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BrokerTec Clearing Company℠

July 14, 2003

Commodity Futures Trading Commission
1155 21st Street
Washington, D.C. 20581

Attention: Ms. Jean A. Webb, Secretary

COMMENT

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

Dear Ms. Webb:

BrokerTec Clearing Company, L.L.C. (BCC) appreciates this opportunity to provide comments to the Commodity Futures Trading Commission (the Commission or CFTC) regarding the captioned rule proposal by The Board of Trade of the City of Chicago (CBOT).

BCC is a derivatives clearing organization registered with the Commission. BCC's clearing members include many of the most internationally active and highly capitalized futures commission merchants currently participating in the U.S. futures markets.

I. SUMMARY

The CBOT's rule proposal raises significant legal and public policy issues that cannot be resolved favorably on the record before the Commission, if at all. As a result, as proposed, Rule 701.1 cannot and should not be approved by the Commission pursuant to CEA Section 5c(c)(3) or 15(b) and, if submitted pursuant to self-certification, should be abrogated by the Commission, in accordance with the procedures established under the CEA, as violative of the Act. In light of the importance of the issues presented by the proposed rules, we urge the Commission to avoid a precipitous rule approval process and to consider the issues presented by the proposed rule with the deliberation merited by the precedents that the proposed rules would establish.

II. DISCUSSION

A. Proposed Rule 701.01

Proposed Rule 701.01 provides that:

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> **Transfer of Open Positions to Clearing Services Provider**. - Each Clearing member shall comply in all respects with any statement of policy or other notice issued by the Exchange relating to the procedures and processes that must be followed to effectuate the transfer of open positions to any Clearing Service Provider.

Proposed Rule 701.01 would thus permit the CBOT to determine, in its discretion, the arrangements governing the transfer of open positions at the Board of Trade Clearing Corporation (BOTCC) and the subsequent clearance of those positions, and to compel compliance by clearing members with those arrangements, without regard to the impact of these arrangements on clearing members, the customers of clearing members holding open positions, BOTCC or on competition generally. It does not permit firms to evaluate these arrangements prior to committing to them. Nor does it permit firms to choose between competing alternatives for the clearance of their open positions. These features of the proposed rule pose significant public policy concerns and raise issues of first impression under the antitrust analysis the Commission is obligated to undertake under CEA Sections 5c(c)(3) and 15(b).

B. Applicable Statutory Provisions

Approval of the proposed rule is governed directly by CEA Section 5c(c)(3) and 15(b). Section 5c(c)(3) provides, in pertinent part, that:

> The Commission shall approve any . . . [new rule submitted for approval by a contract market] unless the Commission that the new . . . rule . . . would violate the Act.

Section 15(b) separately provides, in pertinent part, that:

> The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this [Act], as well as the policies and purposes of this chapter, in . . . . approving any bylaw, rule, or regulation of a contract market . . . .

In addition to the protection of the public interest generally, the objectives of the Act are also informed, in part, by the core principles applicable to contract markets. Two in particular are relevant here: CEA Sections 5(d)(18) and 5(d)(2). CEA Section 5(d)(18) provides that:

> Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid adopting any rules or taking any actions that result in any unreasonable restraints of trade; or imposing any material anticompetitive burden on trading on the contract market.

CEA Section 5(d)(2) further provides that:

> The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

The following sections evaluate the proposed rules in light of the foregoing statutory considerations and conclude with procedural considerations relating to the adequacy of the record before the Commission in the context of the instant rule approval request.

III. ANALYSIS

A. Public Interest Considerations Generally

Proposed rule 701.01 would obligate clearing members, and their customers, to participate, with respect to their open positions, in whatever clearing arrangements the CBOT may in the future design and implement. The rule thus not only obligates firms to transfer their open interest but, by implication, would require existing clearing members to become members of the CBOT's new clearinghouse (or, at a minimum, to establish a clearing relationship with another firm that does). The public interest concerns raised by this proposal are self-evident.

Clearing firms and institutional futures market participants expend significant resources to understand and evaluate the risks and related considerations presented by the structure and rules of the clearinghouses that clear their positions. While financial integrity of the clearinghouses is an overriding concern (and Commission registration assures a minimum level of financial integrity), it is by no means the only consideration. Nor do firms make strictly binary decisions about participation in a clearinghouse based on an evaluation of its financial integrity.

Firms frequently establish credit limits that circumscribe the degree of credit exposure to which they are willing to expose themselves -- both as a general matter and specifically in the context of their participation (directly or through an FCM) in a clearinghouse. They also make decisions as to how and through which entities they participate in a clearinghouse. A number of firms originally created special purpose clearing entities to participate as members in the Chicago Mercantile Exchange Clearinghouse specifically because of its guarantee structure. Clearinghouses are prudently risk managed – they are not risk free and no one, including the Commission, views them as such.

