Board of Trade
CLEARING CORPORATION

Dennis A. Dutterer
C. President and Chief Executive Officer

01-09
(2)

June 13, 2001

Re: **Regulatory Framework for Clearing Organizations**
(66 Fed. Reg. 24308 (May 14, 2001))

VIA E-MAIL & FEDERAL EXPRESS

COMMENT

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

Dear Ms. Webb:

The Board of Trade Clearing Corporation (the "Clearing Corporation") appreciates this opportunity to offer its comments on the proposals by the Commodity Futures Trading Commission (the "Commission") to implement provisions of the Commodity Exchange Act (the "Act") relating to clearing organizations. At the outset, the Clearing Corporation would like to express its appreciation to the Commission for acting promptly to implement the Commodity Futures Modernization Act of 2000 (the "CFMA"). The Clearing Corporation is also appreciative of the fact that the present proposal takes into account many of the comments that were made by the Clearing Corporation in response to the Commission's June 2000 Regulatory Reinvention proposals.

The amendments made to the Act by the CFMA were profound. For clearing organizations, which will now be regulated separately from the exchanges and markets to which they provide trade processing, clearing or other services, the statutory changes will likely result in a more formal and structured program of regulatory oversight than has historically been the case. For that reason and others, the Clearing Corporation offers the following comments and suggestions to further refine the Commission's proposal. Our comments are intended to strengthen the integrity of the clearing system and permit the clearing organizations to operate in a safe and sound manner, and as efficiently as possible, without in any way compromising the Commission's regulatory objectives.[1]

---

[1] As a practical matter, the clearing organizations are inextricably linked, not only by formal agreements (such as those establishing cross-margining and common banking facilities, inter-market linkages and information-sharing arrangements), but also by the fact that many of their members also belong to other clearing organizations. As a consequence, the failure of a member on one market will almost certainly have repercussions in other markets. Although the Clearing Corporation has never failed to honor its obligations to its members, on time and in full, (footnote continued)

141 West Jackson Boulevard
Chicago, Illinois 60604
(312) 786-5703

Scope. Proposed Regulation 39.1 provides that the provisions of Part 39 apply to any derivatives clearing organization ("DCO") that is registered, is required to register or which voluntarily applies to register with the Commission pursuant to Sections 5b(a) or 5b(b) of the Act. Regulation 39.1 should be amended expressly also to include DCOs that are deemed to be registered pursuant to Section 5b(d) of the Act.[2]

Exemption. Regulation 39.2 would exempt DCOs from all but certain enumerated Commission Regulations. The Clearing Corporation concurs generally with the judgments that have been made by the Commission, but urges the Commission to further revise that Regulation to clarify its intended application. In particular, proposed Regulation 39.2 provides that DCOs and the clearing of agreements, contracts and transactions by a DCO are generally exempt from all provisions of the Commission's regulations other than those specifically enumerated in Regulation 39.2, which "are applicable to a derivatives clearing organization and its activities as though they were set forth in this section and included specific reference to derivatives clearing organizations." We respectfully suggest that this drafting convention (which was first employed in 1982, when the Commission adopted the Part 33 rules to govern the trading of options on contract markets) needs to be complemented by the inclusion of text to the effect that references in the enumerated regulations to a "clearinghouse" or "clearing organization" shall be deemed to mean a "designated clearing organization." *Cf.* Regulation 33.2(a)(1).

In addition, we recommend that the reference to Regulation 1.38, which relates to the open and competitive execution of transactions, be amended to refer more narrowly to Regulation 1.38(b). The only portion of that Regulation specifically applicable to clearing is contained in paragraph (b), which merely requires that any person clearing a non-competitive transaction (such as a transfer trade) so identify the transaction in its records. The failure to specify that only the recordkeeping portion of Regulation 1.38 is applicable to the clearing process leaves DCOs vulnerable to claims that they are somehow responsible for compliance with the open outcry requirement embodied in Regulation 1.38(a).

