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Dennis A. Dutterer
President and Chief Executive Officer

March 30, 2001

VIA E-MAIL AND FEDERAL EXPRESS

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

Dear Ms. Webb:

The Board of Trade Clearing Corporation (the "Clearing Corporation") appreciates this opportunity to offer its comments and suggestions on the proposals (the "Proposed Regulations") by the Commodity Futures Trading Commission to implement the amendments made to the Commodity Exchange Act (the "Act") by the Commodity Futures Modernization Act of 2000 (the "Modernization Act").[1]

The Clearing Corporation is the world's largest fully independent futures and futures options clearinghouse and the only futures clearinghouse that is rated "AAA" by Standard & Poor's. The Clearing Corporation, which was formed in 1925, currently serves as the clearing organization for the Chicago Board of Trade, the MidAmerica Commodity Exchange and the Merchants' Exchange of St. Louis. The Clearing Corporation has in the past provided trade processing services for the New York Cotton Exchange and the Commodity Clearing Corporation, and has entered into agreements to provide trade processing and related services for other clearing organizations and for markets that are expected to be organized as exempt boards of trade, exempt commercial markets, and/or registered derivatives transaction execution facilities ("DTEFs").

The changes wrought by the Modernization Act are far-reaching and profound, and we applaud the Commission's effort to move promptly and in good faith to give effect to the requirements of the Modernization Act. It is nonetheless vitally important that the Commission adhere to the spirit of the Modernization Act. At the

[1] A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations - Regulatory Reinvention, 65 Fed. Reg. 38936 (June 22, 2000)

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

same time, the public interest would be ill-served if the Commission were to fail to exercise its reasoned judgment to ameliorate some of the anomalies that crept into the statute as a consequence of its hurried enactment in the waning days of the 106th Congress. The Clearing Corporation's comments on the proposed Regulations are offered in furtherance of this critical balance. Many of the Clearing Corporation's comments expressed below arise out of our concern that a number of the Commission's proposals could have the unintended effect of burdening registered derivatives clearing organizations ("DCOs") and other registered entities.

A. Clarifications Needed to Reflect the Current Marketplace

Certain aspects of the Proposed Regulations reflect an outdated view of the role of clearing organizations and of the relationship between contract markets and DCOs. In the past, most futures clearing organizations were merely an adjunct to a single contract market. Clearing organizations have become increasingly independent, however, and now provide their services to multiple marketplaces.[2] The Modernization Act reflects this reality and correspondingly treats DCOs as separate and distinct entities, subject to the special requirements of Section 5b of the Act.

The Proposed Regulations and core principles, however, in some instances continue to reflect an outdated and inaccurate view of the relationship between the contract markets and the DCOs. For example, Appendix B to Part 38 provides that "every contract market should have routine access to the positions and trading done by members of its clearing facility." *Id.* at 14280 (Core Principle 4, ¶ (b)(3)). A contract market and its DCO may well be distinct legal entities, and a DCO typically will be bound by its obligations to its members or participants not to disclose sensitive commercial information - to the exchange or market on which they are trading or otherwise - without good cause. The Clearing Corporation suggests that the Commission revise the quoted text to provide for access only in furtherance of the contract market's self-regulatory responsibilities and only upon a showing of need or other good cause.

Similarly, Core Principle 6 appears to impose certain responsibilities on contract markets that historically have been the purview of the risk counterparty, the

[2] In addition to the Clearing Corporation, at least two futures clearinghouses provide or have in recent years provided services to more than one exchange: the New York Clearing Corporation (Coffee, Sugar & Cocoa Exchange; New York Cotton Exchange; Cantor Exchange; and, in its earlier incarnation as the Commodity Futures Clearing Corporation of New York, the New York Futures Exchange) and The Intermarket Clearing Corporation (New York Futures Exchange; Philadelphia Board of Trade; Amex Commodities Corporation).

clearinghouse. As the financial guarantor of cleared transactions, the clearinghouse (not the exchange) typically has the authority to call for additional margin from clearing members, to set settlement prices, and to order the liquidation or transfer of open positions from a defaulting clearing member to another clearing member.

