COMMENT

(18)

Board of Trade
CLEARING CORPORATION

Thomas J. Hammond
Executive Vice President
Clearing Services

August 4, 2000

BY AIR COURIER

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

Re: A New Regulatory Framework for Clearing Organizations (Clearing Organization Reinvention), 65 Fed. Reg. 39027 (June 22, 2000); A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations (Regulatory Reinvention), 65 Fed. Reg. 38986 (June 22, 2000)

Dear Ms. Webb:

The Board of Trade Clearing Corporation (the "Clearing Corporation") appreciates this opportunity to offer its comments and suggestions on the proposals by the Commodity Futures Trading Commission to modernize and re-orient its regulatory program.

The Clearing Corporation is the world's largest fully independent futures and options clearinghouse and the only futures clearinghouse that is rated "AAA" by Standard & Poor's. Day in and day out, the Clearing Corporation compares the data that is submitted by its members, matches the resulting trades, collects and disburses original and variation ("mark-to-market") margin payments through a network of banks, and provides an ironclad guarantee of performance for every trade that is accepted by it for clearing. The Clearing Corporation, which was formed in 1925, currently serves as the clearing organization for the Chicago Board of Trade and the MidAmerica Commodity Exchange, has in the past provided trade processing services for the New York Cotton Exchange and the Commodity Clearing Corporation, and has entered into an agreement to serve as the clearing organization for the Merchants' Exchange of St. Louis. The Clearing Corporation is or has been a party to cross-border, inter-exchange trading links and a variety of cross-margining and common banking arrangements with other futures and securities clearinghouses. Despite the complexity of these undertakings, and despite the fact that the Clearing Corporation has been the contract counterparty to more than one billion transactions since its inception in 1925, the Board of Trade Clearing Corporation has never defaulted in its obligations to its clearing members.

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The Clearing Corporation welcomes the Commission's decision to foster an environment in which new trading approaches can be established and tailored to the needs of market participants as long as certain criteria are satisfied. We agree wholeheartedly with the Commission's assessment that the regulations currently governing the organized markets must be revised extensively if the futures exchanges, the clearinghouses, and their member firms are to be able to compete effectively with over-the-counter products and dealer markets that are substantially (and, in many cases, entirely) unregulated, and with foreign markets that are given wide latitude to innovate, subject only to broad governmental oversight. Although we disagree (in some cases, profoundly) with certain aspects of the Commission's proposal, we lend our enthusiastic support for this historic effort to reevaluate and comprehensively restructure the regulatory framework.

In general, we have three principal concerns about different aspects of the Commission's proposal. *First,* the Clearing Corporation objects strongly to the Commission's apparent willingness to confer special treatment on securities clearinghouses, banks and bank affiliates and foreign clearinghouses. *Second,* we believe that the Commission's proposal would inappropriately expand the scope of the Act and Regulations by making various provisions thereof newly – and inappropriately – applicable to clearing organizations. *Third,* we are concerned that, despite the Commission's best intentions, the "core principles" are unduly rigid and prescriptive. Finally, we have provided a number of additional comments and suggestions relating to various other aspects of the Commission's proposal.

I. The Commission Should Reconsider the Proposed Exemption of Non-Futures Clearinghouses.

The futures, cash and option markets are inextricably intertwined, with the result that every clearinghouse has a stake in the financial and operational integrity of every other clearinghouse. The Clearing Corporation accordingly has grave reservations about the wisdom of that aspect of the Commission's proposal that would exempt securities clearinghouses, banks (and bank affiliates), and foreign clearinghouses from the substantive requirements that otherwise would apply to clearing organizations that have been recognized by the Commission pursuant to Part 39 of the Commission's regulations.

There is only a superficial resemblance between the services offered by futures and securities clearinghouses. There is even less of a resemblance between a clearinghouse and the funds transfer and netting systems that are subscribed to by banks, thrifts and trust companies. As to the proposed exemption for foreign clearinghouses, many of them operate under legal systems that are simply incompatible with the bankruptcy and other laws which govern clearing organizations in this country. It is for these reasons that the Clearing Corporation wishes to express its utmost concern regarding the Commission's apparent willingness to permit anyone to

set up shop as the clearing organization for a futures market that is organized as a derivatives transaction facility ("DTF") as long as the clearing organization in question has passed muster with the Securities and Exchange Commission ("SEC"), is organized as or affiliated with a bank, or has been approved by foreign regulators.

Even if the Commission were prepared to accept "substituted compliance" based upon a securities clearing agency's presumed observance of relevant SEC rules, we still do not understand how that approach would satisfy the Commission's standards in areas (such as the segregation of customer funds) where there is no comparable requirement for securities clearing agencies. Moreover, even assuming *arguendo* that the rules of the Commission and the SEC were entirely congruent (which they are not),[1/] nothing in the Commission's proposal would require a securities clearing agency to consent to the Commission's jurisdiction or condition a securities clearing agency's ability to proceed on the effectiveness of information-sharing agreements between and among interested parties and their regulators.

The Clearing Corporation is equally concerned about the Commission's proposal to give banks, their subsidiaries and affiliates unrestricted entrée into the realm of futures clearing. Unlike a securities clearing agency, which must at least satisfy certain minimum standards before it will be approved for that purpose by the SEC, a bank subsidiary or affiliate would need to have no special competence or expertise to establish itself as the clearing organization for a DTF.[2/] Indeed, under the terms of the proposed Regulation 39.2(b)(3), dozens of futures commission merchants

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1/ Future trades are marked-to-market on the day after the trade, with interim variation margin collections being made on the trade date; stock trades are not settled until the third business day after the trade date ("T+3"). The Clearing Corporation and other futures clearinghouses guarantee cleared transactions upon confirmation of a "matched trade"; the National Securities Clearing Corporation guarantee does not even become effective until midnight of the day that the trade is reported back to participants as having been compared.

2/ *See generally* General Accounting Office, PAYMENTS, CLEARANCE, AND SETTLEMENT: A GUIDE TO THE SYSTEMS, RISKS, AND ISSUES 15-46 (wholesale payment systems), 91-130 (retail payment systems), and 66-76 (futures clearing systems) (GAO/GGD-97-73 June 1997). The Commission's proposal apparently assumes that a bank's non-banking affiliates are regulated and supervised as strictly as banks. This assumption is flawed. For example, examinations of non-banks tend to be less frequent and less detailed. Non-banks are also subject to fewer prudential restrictions on counterparty exposure and on transactions (such as asset transfers). It is noteworthy that other statutory schemes do not confer special dispensations on non-bank affiliates. For example, banks – but not their non-bank affiliates – generally are exempt from registration under the Securities Act of 1933. *See* 15 U.S.C. § 77c(a)(2).

could overnight become futures clearing organizations simply by virtue of their ownership by a bank holding company.