Regulation 39.2 would make Parts 15 -18 of the Regulations applicable to agreements, contracts and transactions cleared by a DCO. Nothing in those Regulations currently applies to the clearing organizations, however. (Although the Clearing Corporation currently provides large trader, volume, open interest and similar data to the Commission, it is not required to do so by the Commission's Regulations. Rather, it does so as a service to its clearing members and to the exchanges and markets for which it provides trade processing and clearing services.) The

---

it nonetheless is keenly aware of the fact that it has the potential to be affected by the conduct of other participants in the clearing system.

[2] Section 5b(d) of the Act provides that a DCO "shall be deemed to be registered" if it acts as the clearing organization for a board of trade that was designated as a contract market prior to the date of enactment of the CFMA.

Commission, therefore, should clarify how it envisions the rules contained in Parts 15 - 18 would be made applicable to a DCO.[3]

Registration Procedures. We commend the Commission for its willingness to establish a 60-day time limit for the consideration of applications for registration as a DCO. *See* 66 Fed. Reg. at 24309.[4]

Proposed Regulation 39.3(a)(2) provides that an applicant for registration as a DCO must meet the definition of a "derivatives clearing organization" contained in Section 1a(9) of the Act. Needless to say, an applicant that has not been grandfathered pursuant to Section 5b(d) of the Act cannot perform the activities envisioned by that definition until it has been registered by the Commission. We recommend, therefore, that Regulation 39.2(a) be amended to permit a DCO to represent that it is its intention to engage in activities within the scope of that definition if its registration is approved by the Commission.

Regulation 39.3(a)(5) would require that the applicant submit "any" agreements between it, its operator or its participants that enable or empower the applicant to comply with the core principles specified in Section 5b(c)(2) of the Act, together with descriptions of "any" system test procedures, tests conducted or test results. These materials can be voluminous. More importantly, these materials frequently will contain trade secrets of the submitting party or be subject to detailed confidentiality procedures established by third-party system providers and other vendors. The Clearing Corporation accordingly recommends that Regulation 39.3(b)(5) be amended to require an applicant only to submit such information as is necessary to demonstrate the applicant's compliance with core principles.

DCO Rules. Regulation 39.4 would establish procedures for the submission and review of the rules of a DCO. In particular, proposed Regulation 39.4(b) would require a DCO that has not voluntarily submitted a rule for prior approval, as provided in Regulation 39.4(a), to submit that rule pursuant to the procedures specified in proposed Regulation 40.6. The Clearing Corporation has already expressed its concerns about certain aspects of the latter Regulation. We hereby incorporate those comments by reference.[5]

---

[3] In this regard, proposed Regulation 39.5(c) establishes a presumption that large trader information is to be filed by futures commission merchants, clearing members, foreign brokers or registered entities other than a DCO. We suggest that the Commission consider including in that list foreign traders and participants in a derivative transaction execution facility.

[4] We believe, however, that an application that satisfies the criteria set forth in proposed Regulation 39.3(a) should be registered – and not merely be "deemed to be registered," as provided in Regulation 39.3(a) – if review of the application is not terminated pursuant to proposed Regulation 39.3(b) or withdrawn pursuant to proposed Regulation 39.3(c).

[5] *See* March 30, 2001 letter from Dennis A. Dutterer, Board of Trade Clearing Corporation, to Jean A. Webb, Commodity Futures Trading Commission Re: A New Regulatory Framework for (footnote continued)

Requests for Information. Proposed Regulation 39.5(a) would require a DCO to file with the Commission, upon its demand therefor, information related to the DCO's "business as a clearing organization, including information relating to trade and clearing details, in the form and manner and within the time specified by the Commission" in its request therefor. Proposed Regulation 39.5(b) would establish analogous requirements in respect of the core principles, but would in this context require the DCO to prepare a "written demonstration, containing such supporting date, information and documents, in the form and manner and within such time as the Commission may specify." The Clearing Corporation believes that these requirements – which are inconsistent with the Core Principles and which are without any basis in the Act – have the potential to be extremely burdensome to the DCOs.