Appendix B to Part 38 provides in respect of Core Principle 6 that "the contract market . . . should be able to . . . call for additional margin . . . from clearing members, order the liquidation or transfer of open positions, (and) order the fixing of a settlement price. . . ." *Id.* at 14281 (Core Principle 6, ¶ (b)). A contract market typically does <u>not</u> have the authority, by itself, to effect some of these requirements without the cooperation of its clearinghouse. For example, a contract market, cannot "order" the liquidation or transfer of open positions, although it <u>can</u> restrict trading by its member for liquidation only and it can suspend the trading rights of its member (which would force liquidation or transfer of positions to another clearing member). A contract market similarly can increase initial and maintenance margin requirements (for members and non-members alike), but the DCO is the entity with authority to call for additional margin from clearing members for deposit with the DCO. Finally, a contract market cannot in all cases "order the fixing of a settlement price." At least at the Clearing Corporation (and, as we understand it, most other DCOs), the fixing of settlement prices - which is inextricably intertwined with the risks assumed by the clearinghouse - remains the exclusive prerogative of the DCO.

Proposed Regulations 36.2(c)(2) and 36.3(c)(2) would give effect to the provisions of Sections 5d(d) of the Act, which authorizes the Commission to require an exempt board of trade publicly to disseminate volume, open and closing price ranges, open interest and "other trading data as appropriate to the market." Section 2(h)(4)(D) sets forth a similar requirement in respect of electronic trading facilities ("price, trading volume, and other trading data to the extent appropriate"). As the Commission is aware, price data and similar information has traditionally generated significant revenue that has helped to defray the cost of self-regulatory programs. This data is considered important property of the entity that has rights in it. The Clearing Corporation, therefore, would urge the Commission to defer any determinations on this subject until it has had a fuller opportunity to evaluate the appropriate balance of public interests entailed by such a requirement.

The Clearing Corporation also feels strongly that the Commission should revise proposed Appendix A to Part 38 explicitly to state that transactions effected on a contract market must (and not merely "should'") be cleared through a registered DCO if they are going to be cleared at all. This language is more consistent with the Modernization Act. *See* 66 Fed. Reg. 14262, 14279 (March 9, 2001) (Designation Criterion 5, ¶ (a)).

We also note that Proposed Regulation 36.3(c)(3) would require electronic trading facilities to obtain an agreement from their participants that they will comply with "all applicable laws." The Commission should take this opportunity to clarify that "all applicable law" (*see* Section 2(h)(5)(D) of the Act) is intended to be limited to applicable provisions of the Act and Commission Regulations and is not intended additionally to reference other sources of law (such as zoning, environmental or labor laws) that could be applicable to a participant in the course of its business.

B. Comments on Rule Submission and Approve Requirements

The Modernization Act has repealed the old rule submission and rule approval requirements formerly contained in Sections 5a(a)(1) and 5a(a)(12) of the Act. In their stead, new Section 5c(c) permits registered entities, including DCOs, to list for trading or accept for clearing any new contract or other instrument, or implement any new rule or rule amendment, upon the submission to the Commission of a written certification that the new contract or instrument or the clearing thereof, or the new rule or rule amendment, complies with the Act and Commission Regulations.

The Commission accordingly has proposed to repeal Regulations 1.41 and 1.41b (but, for reasons that are unclear, not Regulation 1.41a). In lieu thereof, the Commission has proposed new Regulations 40.2 - 40.7, which set forth requirements and procedures governing the adoption of rules and the listing of new products by registered entities.