Such a result is simply not consistent with sound public policy or with the Commission's role as the guardian of the integrity of the nation's futures markets. Nor is such a broad and sweeping deregulation contemplated by the Report of the President's Working Group on Financial Markets. To the contrary, the Working Group Report recommended only that "impediments in current law to the clearing of OTC derivatives" be eliminated.[3/] As to securities clearing agencies, the Working Group Report recommended only that they be permitted to clear OTC derivatives, excluding instruments involving a "non-financial commodity with a finite supply," and that they continue to have the exclusive right to clear OTC derivatives that are themselves securities.[4/] As to banks, their subsidiaries and affiliates, the Working Group Report recommended only that they be permitted to clear OTC derivatives, subject to regulation by the Federal banking authorities.[5/]

[3/] Report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (November 1999) ("Working Group Report"), at 2 (emphasis added).

[4/] Working Group Report, at 20. Although the Working Group Report does not elaborate on this point, existing law would reserve to the securities clearing agencies the following OTC products, all of which are themselves "securities": stock options; options on stock indices; options on debt securities (subject to an exception for certain OTC options on Treasury securities); options on debt indices; and foreign currency options traded on a national securities exchange. Although presumably not intended to be included, the possibility exists that this list could be expanded to include instruments that are not securities but that may permissibly be traded by an OTC derivatives dealer under the terms of the SEC's "broker-dealer lite" regulations, including contracts, agreements, or transactions that provide, in whole or in part, for the purchase or sale of, or that are based on the value of, or any interest in, one or more commodities, securities, currencies, interest or other rates, indices, quantitative measures, or other financial or economic interests or property of any kind. *See* 17 C.F.R. § 240.3b-13(a)(1).

[5/] Working Group Report, at 20. When taken together, the recommendations of the President's Working Group effectively would (i) permit futures clearing organizations regulated by the Commission also to clear OTC derivatives (other than OTC derivatives that are themselves securities); (ii) permit securities clearing agencies regulated by the SEC to clear all OTC derivatives (other than those involving a nonfinancial commodity with a finite supply); (iii) permit only securities clearing agencies to clear OTC derivatives that are securities; (iv) permit the Commission to develop rules governing the clearing of OTC derivatives involving a non-financial commodity

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The Working Group, drawing upon the combined expertise of futures, securities and banking regulators, did not think it to be necessary to allow securities clearing agencies, banks and bank subsidiaries and affiliates to act as the clearing organization for a futures market wholly outside the regulatory regime established under the Commodity Exchange Act (the "Act") and Commission regulations. We think that it would be a profound mistake for the Commission unilaterally to cede its authority and allow entities with no experience in futures clearing (indeed, in the case of bank affiliates, no experience with clearing whatsoever) to establish futures clearing organizations, without at a minimum obtaining reciprocal commitments from the SEC and other financial regulators that they will establish comparable exemptions.

The Clearing Corporation believes that the lack of operational and regulatory comparability described above should cause the Commission to reevaluate and withdraw this proposed exemption. If the Commission is unwilling to do so, we urge the Commission to conform the exemptions for securities clearing agencies, banks and bank affiliates to those applicable to foreign clearing organizations. The effect of such a change would be to ensure that such an entity is not merely "subject to the jurisdiction of" the SEC or federal banking authorities (*see* proposed Regulation 39.2(b)(2) and (3)), but rather that the futures and derivatives clearing activities undertaken by such an entity are, in fact, subject to "regulation and oversight" by other Federal regulatory authorities (*see* proposed Regulation 39.2(b)(4)(i)).

We are aware that the argument has been made that this aspect of the Commission's proposal is substantially similar to the clearing provisions contained in Commodity Futures Modernization Act of 2000. With all due respect, we find that argument to be wholly unconvincing. First, there is little certainty that any such legislation will be enacted before the expiration of this session of Congress. If the Congress fails to act, the rules adopted by the Commission will be controlling unless and until Congress adopts legislation that establishes a different standard. We think that Congress would almost certainly be heavily influenced by the considered views of the Commission on a sensitive subject such as clearing. The Clearing Corporation, therefore, urges the Commission not to surrender this opportunity to shape the debate and thereby preserve the ability of all clearinghouses to compete on an equal footing.

[5/](...continued)
with a limited supply; and (v) permit banks (including bank subsidiaries, affiliates and Edge Act corporations) to clear all other OTC derivatives, other than OTC derivatives that are securities. The Framework for Regulation, therefore, generally is consistent with the recommendations of the Working Group *except* that the Working Group did *not* recommend that securities clearing agencies and banks be permitted to clear futures contracts. *Id.*

The Commission should be aware that futures clearinghouses will find it difficult to survive in this new competitive environment if the Commission unilaterally cedes the field to securities clearing agencies, foreign clearinghouses, and banks by giving them the right not only to clear over-the-counter ("OTC") derivatives, but also to clear futures and option contracts traded on DTFs without a reciprocal ability on the part of futures clearinghouses to clear securities products.[6/] If, as expected, trading volume in financial futures and other products migrates to DTFs, traditional futures clearing organizations will be left with declining revenues and diminished capital with which to support agricultural futures and other established products.

The Clearing Corporation, therefore, urges the Commission to reconsider this exemption.

II. The Commission's Proposal Would Inappropriately Expand the Scope of the Act and Regulations.

Proposed Regulation 39.5 would, for the first time, make clearinghouses subject to various provisions of the Act and Regulations that simply do not – and should not – apply to clearing organizations.[7/] This is not a trivial matter. Holding a clearinghouse accountable for acts or

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[6/] Chairman Rainer made essentially the same point in his June 21, 2000 testimony before the Senate Committee on Agriculture, Nutrition and Forestry and the Committee on Banking, Housing and Urban Affairs regarding comparable provisions of S. 2697:

> S. 2697 also permits clearing of OTC derivatives and authorizes a mechanism for the CFTC to regulate facilities that clear OTC derivative contracts. Again, the President's Working Group specifically recommended removing legal obstacles to the development of appropriately-regulated clearing systems to reduce systemic risk, and we support this recommendation with the following reservation. The bill would allow securities clearinghouses to clear a broader range of contracts than futures clearinghouses. Futures clearinghouses would have to register in a dual capacity – as futures and as securities clearinghouses – to clear the same mix of contracts available to securities clearinghouses holding a single registration. By declining to grant futures clearinghouses equal opportunity to compete, the bill may put the government in the position of determining winners and losers. We urge the Committees to avoid placing futures clearinghouses at a competitive disadvantage.

[7/] The Commission's proposal to this extent appears to be based on a flawed legal premise. Specifically, the Commission has indicated that it believes that it has the authority to treat and define a clearing organization as a "contract market" for purposes of the Act and Regulations, citing the

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omissions that have nothing whatsoever to do with the trade matching and credit enhancement functions that are provided by a clearing facility unnecessarily and inappropriately creates the potential for liability, in enforcement proceedings and in private civil litigation brought under Section 22 of the Act, for conduct that was never previously thought to be actionable.[8/] Clearinghouses should not be made subject to these requirements without a careful and thorough

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[7/](...continued)
1978 decision of the United States District Court for the District of Columbia in *Board of Trade Clearing Corporation v. United States*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,534 (D.D.C. 1978). In fact, the District Court merely held, and *Clearing Corporation v. United States* stands solely for the proposition that, the Commission could construe the term "contract market" to include a clearing organization for purposes of the rule review requirements of Section 5a(a)(12) and Regulation 1.41. *Clearing Corporation v. United States* did not address any other provision of the Act and provides no basis for the Commission to seek to impose on clearing organizations obligations that Congress has seen fit only to impose on the exchanges (*i.e.*, the "contract markets").