Core Principle A is unambiguous: a registered DCO or an applicant for DCO registration "shall demonstrate to the Commission that [it] complies with the core principles ... [but] shall have reasonable discretion in establishing the manner in which it complies with the core principles." Section 5b(c)(2)(A) of the Act; 66 Fed. Reg. at 24313. The flexible precepts embodied in Core Principle A – which lay the foundation for all of the Core Principles that follow – are completely at odds with, and would be undermined by, the prescriptive dictates of Regulation 39.5.

Nor does Core Principle J support the Commission's proposal. Core Principle J requires a DCO or an applicant for DCO registration to "provide to the Commission all information necessary for the Commission to conduct [its] oversight function." The burden, therefore, is on the DCO or applicant to make a proper showing of compliance. Nothing in Core Principle J, however, authorizes the Commission to require "written demonstrations" or descriptions of "trade and clearing details, in the form and manner ... specified by the Commission" as contemplated by proposed Regulation 39.5.[6]

The documentation requirements that would be established by Regulations 39.5(a) and (b) do not have any grounding in the language of the Act. Nothing in the Act precludes the Commission from requesting information of the type contemplated by Regulation 39.5, and it is difficult to envision circumstances in which a DCO would decline to provide it if there was a serious question as to the DCO's compliance with the core principles. It is quite another matter, however, for the Commission – which is supposed to be transforming itself into an "oversight regulator"– to require this information to be submitted in the form and manner specified and by whatever deadline may be specified by the Commission. Regulation 39.5, and the corresponding provisions of Core Principle A (which would allow the Commission to require a

---

Trading Facilities, Intermediaries and Clearing Organizations – Regulatory Reinvention, 66 Fed. Reg. 14262 (March 9, 2001) (Comment File 01-003).

[6] The Commission observed in its proposing release that Section 5c(d) of the Act allows the Commission to notify a DCO that it is in violation of a core principle. However, the Clearing Corporation cannot agree with the Commission's further statement that the data and document submission requirements established by Regulation 39.5 therefore would "constitute a useful alternative to the more formal procedures of Section 5c(d)." 66 Fed. Reg. at 24309 n.13.

DCO to demonstrate that it is operating in compliance with core principles), should be revised accordingly.[7]

The Clearing Corporation's concerns are not merely theoretical. For example, Regulation 39.5(a) would authorize the Commission to require the submission of data and other information in a form that is different than that which it is customarily collected and maintained by the DCO. This may not appear to be significant, but the associated software programming has the potential to be extremely time-consuming and expensive. The Clearing Corporation has similar reservations about proposed Regulation 39.5(b), which would require a DCO to create one or more documents to respond to the specifics of the Commission's inquiries. Proposed Regulations 39.5(a) and 39.5(b) also provide that the required information must be submitted in the time specified by the Commission. It is not uncommon, however, for commercial agreements (such as software license and data distribution agreements or a clearing organization's agreements with the exchanges and markets for which it provides services) to include advance notice requirements in the event that a demand is made for information from a third party, including a governmental authority. A demand for the prompt provision of information to the Commission, therefore, could cause a DCO to breach its agreement with that third party, with potentially significant consequences.[8]

Legal Certainty. The Clearing Corporation strongly supports the Commission's decision to ensure that agreements, contracts and transactions cannot be disaffirmed or otherwise challenged as a result of a violation by the DCO of Section 5b of the Act or Part 39 of the Regulations. As

---

[7] We presume that it is the Commission's intention to request information only in respect of a DCO's business as a derivatives clearing organization (and not, for example, in respect of a DCO's business as a securities clearing organization). Regulation 39.5(a) should be amended to clarify this point.

[8] If the Commission nonetheless decides to include these provisions in the final rules, the Clearing Corporation would urge the Commission to seriously consider the inclusion of a reservation of authority whereby only the Commission (and not the staff) would be authorized to issue demands for information under Regulation 39.5. Such a limitation would help ensure that this authority is used sparingly and only for purposes that are demonstrably related to the Commission's oversight responsibilities. *Compare* Section 5a(a)(12)(A) of the Act, which prior to its amendment by the CFMA, provided that "[t]he determination to review such rules [i.e., rules submitted by a contract market or clearing organization for Commission review, but not for prior Commission approval] ... shall not be delegable to any employee of the Commission."