Those Regulations are preceded by the definitions in Regulation 40.1, which define the term "contract market" to include a clearing organization that clears trades for the contract market "unless reference is made within the same section of the . . . Regulations to derivatives clearing organization(.)" *See* 66 Fed. Reg. at 14263 n.3 ("meaning of 'designated contract market' in all . . . Commission rules (other than those in Part 38, relating specifically to contract markets) must be inferred from its context"). This historical convention of including a clearing organization within the definition of a contract market is unnecessary and confusing. This convention simply no longer works in a regulatory scheme in which DCO's and contract markets are regulated separately. For example, Proposed Regulation 40.3 relates to the voluntary submission of new products for Commission review by a "contract market." Clearly, this provision is not intended to be applicable to DCOs. The Commission, therefore, should define DCOs separately from the term "contract market," and make any necessary conforming amendments to Regulations 40.2 - 40.7 in order to avoid any unnecessary ambiguity.

Regulation 40.2 sets forth the requirements for self-certification of new rules and rule amendments. Regulation 40.2 also would require a DCO to certify, in respect of a product that it clears that is not traded on a contract market or DTEF, that the trading product or instrument complies with the Act and Commission Regulations. As a preliminary matter, it is not clear to us that the Commission has the authority under Section 5c of the Act to require a DCO to make such a certification. Moreover, it is not clear how a DCO could ever make such a certification about a product or instrument that it has not designed and for which it is providing only a discrete set of services.[3]

Proposed Regulations 40.4 and 40.6(a)(2) implement the special statutory requirements applicable to agricultural contracts that have open interest by requiring prior Commission approval of any new rule or rule amendment that materially changes a "term or condition" of an agricultural futures or option contract that has open interest. The Commission is not authorized by Section 5c(c)(2)(B) to impose such an advance approval requirement in respect of registered entities other than contract markets. Regulation 40.6(a)(2) needs to be revised accordingly.

Proposed Regulation 40.5 governs the voluntary submission of rules to the Commission for its review and approval. We are particularly concerned with the provisions of subsections (d) and (e) of Proposed Regulation 40.5.

Proposed Regulation 40.5(d) provides that the Commission can notify a registered entity that a proposed rule "would violate" or "appears to violate" a specific provision of the Act or Commission Regulations or that "the violation of which cannot be ascertained from the submission." Regulation 40.5(e) would provide that such a determination is "presumptive evidence that the entity may not truthfully

[3] At most, a DCO should be required to certify that its clearing of the product or instrument complies with the Act and Commission Regulations, although it is not at all obvious what purpose would be served by such a requirement. A DCO remains subject at all times to the requirements of Section 5b of the Act and to the Regulations that are expected to be promulgated as new Part 39. A rote reiteration of the fact of this compliance would seem to do little to advance the Commission's regulatory oversight objectives.

certify that the same, or substantially the same, proposed rule or rule amendment does not violate the (Act) or rules thereunder." The Clearing Corporation believes that Regulation 40.5(e) is ill-advised and should be withdrawn for the following reasons:

First, Regulation 40.5(d) would allow the Commission to issue notices of non-approval based solely on noncompliance with the "form or content requirements" of Regulation 40.5. Technical noncompliance should not be allowed to stand in the way of a subsequent, conforming submission that is untainted by a presumption that the rule in question violates the Act and Commission Regulations.

Second, the Commission cannot circumvent the specific requirements of the Act and superimpose its judgment on a DCO (or other form of registered entity) by the simple expedient of sending a letter or other form of notice. Section 5e of the Act provides that the failure of a registered entity to comply with any provision of the Act, or any regulation or order of the Commission, shall be cause for the suspension or revocation of the registered entity. Section 5e further provides, however, that any such proceeding be conducted in a manner consistent with the procedural safeguards, including the right to a hearing on the record, provided by Sections 6b and 6(b) of the Act.[4]

Third, a letter from the Commission or its staff (*see* Proposed Regulation 40.7(a)(1)) "briefly specify(ing) the nature of the issues raised" cannot, as a matter of administrative law, constitute "evidence" of noncompliance. That is because the Commission is not permitted to make such a determination

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[4] *See United States v. Florida E. Coast Ry. Co.*, 410 U.S. 224 (1973) (*held*, when agency determination required by statute to be made "on the record," Sections 556 and 557 of the Administrative Procedure Act, 5 U.S.C. §§ 556, 557, apply and give affected party the right to present oral evidence and cross-examine witnesses in a trial-type hearing).