[8/] For example, the incorporation by reference of Section 4i of the Act (relating to speculative position limits) and Commission Regulation 1.38(a) (relating to the execution of transactions other than by open outcry), is particularly problematic because their inclusion in Regulation 39.5 implies that a clearing organization is somehow responsible for enforcement of these requirements. In like fashion, we see no reason to make any of the following applicable to recognized clearing organizations: the exchange-trading requirements of Section 4(a); the provisions of the Act authorizing the Commission to regulate foreign futures (Section 4(b)); trade practice prohibitions (Section 4c(a)); the 1982 Congressional direction to the Commission to repeal its option pilot program (Section 4c(c)); the dealer option exemption (Sections 4c(d) and (e)); the exemption of foreign currency options traded on a national securities exchange (Section 4c(f)); the audit trail provisions of Section 4c(g); commodity trading advisor and commodity pool operator antifraud provisions (Section 4o); the "public interest" test applicable to contract market designation (Section 5(7)); the rule supplementation provisions of Section 8a(7); or the procedures relating to disciplinary action and appeals thereof set forth in Sections 8c(a)-(d) of the Act (especially inasmuch as the Commission has never construed those provisions, or Parts 8 and 9 of its Regulations thereunder, to apply to clearing organizations). We similarly do not agree with the proposed applicability of Parts 15 -21, relating to large trader reporting. Although the Clearing Corporation currently provides large trader, volume, open interest and other similar data to the Commission, it is not required to do so by those Regulations. To the extent that the Clearing Corporation is involved in this process, it does so as a service to its clearing members and to the Chicago Board of Trade and MidAmerica Commodity Exchange.

evaluation of their relevance and the consequences of their applicability to a regulated clearinghouse.

The Clearing Corporation also wants to register its vigorous opposition to proposed Regulation 39.6. That Regulation would punish anyone who cheats or defrauds any other person or who willfully makes a false report or statement "in connection with any transaction cleared by a recognized clearing organization." Although it is difficult – if not impossible – to envision circumstances in which a clearing organization could engage in conduct that violates Regulation 39.6, our objection is not merely formal or hypertechnical. The effect of this Regulation would be the assertion of the Commission's enforcement authority over otherwise-exempt transactions simply because those transactions are submitted to clearing. We submit that this is unwise as a matter of public policy. The Commission's Part 35 and 36 Regulations would do much to enhance legal certainty by declaring that clearing does not, by itself, make an exempt transaction subject to the Commodity Exchange Act; the Commission should not undermine that objective by interposing a potentially significant impediment to the use of clearing facilities by market participants whose business affairs are otherwise outside the scope of the Act. If it is nonetheless the Commission's intention merely to provide a safeguard against the possibility of fraud in the clearing process itself we would suggest that the Commission not incorporate by reference Section 4b of the Act or Regulation 33.10 and instead revise Regulation 39.6 to read as follows:

> Sec. 39.6 Fraud and Manipulation in Connection With the Clearance of Transactions ~~Cleared~~ by a Recognized Clearing Organization.
>
> It shall be unlawful for any person, directly or indirectly, in or in connection with the clearing of any transaction ~~cleared~~ by a recognized clearing organization:[9/]
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> * * *

III. The Part 39 "Core Principles" Are Inappropriately Prescriptive.

[9/] We have not proposed any further revisions to Regulation 30.6 based upon our understanding that, if adopted, the Regulation would be construed to require proof of scienter. *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).

The Commission is proposing a fundamental realignment of the regulatory scheme applicable to futures exchanges and other boards of trade to enable them to respond more effectively to competitive challenges. In particular, the Commission has stated its intention to replace the "one-size-fits-all" model it currently has in place with broad, flexible "core principles" that would apply in varying degrees to three tiers of markets: regulated futures exchanges, derivatives transaction facilities and exempt multilateral transaction facilities. In like fashion, the Commission has stated its intention to simplify and streamline the regulation of intermediaries by providing them with greater flexibility in numerous areas that are now the subject of prescriptive Commission regulations.

It surely cannot have escaped the Commission's attention that the Commodity Exchange Act and the Commission's Regulations are focused narrowly in their application to clearing organizations.[10/] It is, therefore, surprising that the Commission is now proposing to impose an array of new responsibilities on the clearinghouses. That these obligations are being imposed under the guise of "core principles" does not change their effect – clearing organizations will be made subject to far greater regulatory compliance burdens than at any time in the past.

The clearinghouses have an admirable record of safety and soundness. The Board of Trade Clearing Corporation has in its 75-year history cleared more than one billion transactions, but has never failed to perform its obligations to its clearing members, in full and on time. The Clearing Corporation's sterling record is attributable to numerous factors, including its strict membership standards and risk management practices. The Clearing Corporation's success in this area is also attributable, in no small part, to its ability to respond flexibly, promptly and appropriately to a member firm's insolvency and to other developments in the markets. The Clearing Corporation, therefore, is apprehensive about any new regulatory regime that would inhibit its ability to respond

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[10/] With the exception of Sections 4d(2) (segregation), 4g (recordkeeping) and 5a(a)(12) (rule review), the Act does not prescribe express requirements for clearing organizations. The Commission historically has been similarly restrained in its approach and has focused its attention on those aspects of the clearing process that, in its considered judgment, necessitated its regulatory involvement – the "early warning" requirements applicable to member firms (Regulation 1.12); certain of the customer funds segregation requirements (Regulations 1.20, 1.25, 1.26, 1.27 and 1.29); the maintenance of a "trade register" (Regulation 1.35(e)); review of clearing organization rules (Regulation 1.41); and restrictions on the use of "inside information" (Regulation 1.59), on service on a clearing organization's governing board and committees (Regulation 1.63) and on voting by interested members of the board or committees (Regulation 1.69). Taken together, these provisions of the Act and Regulations provide core protections to the markets and market users, consistent with the Commission's role as an oversight regulator.

as necessary to the exigencies of the marketplace and urges the Commission to evaluate carefully whether it is necessary or appropriate to engraft a new layer of regulation on the futures clearinghouses.

We are concerned that the level of specificity envisioned by Part 39 and, in particular, Appendix A goes far beyond anything that is required currently by the Commission's regulations, is wholly inconsistent with the Commission's intention to transform itself into an "oversight regulator" and, most importantly, has the potential to inhibit the flexibility and adaptability that enables the clearinghouses successfully to manage risk. In particular, the fourteen core principles for clearinghouses, and the accompanying nine pages of "guidance" provided by Appendix A, are far more intrusive and detailed than anything that now applies to clearing organizations. (To cite one of the more extreme examples, proposed Appendix A to Part 39 specifies that testing of a clearinghouse's automated systems be performed by "an independent third-party professional that is a certified member of the Information Systems Audit and Control Association.")

