulate the regulatory functions of an exchange from its commercial interests, combined with a disciplinary panel structure that strengthens impartial adjudication and reduces potential conflicts of interest by including at least one public person on every panel and ensuring that such panels are not dominated by any group or class of exchange participants," is sufficient to assure rigorous compliance with Core Principle 15. We also agree with Commissioner Hatfield's statement that, "Such an approach would be narrowly tailored to focus specifically on regulatory governance and functions, and would be in keeping with the flexibility the CFMA intended to afford exchanges to conduct business without undue interference from regulators."

Thank you for this opportunity to comment on the Proposal. If the Commissioners or staff have any questions regarding the matters addressed in this letter I can be reached at NYBOT at (212) 748-4083.

Sincerely,

Audrey R. Hirschfeld
Senior Vice President & General Counsel

Attachment
cc: Chairman Reuben Jeffery III
Commissioner Walter L Lukken
Commissioner Michael Dunn
Commissioner Fred Hatfield

September 6, 2006

Ms. Eileen A. Donovan
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW,
Washington, DC 20581

Re: Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations;
CFTC Proposed Acceptable Practices, 71 FR 38740 (July 7, 2006)

Dear Ms. Donovan:

We submit these comments as public members of the Board of Governors of the Board of Trade of the City of New York, Inc. (NYBOT®), in response to the "Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations Proposal" (the "Conflicts Proposal") published by the Commodity Futures Trading Commission (CFTC) in the Federal Register on July 7, 2006. We strongly support the continued ability of exchanges to have a diversity of contract market interests represented on their boards as an effective means of protecting market integrity and the public interest. Requiring at least half of the board to be public members may create an outward appearance of impartiality, but in reality it will just hamper the ability of boards to receive input from a variety of market participants and to have the informed give-and-take among diverse members that is a hallmark of sound decision-making. We respectfully recommend that the CFTC delete the board composition provision from the Conflicts Proposal.

The Commodity Futures Modernization Act of 2000 (CFMA) amended the Commodity Exchange Act (CEA) to move away from prescriptive regulations and to give exchanges flexibility to develop rules that meet "Core Principles" for good governance and compliance with self-regulatory duties. In Appendix B to Part 38 of the CFTC Regulations [17 C.F.R. Part 38, App. B.] the CFTC provides guidance to exchanges for meeting the 18 Core Principles listed in the CEA. For some principles, "acceptable practices" are described. While not the exclusive means for meeting a particular principle, an exchange that complies with acceptable practices will be considered by the CFTC and the public to be in compliance with the relevant principle. Logically, such practices should be widely recognized as fulfilling the intent of the relevant Core Principle and limited to those practices deemed necessary to accomplish the regulatory goal embodied in the Core Principle. However, the proposed acceptable practice for governing board composition is not used by any exchange and was not highly recommended during the CFTC's self-regulatory organization (SRO) study as a means of minimizing conflicts of interest.

The 50 percent public member requirement is more restrictive than the board composition rule that was in place prior to enactment of the CFMA. At that time, the CFTC required exchange boards to include representatives from diverse groups of market participants (such as agricultural or other commercial firms that produce, sell or use the products traded on the exchange, futures commissions merchants, and floor brokers) and at least 20% non-members.

NYBOT currently meets the previous board composition requirements. We find that this allows the board to be well balanced and to have expertise from a variety of perspectives. To meet the proposed 50% public member requirement without reducing existing positions on the board, NYBOT would have to increase the size of its board from 25 to 40 members by adding 15 new, public directors, which is simply not viable.

As NYBOT public members, we vote on board decisions, serve on disciplinary committees and comprise a regulatory oversight committee that reviews and makes recommendations regarding the Exchange's self-regulatory operations. NYBOT also has an effective conflict of interest rule for board members, which precludes a member from voting on certain decisions where the member or the member's firm may have a material interest. These direct means of avoiding conflicts and including public participation are sufficient and more effective than the proposed board composition requirement.

We therefore urge the CFTC not to adopt the proposed board composition requirement as an acceptable practice for avoiding conflicts of interest.

Respectfully submitted,

Maxine Champion
President, Champion Strategies
Washington, D.C.

Christopher A Dunn, Esq.
Partner, Willkie, Farr & Gallagher
Washington, D.C.

Hugh R. Lamle
President, M.D. Sass Investors Services, Inc.
New York, N.Y.

Terrence F. Martell, Ph.D.
Director, Weissman Center for International Business
Baruch College
New York, N.Y.

John C. Santos, Jr.
Managing Director, Brown Brothers Harriman & Co.
New York, N.Y.

cc: Chairman Reuben Jeffery III
Commissioner Walter L Lukken
Commissioner Michael Dunn
Commissioner Fred Hatfield