Regulation 40.6(b) would authorize the Commission (but not its staff) to stay the effectiveness of a rule implemented during the pendency of proceedings brought by the Commission for filing a false certification or to alter or supplement the rule pursuant to Section 8a(7) of the Act. 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 administrative proceedings. 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 amend Regulation 40.6(b) to specify that any such stay of effectiveness will not affect contracts and positions previously established in reliance on the rule in question. We further suggest that the Commission endeavor in such circumstances to delay the effectiveness of any such stay for a period of time in order to give the registered entity and market users an opportunity to make appropriate arrangements.

without first providing notice and an opportunity for a hearing to the DCO or other registered entity.[5]

Fourth, the Proposed Regulation is ill-advised in that it creates a perverse disincentive to the voluntary submission of rules and rule amendments. A registered entity that believes in good faith that a proposed rule is in compliance with the Act and Commission Regulations but understands that the subject is not free from doubt may want to seek the Commission's approval of its proposal. This is, of course, precisely the scenario contemplated by Section 5c(c) of the Act. A registered entity could, in such circumstances, acknowledge the risk that the Commission or its staff may believe the rule or rule amendment to be nonconforming. The registered entity may nonetheless be willing to make such a submission if it would not thereafter be precluded from implementing the rule, based upon its own judgment that the rule is not in violation of the Act or Regulations, even if the Commission or its staff should tentatively reach a different conclusion. In such circumstances, the registered entity should be in a position where it can respectfully disagree with the Commission or its staff and proceed as it would have had it had not made a voluntary submission in the first instance. The Commission will effectively nullify the voluntary submission procedure set forth in Section 5c(c) if it is unwilling to allow the registered entities to proceed in this fashion.[6]

Proposed Regulation 40.6(a)(2) provides an exception for rules or rule amendments adopted in response to an "emergency" (as defined in Proposed Regulation 40.1), and would in such circumstances require the filing to be made at the time of implementation. We encourage the Commission to adopt instead the more pragmatic standard currently embodied in Regulation 1.41(f)(2)(i) ("every effort

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[5] *Clement v. SEC*, 674 F.2d 641, 647 (7th Cir. 1982) (vacating order of the Securities and Exchange Commission ("SEC") where SEC order did "not demonstrate a careful analysis . . . of the rule change's impact"); *Belenke v. SEC*, 606 F.2d 193, 197 (7th Cir. 1979) ("opportunity for a hearing is required" in respect of exchange rule submissions "when the SEC determines that proposed rule changes are inconsistent with the Act"). This is particularly the case where "the violation of (the Act or Regulations) cannot be ascertained from the submission." *See* proposed Regulation 40.5(d). The Commission's proposal would in such circumstances allow it effectively to presume, based solely upon the submission of the registered entity, that the rule in question violates the Act or Commission Regulations. An agency cannot employ such a presumption absent a "sound factual connection" between the facts giving rise to the presumption and the facts presumed. *NLRB v. Baptist Hospital, Inc.*, 442 U.S. 773, 787 (1979).

[6] The course of action being proposed by the Commission in Regulation 40.5(d) is strikingly at odds with the more flexible approach that the Commission has indicated it will employ in instances of apparent violations of a core principle. *See* 66 Fed. Reg. at 14264 n. 10 ("It would be the Commission's intent to explore such informal methods of resolving issues of compliance with core principles by registered entities prior to invoking (the) more formal mechanisms" permitted by Section 5c(d) of the Act.

practicable" to provide advance notice; if not practicable, then notice required to be provided "at the earliest possible time").

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The Board of Trade Clearing Corporation appreciates the opportunity to communicate its views on this important 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 of the Clearing Corporation (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,

Dennis Dutterer

Dennis A. Dutterer

cc: Honorable James E. Newsome
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable Thomas J. Erickson
Paul M. Architzel
Alan L. Siefert
Lawrence B. Patent
Riva Spear Adriance
Nancy K. Brooks
Kenneth M. Rosenzweig