Finally, we are concerned that the "core principles" will take on the force of law, and that all clearinghouses – applicants for recognition and existing clearinghouses alike – will be required either to affirmatively demonstrate their compliance or satisfy the Commission's staff that one or more of the principles should not apply. We therefore urge the Commission to make explicit in the Part 39 Regulations (and not merely in the preamble to any final rules) that the "guidance" provided by Appendix A is merely illustrative and is not, nor is it intended to be, definitive or exclusive or a checklist of steps that must be taken in all cases.

IV. Additional Comments.

The term "clearing organization" would be defined in Regulation 39.1(a)(1) to mean "a person, entity or association thereof, which performs a credit enhancement function by becoming a universal counterparty to market participants, or by operating a facility for the netting of obligations and payments." The proposed definition would conflate two distinct functions, only one of which is characteristic of a clearing organization. Credit enhancement is the critical attribute of a clearing organization. By comparison, and as the Commission has itself observed in the context of its swap exemption (*see* Commission Regulation 35.2 and proposed Regulation 35.2(d)(1) and (2)), payment netting is merely an operational efficiency that reduces costs to market participants. Payment netting, therefore, should not be included as a benchmark for status as a "clearing organization."

At the same time, the proposed definition is potentially too broad, in that it would include persons who do nothing more than provide trade processing services for a recognized clearing organization. For example, the Clearing Corporation formerly provided certain trade comparison,

margin calculation and reporting services for trades made on the New York Cotton Exchange but cleared by the Commodity Clearing Corporation (the clearinghouse for the Cotton Exchange and predecessor to the New York Clearing Corporation). Read literally, the Clearing Corporation – which had no financial responsibility for Cotton Exchange trades – nonetheless could have been deemed to be "operating a facility" for the netting of payments and obligations and, therefore, to have been a "clearing organization" for the Cotton Exchange.

The Commission also has requested comments on what obstacles, if any, exist to combining cash market and derivatives clearing functions in a recognized clearing organization. 65 Fed. Reg. 39027, 39028 n.4 (June 22, 2000). One obvious impediment is the potential application of incompatible insolvency statutes (a problem that would be ameliorated by H.R. 1161, legislation that has been introduced by Congressman Leach). Of at least equal concern is the historical reluctance of the Commission's fellow regulators to facilitate anything resembling combined clearing unless it is made subject to the relevant agency's jurisdiction. The Clearing Corporation's experience is instructive. Anticipating the convergence of the cash and futures markets, the Clearing Corporation formed a subsidiary, the Clearing Corporation for Options and Securities ("CCOS"), that applied to the SEC in 1992 for approval to clear government securities transactions. That application was not approved until three years later, despite the fact that the Clearing Corporation was going to operate CCOS on a day-to-day basis and was prepared to bear responsibility for 50% of any defaults suffered by its securities clearing subsidiary. Even after SEC approval was granted, CCOS never was able to obtain required no-action relief for CCOS members from the SEC staff, despite the fact that the Government Securities Clearing Corporation had obtained comparable relief for its members years earlier.[11/]

The Commission also has proposed to amend Regulation 1.41. In essence, under the revised Regulation, a recognized clearing organization could make a proposed rule or rule amendment effective without prior Commission review or approval provided that certain conditions are satisfied. Unlike the Commission's previously proposed Regulation 1.41(z), however, clearing organization rules adopted pursuant to Regulation 1.41(c) would be subject to temporary abrogation pending a determination by the Commission that the rule should be disapproved, altered or supplemented. 65 Fed. Reg. 38986, 38982 (June 22, 2000). We are sympathetic to the Commission's concern that a rule that has been improperly adopted should not be permitted to remain in effect pending the conclusion of the Commission's internal processes.

[11/] The experience of The Options Clearing Corporation ("OCC") is similarly instructive. OCC, a registered securities clearing agency, formed a futures clearing subsidiary ("ICC") in the mid-1980s. The SEC would not approve a proposed cross-margining program between OCC and ICC, however, until ICC also registered with the SEC as a securities clearing agency.

At the same time, the Commission needs to be cognizant of the needs of market participants for legal certainty. We would, therefore, suggest that the Commission further limit its discretion in this area by including in Regulation 1.41 a provision that would delay the effectiveness of any such stay for a period of time (*e.g.*, not less than 20 days) in order to give the self-regulatory organization and market users an opportunity to make appropriate arrangements.

It also was unclear to us whether the Commission intends the rule review requirements of Regulation 1.41 to apply even if the rule of the recognized clearing organization is applicable only to trades made on an exempt multilateral transaction execution facility ("exempt MTEF"). As drafted, Regulation 1.41(c) would appear to impose such a requirement, even though exempt MTEFs are not subject to similar requirements.

We have enclosed with this letter proposed revisions to the text of Part 39. Although many of the changes that are proposed therein are offered merely as suggestions to clarify what we understand to be the Commission's intent, other proposed revisions are intended to address the substantive concerns alluded to in Part III of this letter. In addition to those proposed textual revisions, we have the following comments and suggestions on the following aspects of proposed Part 39 and Appendix A thereto:

The Commission should revise proposed Regulation 39.2(b) to clarify that transactions effected pursuant to Parts 35 or 36 do not become subject to the jurisdiction of the Commission simply because they are submitted to a Part 39 clearing organization. Failure to do so will almost certainly inhibit the use of clearing facilities for those exempt transactions.

The antitrust laws are intended to foster competition. Consistent therewith, Section 15 of the Act requires the Commission to endeavor to take the least anticompetitive means available to it – in effect, to avoid tipping the scales in favor of one or more parties or sectors of the industry. Although apparently intended to parallel the provisions of Section 15, Regulation 39.3(c)(14) would inappropriately impose upon a registered clearing organization the duty to avoid imposing "any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder." However, nothing in Section 15 or in the antitrust laws is intended to constrain competition as long as that competition does not result in an unreasonable restraint of trade or the unlawful use of monopoly power. It is <u>not</u> the duty of a clearing organization to avoid imposing burdens on its competitors as long as those burdens are imposed lawfully, through innovation, reduced fees, enhanced services or otherwise. It is possible that the Commission intended Regulation 39.3(c)(14) to reiterate the substantive requirements of the antitrust laws (which Congress has not felt necessary to do in Section 15). If that is the

case, we would suggest that the far more prudent course would be for the Commission to be silent on the subject lest it impose duties that are not coextensive with the antitrust statutes and decisions of the courts construing the Sherman and Clayton Antitrust Acts. Regulation 39.3(c)(14), therefore, should be deleted in its entirety.

The Commission should clarify that it does not construe proposed Regulation 39.4(e)(1) to require a "grandfathered" clearing organization to submit its rules to the Commission pursuant to Regulation 1.41, even though those rules will not be submitted pursuant to Regulation 39.4(b)(3).

The Commission should revise Appendix A - Core Principle 2 to eliminate the requirement that a recognized clearing organization "establish specific criteria for the types of derivatives it will clear" (something that would require an extraordinary degree of prognostication) and the related requirements that the clearing organization describe the clearing function for, and how it will account for the different risks associated with, those instruments. At a minimum, make clear that this is not a "back-door" attempt to exert control over the contract market designation process by limiting the contracts that can be cleared by a recognized clearing organization.