As a result, even if a firm is willing to accept $200mm in credit exposure to clearinghouse "B" and $200mm in credit exposure to clearinghouse "C", that same firm is not necessarily willing to accept $400mm in credit exposure either to clearinghouse "B" individually or to clearinghouse "C" individually. Indeed, many clearing members and market participants are directly or indirectly subject to regulatory requirements, and many of the fiduciaries managing institutional participants in the futures markets are subject to fiduciary obligations,

which require them to make prudent credit risk management judgments and to develop policies and procedures, including risk limits, for managing their credit exposures.

There are many other important considerations that firms take into account in evaluating whether, how and through which entity they will participate in a clearinghouse. These include:

- What operational risks are associated with participation in the clearinghouse;
- How and to what extent losses associated with defaults are allocated among clearing members;
- What categories of risks are accepted by the clearinghouse;
- What categories of loss are guaranteed;
- What are the direct and indirect costs of participation in the clearinghouse;
- How do the various constituencies affected by the clearinghouse participate in its governance structure or in the committee(s) responsible for managing clearinghouse risks and establishing associated rules; and
- What legal and credit risks are introduced by the clearinghouse's membership criteria?

These are not trivial considerations. Nothing in the CBOT's rule proposal provides any basis for evaluating these considerations. Even if one assumed (which one cannot for purposes of the rule approval) that what the CBOT and the Chicago Mercantile Exchange have in general terms described will, in fact, evolve – that information does not resolve a single one of the foregoing considerations, nor obviate the need for individual firms to evaluate these considerations.

These judgments cannot be delegated, and as a matter of the public interest the Commission should not effectively compel CBOT clearing members or their customers to delegate this responsibility, blindly to the CBOT, in the exercise of ***its*** own commercial discretion. Approval of the proposed rule by the Commission would have precisely this effect with respect to open positions by requiring that these positions be transferred at the CBOT's direction.[1]

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[1] We note that this concern can ***not*** be eliminated solely by permitting a firm that does not wish to become a clearing member of the new clearinghouse to carry transferred positions through a firm that is a clearing member of the new clearinghouse. Rather than eliminating credit risk, such arrangements expose the firm ***both*** to the credit risk of the clearinghouse and its clearing firm (and to additional costs).

To be clear, these deficiencies cannot be addressed merely by extending the comment period or the Commission's deliberation of these issues. These considerations preclude Commission approval of any rule that would obligate a firm to participate in and accept the risk of a clearinghouse with respect to any position that is executed prior to the point in time when the firm is able to conduct due diligence on the relevant clearinghouse. We discuss immediately below the public policy concerns presented by permitting the CBOT to require the involuntary transfer of open positions under the circumstances contemplated by the proposed rule, even where the successor clearing arrangements are known at the time the positions are established.

B. Antitrust considerations

1. Threshold considerations.

There has recently been considerable informal discussion of the competitive and related antitrust issues that are raised by the scope and character of the linkages that exist between futures exchanges and clearinghouses. Much of this discussion, however, has been mired in false analogies and false premises. The Commission must recognize that the proposed rule, if adopted, would establish a significant precedent that is antithetical to this nation's antitrust laws.

First, it should be clear that approval of Rule 701.01 ***is not equivalent***, from an antitrust perspective, to the approval of an exchange rule designating specific clearing arrangements for its contracts (something all contract markets must do). By approving Rule 701.01, the Commission is ***not*** merely doing once again, what it has done many times over the years when it has approved contract market rules specifying clearing arrangements.

This is because, despite all the discussion about alternative clearing models embracing choice in one form or another, to-date no alternatives to the use of a single dedicated clearinghouse exist and none have been proposed in an implementable form. Put differently, the discussion to-date has been largely theoretical. As a result, no exchange rule has operated to limit the choices actually available to clearing members (and their customers). This point bears emphasizing. Until this rule approval request, no established exchange has proposed to take an action that would clearly operate as a restraint on the competitive choices actually available to a clearing firm (and its customers).

Although the issue in the instant case is limited to the choice as to where pre-existing open positions will be maintained once the CBOT initiates its new clearing arrangements (whatever they might ultimately be), and does not apply more generally to new positions, as to which no practical alternatives currently exist, it is nonetheless an important issue of first impression. And the issue it raises is whether the CBOT's proposal to eliminate that choice, a *prima facie* restraint of trade, is permissible under the standards established by the CEA. We are aware of no economic or other public policy argument in the record before the Commission that would justify this action by the CBOT and we are extremely skeptical that, even with time, the CBOT could develop such a record.