In this regard, the Commission has indicated that it intends to conform its March 9, 2001 proposed rules for registered entities to the present proposal. 66 Fed. Reg. at 24308 n.6. Nothing in this proposal suggests that the Commission intends to delegate to the staff the authority to make requests pursuant to Regulation 39.5. It is, therefore, the Clearing Corporation's understanding that the delegations of authority would be conferred by proposed Regulation 40.7 (*see* 66 Fed. Reg. 14262, 14286 (March 9, 2001)) will not be expanded to include Regulation 39.5.

drafted, however, the Regulation merely is an invitation to disgruntled parties to cast their claim as one arising under some other provision of the Act and Regulations. The Clearing Corporation accordingly urges the Commission to revise Regulation 39.6 to provide this protection for all agreements, contracts and transactions submitted to a DCO for clearing, notwithstanding actual or asserted noncompliance by a DCO with any of the provisions of the Act or Regulations (and not merely Section 5b or Part 39).[9]

Antifraud Provisions. The Clearing Corporation appreciates the Commission's decision to revise proposed Regulation 39.7 to make clear that it applies only "in or in connection with the clearing of transactions by a designated clearing organization." The Clearing Corporation nonetheless believes that it is important that the Commission confirm that violations of that Regulation, which is derived from Section 4b of the Act, will require proof of scienter.[10]

Proposed Regulation 39.2 would incorporate by reference Regulation 33.10, the special antifraud provision for exchange-traded options. Proposed Regulation 39.2, however, does not contain the limiting language that is included in proposed Regulation 39.7 (*i.e.*, that it applies only "in or in connection with the clearing of transactions by a designated clearing organization").[11] It is, in any event, unnecessary to include special provisions for options because the Commission's concern – that fraud in connection with the clearing process might not otherwise be captured by other provisions of the Act and Regulations – would be addressed by the adoption of Regulation 39.7.[12] Regulation 39.2, therefore, should be revised to delete the reference to Regulation 33.10.

Core Principles. The Clearing Corporation supports the Commission's decision to clarify that the guidance contained in Appendix A to Part 39 is illustrative and not binding and that a DCO

---

9 In this connection, the Clearing Corporation further suggests that the Commission confirm that it is its intention that Regulation 39.6 would apply not only to "cleared" transactions, but also to any transaction that is submitted to a DCO for clearing. (This distinction could be important in circumstances where the insolvency of a clearing member or DCO participant interferes with normal clearing processes.) In addition, the Clearing Corporation also suggests that the Commission confirm that references to "clearing " or to "cleared transactions" are meant to include any of the other activities, such as payment netting, contemplated by the statutory definition of the term "derivatives clearing organization."

10 *See In the Matter of Staryk*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,206, at 45,810 (CFTC 1997); *Hammond v. Smith Barney Harris Upham & Co.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617, at 36,659 (CFTC 1990).

11 For example, a broker who fills a customer order to buy while simultaneously selling the same contracts for his own account and who later improperly allocates the losing trade to his customer will cause the clearinghouse to issue "a false report or statement thereof." *See* Regulation 33.10(b). The incorporation of Regulation 33.10 into Part 39, therefore, has the potential to make a DCO responsible in private litigation for the acts of third parties over which it has no control and which do not involve fraud "in or in connection with the clearing of transactions" by the DCO.

12 66 Fed. Reg. at 24310.

remains free to demonstrate its compliance with core principles in whatever fashion it deems appropriate. The Clearing Corporation is nonetheless concerned that certain aspects of Appendix A are unduly prescriptive or impractical in their application. Our specific suggested revisions are set forth below:

- Core Principles B.1 and B.1.a call for information about the "amount of" resources dedicated to or available to support particular functions. It will in many cases be difficult to quantify resource allocations. We therefore suggest that these provisions be revised by the deletion of the quoted text.

- Core Principle B.1.a would require a DCO to address the sufficiency of those resources "to assure that no break in clearing operations would occur in a variety of circumstances," Core Principle B.1.b calls for a description of the "level of ... default such resources could support[.]" As to the first of these points, it is not unusual for there to be temporary breakdowns in one or more of the hundreds of clearing programs and services offered by the various clearinghouses that do not materially and adversely affect the clearinghouses' clearing and guaranty obligations.[13] More fundamentally, we believe that the relevant inquiry is whether the DCO's resources are believed to be sufficient to cover the default of one or more clearing members. Core Principles B.1.a and B.1.b should be revised accordingly and combined.