Section 5a(a)(12) of the Act authorizes the Commission to review and approve the rules of a contract market, *"except those rules relating to setting of levels of margin"* (emphasis added). The Commission accordingly needs to revise Appendix A - Core Principle 3(2)(c), which would require a clearing organization to submit information explaining "[w]hy particular margin levels would be appropriate. . . ."

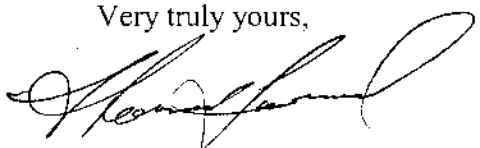
Appendix A - Core Principle 4 requires the submission of information in respect of cross-margining programs, including a demonstration that collateral assets would be subject to "fair and efficient loss-sharing arrangements." We think it is inappropriate for the Commission to presume that cross-margining arrangements necessarily will include loss-sharing provisions.

Appendix A - Core Principle 5(1)(c) includes a requirement that a clearing organization describe how its facilities for the deposit of funds will "ensure adequate diversification of concentration of risk." This would appear to require a recognized clearing organization to appoint more than one settlement bank and could be read to preclude the use of a "concentration bank" for margin settlement.

* * *

The Board of Trade Clearing Corporation appreciates the opportunity to communicate its views on this vitally important subject. The Commission and its staff should not hesitate to call me (at 312/786-5730) or Nancy K. Brooks, Vice President and General Counsel (at 312/786-5711), if you have any questions regarding any aspect of this letter or if you would otherwise like to discuss these matters further.

Very truly yours,



Thomas J. Hammond
Executive Vice President

Enclosure

cc: Honorable William J. Rainer
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable James E. Newsome
Honorable Thomas J. Erickson
Paul M. Architzel
John C. Lawton
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[Federal Register: June 22, 2000 (Volume 65, Number 121)]
[Proposed Rules]
[Page 39027-39033]
From the Federal Register Online via GPO Access [wais.access.gpo.gov]

COMMODITY FUTURES TRADING COMMISSION[*/]

17 CFR Part 39

A New Regulatory Framework for Clearing Organizations

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed Rulemaking.

* * * * *

PART 39--RECOGNIZED CLEARING ORGANIZATIONS

Authority: 7 U.S.C. 2, 6(c), 7a, 12a(5).

[*/] *NOTE: This document supplements and forms a part of the April 4, 2000 letter submitted to the Commodity Futures Trading Commission by the Board of Trade Clearing Corporation in response to the Commission's request for comments on A New Regulatory Framework for Clearing Organizations (65 Fed. Reg. 39027 (June 22, 2000)) and A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations (65 Fed. Reg. 38986 (June 22, 2000)). The revisions contained herein represent only some of the changes to Part 39 suggested by the Clearing Corporation. This document, therefore, should be read in conjunction with the Clearing Corporation's April 4 letter.*

Sec. 39.1 Definitions and Scope.

(a) Definitions. For purposes of this part:

(1) "Clearing organization" means a person~~, entity or association thereof, which~~ that performs a credit enhancement function in connection with transactions executed on a designated contract market or pursuant to parts 35-38 of this chapter by becoming a universal counterparty to market participants or by ~~operating a facility for the~~ netting payment ~~of~~ obligations and ~~payments of such transactions~~ entitlements; but does not include those netting arrangements specified in Sec. 35.2(d)(1) and (d)(2), nor does it include an entity that is a single counterparty offering to enter into, or entering into, bilateral transactions with multiple counterparties.

(b) Scope. (1) This ~~Section~~ Part applies to all cleared transactions effected on or through a designated contract market, a recognized futures exchange under part 38 of this chapter, a derivatives transaction facility under part 37 of this chapter, an exempt multilateral transaction execution facility under part 36 of this chapter, and to exempt bilateral transactions under part 35 of this chapter.

(2) A clearing organization that has been recognized by the Commission under Sec. 39.3 of this part shall be deemed to be a contract market for purposes of the Act; and Commission rules thereunder; provided, however, a recognized clearing organization shall be exempt from all provisions of the Act and Commission regulations thereunder except as reserved in Sec. 39.5 of this part.

Sec. 39.2 Permitted clearing.

(a) Any transaction effected on a designated contract market, recognized futures exchange, or derivatives transaction facility, if cleared, shall be cleared by a recognized clearing organization.

(b) A transaction effected pursuant to Part 35 or Part 36 of this chapter, if cleared, shall be cleared by any of the following authorized clearing organizations:

(1) A recognized clearing organization under this part; or

(2) A foreign clearing organization that demonstrates to the Commission that it:

(i) Is subject to home country regulation and oversight comparable to the standards set forth by the Commission for recognition of clearing organizations under this part; and

(ii) Is a party to and abides by appropriate and adequate information-sharing arrangements.

(c) Transactions not specified in Sec. 39.1(b)(1) of this part may also be cleared by a recognized clearing organization.

Sec. 39.3 Conditions for Recognition as a Recognized Clearing Organization.

To be recognized by the Commission under this part 39 as a recognized clearing organization, an entity:

(a) Need not be affiliated with a designated contract market or recognized futures exchange under part 38 of this chapter, derivatives transaction facility under part 37 of this chapter or exempt multilateral transaction execution facility under part 36 of this chapter;

(b) Must have rules and procedures relating to its governance and the operation of its clearing function; and

(c) Must adopt and maintain in effect rules, standards, policies or procedures reasonably designed to assure compliance by the registered clearing organization with the ~~initially, and on a continuing basis, meet and adhere to the~~ following ~~fourteen~~ core principles:

(1) ~~Financial resources:~~ Adequate ~~capital~~ financial resources to fulfill its guarantee function ~~without interruption~~ in various market conditions.

(2) ~~Participant and product eligibility:~~ Appropriate admission and continuing eligibility standards for members or participants of the organization, members of its governing board, and for persons with material ownership interests in the ~~and defined criteria for instruments it will accept for~~ clearing organization.

(3) ~~Risk management:~~ Ability to manage the risks associated with carrying out its guarantee function ~~through the use of appropriate tools and procedures.~~

(4) ~~Settlement procedures:~~ Ability to complete settlements on a timely basis under varying circumstances, to maintain records ~~an adequate record~~ of the flow of funds associated with ~~each transaction~~ the transactions it clears, and, to the extent applicable, to comply with the terms and conditions of ~~any permitted~~ netting or offset arrangements with other clearing organizations.

(5) ~~Treatment~~ Protection of customer, member and participant funds, including segregation of ~~client~~ customer funds ~~: Adequate standards and procedures~~ from those of clearing organization members and participants and the clearing organization, if required by applicable law or the rules of the clearing organization. ~~designed to protect and ensure the safety of client funds.~~

(6) ~~Default rules and procedures:~~ Rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the clearing organization.

(7) ~~Rule enforcement. Adequate arrangements~~ Arrangements and resources for the effective monitoring and enforcement of compliance with its rules ~~and for resolution of disputes.~~

(8) ~~System safeguards: An adequate~~ program of oversight and risk analysis to ensure that its automated systems function properly, ~~and~~ have adequate capacity, and security, and are supported by emergency and disaster recovery procedures.