Second, the issues surrounding linkages between exchanges and clearinghouses are only, in part, about competition between clearinghouses for the business of an exchange. In truth, the issues of primary concern in the context of linkages between clearinghouses and exchanges involve ***competition between exchanges.*** This is a far graver concern. And it is a grave concern because the ability of an exchange to bundle execution and clearing enables it also to monopolize the open interest in its positions and through this monopoly to preclude margin, risk and, most importantly, settlement offsets between its contracts and competing contracts. The preclusion of such offsets imposes an almost insurmountable obstacle to competition from a new exchange.

Thus, the issues presented by the proposed rule are not routine or trivial.

Finally, the fact that contract markets have an obligation to establish clearing arrangements does not give exchanges *carte blanche* as to how they do so. Contract markets have a parallel obligation to establish trading rules and to conduct surveillance of their markets. No reasonable person would construe that responsibility as authorizing a rule that would subject members to transaction execution requirements imposed by the exchange ***after*** the execution of the affected transaction, due process concerns aside. The instant rule proposal presents analogous concerns.

Accordingly, the fact that the CBOT is obligated under the CEA to provide for successor clearing arrangements prior to the discontinuation of its relationship with BOTCC does not answer the question whether the CBOT's specific proposal for the transitioning of open interest satisfies applicable antitrust and public interest considerations. We turn to those issues immediately below.

2. Applicable statutory considerations.

CEA Sections 5(d)(18) and 5c(c)(3), on the one hand, and Section 15(b), on the other hand, are somewhat different. Because it is not necessary to do so for purposes of the instant analysis, we do not analyze here in detail the structural and procedural requirements of the different provisions. Taken together, these provisions effectively require that the Commission affirmatively evaluate[2] whether the proposed rule operates as an unreasonable restraint of trade and if it does, whether it is justified, for example, because it promotes other public interest considerations more effectively than the less anticompetitive alternatives that may

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[2] The relevant text of CEA Section 15(b) specifically requires that the Commission "endeavor to take the least anticompetitive means " in approving a rule. The term "endeavor" may, under certain circumstances, permit a Commission action to withstand scrutiny on appeal if the Commission, after endeavoring to do so, actually fails in the court's view to take the least anticompetitive means in approving an exchange rule. Under no reading, however, does the term "endeavor" obviate the Commission's obligation to evaluate affirmatively and rigorously the relative antitrust and other public policy considerations presented by the proposed rule.

Similarly, CEA Section 5(d)(18) provides that a contract market "shall endeavor to avoid" restraints of trade and burdens on competition. The use of the phrase "endeavor to avoid" cannot, however, be read as sanctioning the abject failure of an exchange to make any effort to avoid imposing a restraint on trade or a burden on competition.

be available. Under these provisions, a rule is not defective merely because it operates as a restraint of trade. Similarly, a rule is not defective merely because there are other alternatives available that are less anticompetitive. Instead, the extent to which the rule operates as a restraint of trade, and the less anticompetitive alternatives that may be available, must be evaluated by the Commission in light of the extent to which they do or do not also promote other public interest objectives fostered by the CEA (such as customer protection, financial integrity, etc.). The extent to which the exchange has taken the steps available to it to avoid or minimize the anticompetitive consequences of its proposed rule (rather than either ignoring them, or in the instant case, affirmatively seeking to achieve them) is also relevant.

By mandating that clearing members transfer their open interest as instructed by the CBOT, rather than leave their open positions at BOTCC, proposed rule 701.01 operates as a *prima facie* restraint of trade *vis-à-vis* the CBOT's clearing members (and their customers). The CBOT's motivation in imposing this requirement is clear. Removing the open interest from BOTCC will significantly impede competition by any exchange that chooses to clear its contracts with BOTCC and to compete with the CBOT.

It is difficult to imagine a rule less susceptible to characterization as the "least anticompetitive means" of accomplishing the objectives of the CEA than proposed rule 701.01. Ignoring the fact that we do not know what the CBOT's "means" will be (or therefore precisely how anticompetitive they will be), they are clearly not the least anticompetitive. Under any calculus, it would be less anticompetitive to transition open interest on a voluntary basis by those clearing members willing to participate in the transition, as it may ultimately be defined by the CBOT.

As noted above, we recognize that this is not the end of the inquiry. Under Section 15(b), the proposed rule could withstand scrutiny if it promotes important public interest objectives of the CEA to a greater extent than the less anticompetitive alternatives that are available (and the Commission determines that these benefits outweigh the relatively greater anticompetitive impact of the proposed rule). We are aware of no such benefits however. We are not aware of any in the record before the Commission and we are skeptical that the CBOT could demonstrate them, given additional time to do so.

Indeed, we believe that other important public policy considerations, such as those summarized in Section III.A. above, militate in favor of the less anticompetitive alternative of voluntary transfer and against the proposed rule. Additionally, the potential impact of the proposed rule in curtailing effective inter-exchange competition, and in establishing a precedent with potentially broader anticompetitive implications is profound and would almost certainly outweigh in relative significance any operational efficiencies that the CBOT might be able to identify as likely to be fostered by proposed rule 701.01.

