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Morgan Stanley [redacted]

July 14, 2003

COMMENT

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

Re: The Board of Trade of the City of Chicago Proposed Rule 701.01

Dear Ms. Webb:

Morgan Stanley & Co. Incorporated ("Morgan Stanley") appreciates the opportunity to submit these comments to the Commodity Futures Trading Commission (the "Commission") regarding the proposed rule 701.01 ("Proposed Rule 701.01") of the Board of Trade of the City of Chicago ("CBOT"). For the reasons that follow, Morgan Stanley urges the Commission **not** to approve the Proposed Rule 701.01. Morgan Stanley also concurs in the views expressed by the Futures Industry Association regarding the inadequacy of the comment period afforded interested parties to comment on each of the proposed rules that the CBOT and the Chicago Mercantile Exchange ("CME") have filed with the Commission for approval pursuant to Commission rule 40.5 in connection with the clearing link to which the CBOT and CME have agreed.

Morgan Stanley and its numerous affiliates are engaged in a broad range of financial service businesses, including securities and futures brokerage, securities underwriting and distribution, proprietary trading, dealer and market-making activities, and asset management. Many of these activities involve exchange-traded instruments while others occur outside an exchange environment. Morgan Stanley is a registered broker-dealer and futures commission merchant ("FCM") and a clearing member of the major futures exchanges with a substantial investment and commitment to the markets maintained by these exchanges. As a result of Morgan Stanley's significant involvement in the exchange markets and our role as a financial intermediary, we have a strong interest in the efficient functioning, liquidity, and integrity of these markets.

Proposed Rule 701.01 provides that "Each Clearing member shall comply in all respects with any statement of policy or other notice issued by the Exchange relating to the procedures and processes that must be followed to effectuate the transfer of open positions to any

Clearing Service Provider." Thus, it appears that Proposed Rule 701.01 would permit the CBOT to require clearing members to comply with the transfer of open positions at the Board of Trade Clearing Corporation (BOTCC) and the subsequent clearance of those positions, without regard to the impact such actions would have on clearing members and their customers with open positions. Short of liquidating its positions[1], there appears to be no protection for a firm if, after evaluating the arrangements governing the subsequent clearance, the firm or its customer(s) determines that the arrangements are unsatisfactory. While this letter should not be construed in any way as suggesting that Morgan Stanley has any objection or concern regarding the proposed arrangements for clearing of the pre-existing CBOT open positions at the CME's clearing house, Morgan Stanley is concerned that the broad scope of Proposed Rule 701.01 might be used to permit the subsequent transfer of open positions to an inadequately capitalized clearing organization with inadequate risk management standards and processing capabilities.

The fact that a subsequent transfer of open positions would only be made to a designated derivative clearing organization ("DCO") that complies with the core principles set forth in the Commodity Futures Modernization Act of 2000 does not provide adequate comfort. In evaluating a DCO for the purpose of determining the level of risk a clearing firm is willing to accept on behalf of itself and its customers, a firm may conclude that such level of risk varies based upon the size and tenor of the positions the firm clears in comparison with the total volume and open interest cleared by the DCO. Thus, the criteria acceptable to a firm may go well beyond the *de minimis* standards requisite for designation of any clearing organization as a DCO. The criteria for a clearing organization for high volume/high open interest exchanges should be substantially higher than those for low volume/low open interest exchanges. These criteria should relate to:

- systems capacity and functionality;
- disaster recovery facilities;
- margin policy;
- credit and liquidity facilities;
- clearing funds and net worth requirements;
- published and audited financial statements; and
- appropriate corporate governance such as a board of directors with a majority of representation through clearing member and independent directors.

Without limiting an exchange's ability to force the transfer of pre-existing open positions to a DCO that can demonstrate that it has **at least** comparable financial integrity and risk management standards, approval of Proposed Rule 701.01, as presented, would establish a precedent that has serious implications for the industry. It would also appear to impair the

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[1] Given the absence of any time parameters in proposed Rule 701.01, such liquidation might have to be very rapid and consequently both very expensive and potentially disruptive to the marketplace.

contractual rights that a clearing member has with the clearing organization. [2] Potential approval by a governmental agency of a rule that impairs contractual rights without just compensation may require additional time to evaluate.

In sum, Morgan Stanley believes that the proposed rule 701.01 establishes a dangerous precedent because of its broad scope. We therefore urge the Commission not to approve the CBOT's proposed rule 701.01 in its current form, but rather that it work with the CBOT and the industry to develop an alternative rule that would address the concerns raised in this letter and those raised in letters filed by other market participants and industry representatives. If the Commission or its staff has any questions concerning these comments, please direct them to William F. McCoy of this Firm at (212) 762-6841 or to the undersigned at (212) 537-1456.

Sincerely,

/s/

John P. Davidson III
Managing Director

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[2] Any argument that existing regulations such as CBOT Rule 911 already authorize the CBOT to require a clearing member to transfer its positions to any clearing organization should be viewed as a misconstruction of the language of the rule. CBOT Rule 911 merely states that "Clearing House" is defined as "The Board of Trade Clearing Corporation, or such other corporation or agency as may be authorized to clear trades for members." The term "as may be authorized" should not be read as granting the CBOT such broad powers. To do so would be inconsistent with the Congressional intent behind the requirement that a DCO comply with core principles.