(9) Reserved ~~Governance: Have fitness standards for owners or operators with greater than ten percent interest or an affiliate of such an owner, and for members of the governing board, and have a means to address conflicts of interest in making decisions.~~

(10) ~~Reporting.~~ Provision to the Commission of ~~all~~ information to facilitate the conduct of the Commission's oversight functions with respect to the ~~necessary for the Commission to conduct its oversight function of the~~ clearing ~~organization's activities~~ organization.

(11) ~~Recordkeeping: Maintain full~~ Maintenance of books and records relating to its ~~of all activities related to~~ business as a recognized clearing organization in a form and manner acceptable to the Commission for a period of five years.

(12) ~~Public information.~~ Public disclosure of information concerning the rules and operating procedures governing its clearing and settlement systems, including default procedures; provided that nothing herein shall be deemed to require the disclosure of trade secrets or proprietary or confidential information.

(13) ~~Information sharing: Enter into and abide by the terms of all appropriate and applicable~~ Participation in domestic and international information-sharing agreements ~~and use relevant~~, to the extent appropriate, and the use of information obtained from such agreements in carrying out the clearing organization's risk management program.

(14) ~~Competition: Endeavor to avoid unreasonable restraints of trade or imposing any burden on competition not necessary or appropriate in furtherance of the objectives of the Act or the regulations thereunder.~~

Sec. 39.4 Procedures for Recognition.

(a) Recognition by certification. A clearing organization that cleared for at least one nondormant contract market within the meaning of Sec. 5.4 of this chapter on January 1, 2000, will be recognized by the Commission as a recognized clearing organization upon receipt by the Commission at its Washington, DC, headquarters of a copy of the clearing organization's rules and a certification by the clearing organization that it meets the conditions for recognition under this part.

(b) Recognition by application. A clearing organization shall be recognized by the Commission as a recognized clearing organization sixty days after receipt by the Commission of an application for recognition unless notified otherwise during that period, if:

(1) The application demonstrates that the applicant satisfies the conditions for recognition under this part;

(2) The submission is labeled as being submitted pursuant to this part;

(3) The submission includes a copy of the applicant's rules and a brief explanation of how the rules satisfy each of the conditions for recognition under Sec. 39.3 of this part;

(4) The applicant does not amend or supplement the application for recognition, except as requested by the Commission or for correction of typographical errors, renumbering or other nonsubstantive revisions, during that period; and

(5) The applicant has not instructed the Commission in writing during the review period to review the application pursuant to procedures under Section 6 of the Act.

(6) Attached to this part as Appendix A is guidance to applicants concerning how the core principles set forth above could be satisfied.

(c) Termination of Part 39 Review. During the sixty-day period for review pursuant to paragraph (b) of this section, the Commission shall notify the applicant seeking recognition that the Commission is terminating review under this Section and will review the proposal under the procedures of Section 6 of the Act, if it appears that the application fails to meet the conditions for recognition under this part. This termination notification will state the nature of the issues raised and the specific condition of recognition that the application appears to violate, is contrary to or fails to meet. Within ten days of receipt of this termination notification, the applicant seeking recognition may request that the Commission render a decision whether to recognize the clearing organization or to institute a proceeding to disapprove the proposed submission under procedures specified in Section 6 of the Act by notifying the Commission that the applicant seeking recognition views its submission as complete and final as submitted.

(d) Delegation of Authority. (1) The Commission hereby delegates, suntil it orders otherwise, to the Director of the Division of Trading and Markets or the Director's ~~delegatee~~ delegate, with the concurrence of the General Counsel or the General Counsel's ~~delegatee~~ delegate, authority to notify an entity seeking recognition under paragraph (b) of this Section that review under those procedures is being terminated.

(2) The Director of the Division of Trading and Markets may submit to the Commission for its consideration any matter which has been delegated in this paragraph.

(3) Nothing in the paragraph prohibits the Commission, at its election, from exercising the authority delegated in paragraph (d)(1) of this section.

(e) Request for Commission Approval of Rules. (1) An applicant for recognition as a recognized clearing organization may request that the Commission approve any or all of its rules

and subsequent amendments thereto, at the time of recognition or thereafter, under Section 5a(a)(12) of the Act and Sec. 1.41 of this chapter. The recognized clearing organization may label such rules as having been approved by the Commission.

~~In addition, rules of the~~ (2) Rules of a recognized clearing organization that have not been submitted pursuant to Sec. 39.4(b)(3) ~~shall be~~ or grandfathered pursuant to paragraph (a) shall be submitted to the Commission pursuant to Sec. 1.41 of this chapter.

~~(2)~~(3) An applicant seeking recognition as a recognized clearing organization may request that the Commission consider under the provisions of Section 15 of the Act any of the entity's rules or policies at the time of recognition or thereafter.

(f) Request for withdrawal of recognition. A recognized clearing organization may withdraw from Commission recognition by filing with the Commission at its Washington, DC, headquarters such a request. Withdrawal from recognition shall not affect any action taken or to be taken by the Commission based upon actions, activities, or events occurring during the time that the clearing organization was recognized by the Commission.

Sec. 39.5 Enforceability.

In accordance with the proviso in Sec. 39.1(b)(2), and except to the extent otherwise provided in the rules of the clearing organization that have been submitted to the Commission in accordance with the requirements of Section 1.41, sections 1a, 2(a)(1), ~~4~~ 4(c), 4b, ~~4c~~ 4c(b) , 4d, 4g, ~~4i, 4o, 5(7),~~ the rule disapproval procedures of sections 5a(a)(12), 5b, 6, 6b, 6c, 8(a), 8(c), 8a(6), ~~8a(7)~~, 8a(9), ~~8c(a), 8c(b), 8(c)(c), 8(c)(d)~~, 9(a), 9(f), 20, 21 and 22 of the Act and Secs. 1.3, 1.20, 1.24, 1.25, 1.26, 1.27, 1.31, ~~1.38~~ 1.38(b), 1.41, ~~33.10, parts 15-21,~~ part 39, and part 190 of this chapter continue to apply.

Sec. 39.6 Fraud and Manipulation in Connection with Clearance of Transactions ~~Cleared~~ by a Recognized Clearing Organization.

It shall be unlawful for any person, directly or indirectly, in or in connection with any transaction cleared by a recognized clearing organization:

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) Willfully to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof; or

(c) Willfully to deceive or attempt to deceive any other person by any means whatsoever.

Appendix A to Part 39--Application Guidance

This appendix provides guidance to applicants for recognition as recognized clearing organizations in connection with satisfying each of the core principles of Sec. 39.4. In addressing the core principles, applicants should address the matters set forth below.

Core Principle 1--Financial Resources. Adequate Capital Resources to Fulfill the Guarantee Function Without Interruption in Various Market Conditions

In addressing core principle 1, applicants should describe or otherwise document:

1. The amount of resources dedicated to supporting the clearing function:

a. The amount of resources available to the clearing organization and the sufficiency of those resources such that no break in clearing operations would occur in a variety of market conditions; and

b. The level of member/participant default such resources could support as demonstrated through use of ~~a~~ hypothetical default ~~scenario~~ scenarios that explains assumptions and variables factored into the ~~illustration~~ illustrations.