In light of the foregoing, the Commission must decline to approve the proposed rules on the current record and, as we believe likely, on any record the CBOT is able to establish if given additional time to do so.

C. Rule Enforcement.

Proposed rule 701.01 also raises important issues regarding the permissible scope of an exchange's control over contracts that were executed on the exchange, but are legally contracts between the clearing member and the clearinghouse. Without reaching the question whether the CBOT's rule amounts to a tortious interference with the contracts in effect between BOTCC and its clearing members, the rule clearly intends to modify or supersede contracts to which the CBOT is not a party (even though it might be an indirect beneficiary of these contracts).

As a threshold matter, we do not regard an exchange rule that modifies the terms of an existing contractual arrangement between a clearing member and a clearinghouse as appropriate, as a matter of public policy, or as legally effective. Assuming for the sake of argument that the CBOT rule could be given effect in the abstract, the rule purports to allow the CBOT unilaterally to modify a contract *ex post facto* - after the contract has been made – raising further serious questions of enforceability. Even if a clearing member were presumed to have consented retroactively to an *ex post facto* modification of a contract to which it is a party, the unlimited breadth of the rule could not reasonably be construed as providing a basis for informed or meaningful consent - it is simply too open-ended. As a result, a serious question exists as to whether a court faced with the issue, applying general principles of contract law and related public policy considerations, would enforce proposed rule 701.01.

As noted above, CEA Section 5(d)(2) obligates a contract market to enforce its rules. In light of the considerations noted immediately above, we wonder whether the proposed rule would be enforceable as a matter of contract and therefore whether it could satisfy CEA Section 5(d)(2).

D. Procedural Considerations

1. Incomplete record.

As noted above, Proposed Rule 701.01 would permit the CBOT to adopt any measures or arrangements it selects to effect the transfer of open interest in contracts executed on the CBOT, without regard to the impact of its action on clearing members, the customers of clearing members holding open positions, the Board of Trade Clearing Corporation or on competition generally. Even if the Commission, as a purely abstract matter, regarded the authority implicit in the rule proposal as permissible, the proposed rule on its face provides the Commission with no basis or record on which to evaluate the range of potential consequences that might attend CBOT action (whatever that action might be) pursuant to this rule.

Similarly, as noted above, the record is bare as to the considerations that could justify the patently anticompetitive implications of the proposed rule.

Under these circumstance we do not believe that an adequate record exists on which the CFTC could approve proposed rule 701.01.

2. Timing.

Although we have endeavored to highlight and discuss in summary fashion as many of the issues we have identified as we were able to under the circumstances, we also concur in the views expressed by the Futures Industry Association regarding the inadequacy of the comment period afforded interested parties.

IV. CONCLUSION

As a perhaps obvious, but nonetheless important, final observation it must be noted that the instant rule approval is ***not*** about whether the CME-CBOT's contemplated clearing arrangement is, or will be, a good thing. It is not about whether these arrangements will or will not deliver savings or other efficiencies to firms. And it is not about whether the Commission is or is not standing in the way of these arrangements. The instant rule approval is about the way that the CBOT intends to achieve its objectives and whether these means are consistent with the purposes and objectives of the CEA. We believe the CBOT's proposed means are grossly overreaching and impermissible and, as important, could adversely impact the prospects for competition in the U.S. futures industry for the foreseeable future.

The CFMA, to a significant extent, placed stewardship of the U.S. futures markets in the hands of futures market participants. The Commission deserves great credit for the actions it has taken since enactment of the CFMA to ensure that this statutory framework and philosophy is implemented faithfully and in a manner consistent with Congress's intent. However, the linchpin to the success of this framework, and the premise for Congress's confidence in the salutary effect of market discipline, lies in the bedrock of our economic system: competition. Without competition there is no market discipline. Without market discipline, the CFMA is a bankrupt statutory framework.

Congress made the Commission the guardian of competition in the CFMA and invested the Commission with a profound responsibility. Instead of the relatively easy task of administering a body of rules, the Commission must apply principles, chief among them and closely linked, the protection of competition and the public interest. The Act requires the Commission to balance competing objectives and to make difficult judgments.

Rule approvals are short-lived. The impact of the absence of competition will have enduring consequences for the futures industry. The record on the competitive implications of the CBOT's proposed rule is not developed. We believe that the CBOT's rule proposal raises profound competitive implications. Under these circumstances and on this record it would be inconsistent with the CEA and imprudent of the Commission to approve the proposed rule.

We thank the Commission for this opportunity to comment on CBOT proposed rule 701.01. Please do not hesitate to contact the undersigned (201 209-7806) if the Commission or any of its staff should have any questions regarding the foregoing.

Respectfully,

Henry D. Mlynarski
President
BrokerTec Clearing Company, L.L.C.

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