- Core Principle B.2.b would require a discussion of how financial and other material information would be updated and reported to the public and the Commission "on an ongoing basis." Core Principle L.a., in turn, would require disclosure to the public of operating procedures governing clearing and settlement systems. Our comments with respect to the submission of information to the Commission are reflected above. As to the public, we do not understand there to be any requirement that confidential and proprietary financial and commercial information be provided to the public at all, much less on an ongoing basis. If it is the Commission's intention to establish such a requirement, it should propose rules to that effect for public comment and not seek to create such requirements under the rubric of illustrative guidance to the Core Principles.

---

[13] For its part, the Clearing Corporation has cleared more than one billion transactions since it was formed in 1925 and has never failed to honor its obligations on time and in full. Notwithstanding that sterling record of achievement, the Clearing Corporation would be reluctant to assure the Commission that there could never be a "break in clearing operations" (such as a brief delays in the issuance of reports during overnight processing or an unscheduled interruption in any of the hundreds of processes performed daily by the Clearing Corporation).

Core Principle C.3.a would require a DCO to describe or otherwise document how it would establish specific criteria for the types of agreements, contracts or transactions it will clear. Other than the fact that this would likely require a DCO to speculate about how it would establish those criteria for instruments that are not yet in existence, it is not clear why the process by which those criteria would be established – as opposed to the criteria themselves – is thought to be important. In like manner, Core Principle D.2.a envisions a description of "[h]ow appropriate forms and levels of collateral would be established and collected." We respectfully suggest that this approach (which is reflected as well in Core Principle C.3.a and a number of the other Core Principles) is focused mistakenly on the process by which a DCO will fulfill its obligations, rather than on the end result.

Core Principle D.2.b would require a discussion of the sufficiency of collateral to allow the DCO to perform its role as "central counterparty." Section 1a(9) of the Act defines the term "derivatives clearing organization" to include entities that net or settle transactions or provide for risk mutualization. Although the futures clearinghouses have traditionally acted as a universal counterparty, nothing in the statutory definition requires a DCO to do so. We suggest, therefore, that Core Principle D.2.b be revised accordingly.

Core Principle G.1.a calls for a description of how a DCO's definition of default would be "enforced," while Core Principles G.1.b and G.2 would have the DCOs address what action they will take upon the occurrence of certain specified events.[14] We suggest that these Core Principles be revised and combined to provide for the articulation by the DCO of the events that will may or will be deemed to give rise to a member or participant default, focusing on the actions it is prepared to take in such circumstances.

Core Principle I.2.b would require that periodic system testing be performed or assessed by independent professionals. While this is an improvement over the standard that proposed by the Commission last year (which would have required that any such professional also be a certified member of the Information Systems Audit and Control Association), we

[14] Some of the factors cited in Core Principle G.1.a are not likely to be events of default. For example, a failure to comply with rules will in most circumstances be a matter for internal discipline (*see* Core Principle H), but not an event of default. Similarly, the fact that a member or participant may have been sanctioned by other regulatory bodies is not likely to be grounds for a declaration of default and a termination of clearing privileges.

see no reason why the Commission should presume that any such testing cannot be conducted by the DCO's own professional staff and that the DCOs should not be empowered to decide when it is appropriate to call upon the services of independent professionals.

* * *

The Board of Trade Clearing Corporation appreciates the opportunity to communicate its views on this subject. The Commission and its staff should not hesitate to call me (at 312-786-5703) or Nancy K. Brooks, Vice President and General Counsel (at 312-786-5711), if you have any questions regarding any of our comments or if you would otherwise like to discuss these matters further.

Sincerely,

Dennis A. Dutterer

cc: John C. Lawton
Alan L. Seifert
Lois J. Gregory
David P. Van Wagner
Nancy K. Brooks
Kenneth M. Rosenzweig