2. The nature of resources dedicated to supporting the clearing function:

a. The type of the resources, including their liquidity, and how they could be accessed and applied by the clearing organization~~;~~ ~~without delay;~~ and

b. Any legal or operational impediments or conditions to access.

Core Principle 2--Participant and Product Eligibility. Appropriate Admission and Continuing Eligibility Standards for Members or Participants of the Organization and Defined Criteria for Instruments it Will Accept for Clearing

In addressing core principle 2, applicants should describe or otherwise document:

1. Member/participant admission criteria:

a. How admission standards for its clearing members would contribute to the soundness and integrity of operations; and

b. Matters such as whether these criteria would be in the form of organization rules that apply to all clearing members, whether different levels of membership would relate to different levels of net worth, income, and creditworthiness of members, and whether margin levels, position limits and other controls would vary in accordance with these levels.

2. Member/participant continuing eligibility criteria:

a. A program for monitoring the financial status of its members; and

b. Whether/how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's financial status.

3. [Reserved] ~~Criteria for instruments acceptable for clearing: a. How the clearing organization would establish specific criteria for the types of derivatives it will clear; and b. How those criteria take into account the different risks inherent in clearing different derivatives and how they affect maintenance of assets to support the guarantee function in varying risk environments.~~

4. Clearing function for each instrument:

a. The clearing function for each instrument the organization undertakes to clear~~; and~~

~~b. How different functions would be made known to participants.~~

Core Principle 3--Risk Management. Ability to Manage the Risks Associated With Carrying Out the Guarantee Function Through the Use of Appropriate Tools and Procedures

In addressing core principle 3, applicants should describe or otherwise document:

1. Use of risk analysis tools and procedures:

a. How the adequacy of the overall level of financial resources would be tested on an ongoing periodic basis in a variety of market conditions; and

b. How the organization would use specific risk management tools, such as ~~including~~ stress testing and value at risk calculations.

2. Use of collateral:

a. How appropriate forms and levels of collateral would be established and collected;

b . How amounts would be adequate to secure prudentially obligations arising from clearing transactions and performing as central counterparty;

~~c. Why particular margin levels would be appropriate for a contract cleared and the clearing member clearing the contract;~~

~~d~~. The appropriateness of required or allowed forms of margin given the liquidity and related requirements of the clearing organization;

e d . How the clearing organization would value ~~ensure appropriate valuation of~~ open positions and ~~valuation of~~ collateral ~~assets~~; and

f e. The proposed margin collection schedule and how it would ~~synchronize with~~ relate to changes in the value of market positions and collateral values.

3. Use of credit limits:

If and how systems would be implemented that would prevent members and other market participants from exceeding appropriate credit limits; and

4. Appropriate use of cross margin reduction programs:

How collateral assets subject to cross-margining programs would provide for clear, fair, and efficient loss-sharing arrangements in the event of a program participant default.

Core Principle 4--Settlement Procedures. Ability To Complete Settlements on a Timely Basis Under Varying Circumstances, To Maintain an Adequate Record of the Flow of Funds Associated With Each Transaction it Clears, and To Comply With the Terms and Conditions of Any Permitted Netting or Offset Arrangements With Other Clearing Organizations

In addressing core principle 4, applicants should describe or otherwise document:

1. Settlement timeframe:

a. Procedures for completing settlements on a timely basis during times of normal operating conditions; and

b. Procedures for completing settlements on a timely basis in varying market circumstances including during a period when a significant participant or member has defaulted.

2. Recordkeeping:

a. The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and

b. How such information ~~the flow of funds associated with each cleared transaction~~ would be recorded, maintained and ~~easily~~ accessed.

3. Appropriate interfaces with other clearing organizations:

How compliance with the terms and conditions of ~~any permitted~~ netting or offset arrangements with other clearing organizations would be met, including, among others, common banking or common clearing programs.

Core Principle 5--Treatment of Client Funds. Standards and Procedures Designed To Protect and Ensure the Safety of Client Funds

In addressing core principle 5, applicants should describe or otherwise document:

1. Safe custody:

a. The safekeeping of client funds, whether in accounts, in depositories, or with custodians, and how it would meet industry standards of safety;

b. Any written terms regarding the legal status of the funds and the specific conditions or prerequisites for movement of the funds; and

c. ~~How~~ The extent to which the deposit of client funds in accounts in depositories or with custodians would result in the ~~also ensure adequate diversification of~~ concentration of risk.

2. Segregation ~~between~~ of customer and proprietary funds:

a. Requirements for segregation ~~and requiring members or~~ to the extent not made ~~participants that clear trades executed on behalf of customers to segregate customer accounts and funds;~~ inapplicable by the rules of the clearing organization; and

b. Requirements or restrictions regarding commingling customer with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products the clearing organization is clearing or which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

3. Investment standards:

How customer funds would be invested ~~to meet~~ consistent with high standards of safety and ~~the proposed~~ associated recordkeeping regarding ~~all~~ the details of such investments.

Core Principle 6--Default Rules and Procedures. Rules and Procedures Designed To Allow for ~~Efficient, Fair, and Safe~~ the Effective Management of Events When Members or Participants Become Insolvent or Otherwise Default on Their Obligations to the Clearing Organization

In addressing core principle 6, applicants should describe or otherwise document:

1. Definition of default:

a. The definition of default and how it would be established and enforced; and

b. How it would address failure to meet margin requirements, the insolvent financial condition of a member or participant, failure to comply with certain rules, failure to maintain eligibility standards, actions taken by other regulatory bodies, or other events.

2. Remedial action:

The authority pursuant to which, and how, the clearing organization ~~would~~ may take appropriate action in the event of the default of a member which may include, among other things, closing out positions, replacing positions, set-off, and applying margin;

3. Process to address shortfalls:

Procedures for the prompt~~, fair, and safe~~ application of ~~Clearing Organization~~ clearing organization and/or member financial resources to address ~~eliminate any~~ monetary ~~shortfall~~ shortfalls resulting from a default.

4. Customer priority rule:

Rules and procedures regarding priority of customer accounts over proprietary accounts of ~~intermediary~~ defaulting members or participants (to the extent not made inapplicable by the rules of the clearing organization) and, ~~and~~ where applicable, in the context of ~~other programs, such as~~ specialized margin reduction programs ~~like~~ (such as cross-margining), ~~or~~ trading links with other exchanges, etc.

Core Principle 7--Rule Enforcement. Adequate Arrangements and Resources for the Effective Monitoring and Enforcement of Compliance With its Rules ~~and for Resolution of Disputes~~

In addressing core principle 7, applicants should describe or otherwise document:

1. Surveillance:

Arrangements and resources for the effective monitoring of compliance with rules ~~including any~~ relating to clearing ~~practice~~ practices and financial surveillance ~~programs~~.

2. Enforcement:

a. Arrangements and resources for effective enforcement of rules and authority and ability to discipline and limit or suspend a member's or participant's activities~~; and~~

~~b. Authority and ability to terminate a member's or participant's activities~~ pursuant to clear and fair standards.

~~3. Dispute resolution:~~

~~Arrangements and resources for resolution of disputes between customers and members, and between members.~~

Core Principle 8--System Safeguards. An Adequate Program of Oversight and Risk Analysis to Ensure That Its Automated Systems Function Properly ~~and have~~, Have Adequate Capacity, Security, and are Supported by Emergency and Disaster Recovery Procedures

In addressing core principle 8, applicants should describe or otherwise document:

1. Oversight/risk analysis program:

a. ~~Any program of oversight and risk analysis and whether~~ Whether it addresses appropriate principles for the oversight of automated systems to ensure that its clearing ~~system functions~~ systems function properly and ~~has~~ have adequate capacity and security;

b . Emergency procedures and a plan for disaster recovery; and

c. Periodic testing of back-up facilities and ability to ~~ensure~~ provide ~~daily~~ timely processing, clearing, and settlement of transactions.

2. Appropriate periodic objective system reviews/testing:

a. Any program for the periodic objective testing and review of the system; and

b. Confirmation that such testing and review would be performed by an independent third-party professional ~~that is a certified member of the Information Systems Audit and Control Association with an appropriate level of experience in the industry~~.

Core Principle ~~9--Governance. Have Fitness Standards for Owners or~~ 10--Reporting. Provision to the Commission of ~~Operators With Greater Than Ten Percent Interest, or an Affiliate~~ Information to Facilitate the Conduct of the Commission's Oversight ~~of Such an Owner, and for Members of the Governing Board, and Have a Means to Address Conflicts of Interest in Making Decisions~~ Functions with Respect to the Clearing Organization

In addressing core principle ~~9~~ 10, applicants should describe or otherwise document:

~~1. Appropriate standards for fitness for clearing organization~~

1.Terms of the clearing organization's organizational or governing ~~owners, operators, affiliates of owners or operators, and members of the governing board based on disqualification standards under Section 8a(2) of the Act.~~

~~2. Collection and verification of information supporting compliance with standards.~~

~~a. Verification information could be registration information or certification of fitness or affidavit of fitness by outside counsel based on other verified information.~~

~~3. Methods to ascertain presence of conflicts of interest and methods of making decisions in that event.Core Principle 10--Reporting. Provision to the Commission of all Information Necessary for the Commission to Conduct its Oversight Function of the Recognized Clearing Organization's Activities~~

~~In addressing core principle 10, applicants should describe or otherwise document:~~

~~1. Information~~ documents, including the provision of information necessary for the Commission to perform its oversight activities of the recognized clearing organization's activities, and~~:~~

~~a. All information available to or generated by the clearing organization that will be made available to the Commission as appropriate to enable the Commission to perform properly its oversight function, including counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities;~~

~~b. The types of information which are not believed to be necessary to provide to the Commission and why; and~~

~~c. The~~ the information the organization intends to make routinely available to members/participants or the general public.

2. Provision of information:

a. The manner in which all relevant information will be provided to the Commission, whether by electronic or other means; and

b. The means by which any information will be made available to members/participants and/or the general public.

Core Principle 11--Recordkeeping. ~~Maintaining Complete~~ Maintainance of Books and Records ~~of all Activities Related to~~ Relating to its Business as a Recognized Clearing Organization in a Form and Manner Acceptable to the Commission for a Period of Five Years.

In addressing core principle 11, applicants should describe or otherwise document:

1. ~~Maintaining~~ Maintainance of records ~~of all activities~~ related to the function of a clearing organization in a form and manner reasonably acceptable to the Commission:

a. The different activities related to the function of the clearing organization for which the organization intends to keep books or records~~; and~~.

~~b. Any activity related to the function of a clearing organization for which the organization does not intend to keep books or records and why this is not viewed as necessary.~~

~~2. Maintenance of full books and records in a form and manner acceptable to the Commission.~~

~~3~~ 2. How the entity would satisfy the requirements of Commission Regulation 1.31 including:

a. What "complete" would encompass with respect to each type of book or record that would be maintained;

b. How books or records would be compiled and maintained with respect to each type of activity for which such books or records would be kept;

c. Confirmation that books and records would be open to inspection by any representative of the Commission or of the U.S. Department of Justice;

d. How long books and records would be readily available and how they would be made readily available during the first two years; and

e. How long books and records would ultimately be maintained (and confirmation that, in any event, they would be maintained for at least five years).

Core Principle 12--Public Information. Disclosure of Information Concerning the Rules and Operating Procedures Governing its Clearing and Settlement Systems, Including Default Procedures

In addressing core principle 12, applicants should describe or otherwise document:

1. Disclosure of information regarding rules and operating procedures governing clearing and settlement systems:

a. Which rules and operating procedures governing clearing and settlement systems should be disclosed to the public, to whom they would be disclosed, and how they would be disclosed;

b. What other information would be available regarding the operation, purpose and effect of rules;

c. How member/participants may become familiar with such procedures before participating in operations; and

d. How member/participants will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of the clearing organization preceding and upon the participant's default.

Core Principle 13--Information Sharing. Participation in ~~Entering Into and Abiding by the Terms of all Appropriate and Applicable~~ Domestic and International Information-Sharing Agreements ~~and Using Relevant~~, to the Extent Appropriate,and the Use of Information Obtained from such Agreements in Carrying out the Recognized Clearing Organization's Risk Management Program

In addressing core principle 13, applicants should describe or otherwise document:

1. Becoming a party to applicable appropriate domestic and international information-sharing agreements and arrangements:

a. ~~The utility of entering into various types of information-sharing arrangements;~~b. The different types of domestic and international information-sharing arrangements, both formal and informal, which the clearing organization views as appropriate and applicable to its operations~~; and~~

~~c. The specific information-sharing agreements or other arrangements to which the clearing organization would become a party and how it would abide by the terms of these agreements~~.

2. Using information obtained from information-sharing arrangements in carrying out risk management and surveillance programs:

a. How information obtained from any information-sharing arrangements would be used to further the objectives of the clearing organization's risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its members/participants;

b. How accurate information is expected to be obtained and the mechanisms or procedures which would make timely use and application of all information; and

c. The types of information expected to be shared and how that information would be shared.

~~Core Principle 14--Competition. Endeavoring to Avoid Unreasonable Restraints of Trade or Imposing Any Burden on Competition not Necessary or Appropriate in Furtherance of the Objectives of the Act or the Regulations Thereunder~~

~~In addressing core principle 14, applicants should describe or otherwise document:~~

~~1. Avoiding unreasonable restraints of trade:~~

~~a. Terms and conditions of access and provision of services;~~

~~b. Any contracts or agreements to which the organization is a party which contain any noncompete clauses or limitations on future activity which may compete with the interests of either party to the contract.~~

~~2. Avoiding burdening competition:~~

~~a. Any practice of the clearing organization that may appear to affect the competitiveness of any other entity or the practice of any entity that may appear to affect the competitive ability of the clearing organization; and~~

~~b. The extent to which the entity has endeavored to adopt a rule or practice that is the least anticompetitive means of achieving the objective, purposes and policies of the Act.~~