The Clearing Corporation

04-3
(5)

Nancy K. Brooks
Vice President,
General Counsel and Secretary

141 W. Jackson Blvd.
Suite 1460
Chicago, Illinois 60604
312.786.5711
Fax 312.786.9171

June 16, 2004

Re: **Futures Market Self-Regulation**

BY ELECTRONIC MAIL AND AIR COURIER

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

COMMENT

Dear Ms. Webb:

Introduction

The Clearing Corporation ("The Clearing Corporation"), a derivatives clearing organization regulated by the Commodity Futures Trading Commission (the "Commission" or "CFTC"), read with interest the recent Request for Comment published in the Federal Register with respect to the draft Amended Amendment for Services (the "Amended Amendment"), which amends the 1984 Joint Audit Agreement.[1]

As background, The Clearing Corporation is a Delaware corporation owned by 50 stockholders, many of which are worldwide derivatives market participants. The Clearing Corporation has an extensive history of contributing to the safety and soundness of futures markets in the United States through its clearing and settlement activities. For over seventy years, The Clearing Corporation cleared and settled the transactions executed on or through the facilities of the Board of Trade of the City of Chicago ("CBOT"). The Clearing Corporation currently clears and settles transactions executed through the facilities of U.S. Futures Exchange, L.L.C. ("USFE") and the Merchant's Exchange.

Executive Summary

The Clearing Corporation has never been permitted to join the Joint Audit Committee ("JAC"), ostensibly because The Clearing Corporation does not have the same regulatory

[1] Federal Register, Vol. 69, No. 70, dated Monday, April 12, 2004, page 19166.

duties for monitoring and auditing FCM compliance with minimum financial and related reporting requirements that self-regulatory organizations ("SROs") have under the Commodity Exchange Act and regulations thereunder. However, we believe that the JAC can be an important forum for confidential sharing of risk information between SROs and independent clearinghouses, such as The Clearing Corporation. The JAC also regularly establishes key policies that impact futures commission merchant ("FCM") reporting to SROs and clearinghouses. For this reason, and as explained in greater detail below, The Clearing Corporation urges the Commission to withhold approval of the Amended Agreement until JAC policies are revised to permit participation in the JAC by independent clearinghouses such as The Clearing Corporation.

Also, as explained in greater detail below, The Clearing Corporation is concerned that certain provisions of the Amended Agreement appear designed to perpetuate an exclusive enclave, rather than promote a forum for confidential sharing of key risk management information among SROs and the clearinghouses. These provisions suggest an insular, exclusive bias that is contradictory to a policy of mutual sharing of key risk management information to decrease systemic risk across the marketplace. Approving the Amended Agreement would be equivalent to condoning continuation of the exclusive practices of the JAC. Clearly, this not in the public interest, nor does it protect the interest of customers, as required by CFTC Reg. 1.52(g). Therefore, the Amended Agreement should not be approved absent changes to these provisions.

Discussion

A. Joint Audit Committee

As the Commission indicated in the Federal Register Release, the JAC originally was formed to allocate responsibilities between SROs for monitoring and auditing FCM compliance with minimum financial and related reporting requirements, thereby decreasing otherwise duplicative regulatory burdens on FCMs, and to facilitate information sharing between JAC members. Over time, the JAC also has established audit guidelines for SRO audits. In addition, the JAC has served as a key industry group for consideration of changes to financial and reporting requirements imposed on FCMs. For example, the JAC worked closely with the exchanges on the development of net capital rules that have become industry standards.

Historically, the JAC has been comprised of the futures exchanges in the United States and the National Futures Association ("NFA"). The CFTC has participated in JAC meetings as a non-voting, "observer". Neither The Clearing Corporation nor other independent clearinghouses in the United States have been permitted to join the JAC. Participation in JAC meetings by such organizations has been limited to joining a meeting to discuss a particular issue on which the JAC is seeking input from the clearinghouses.

B. Information Sharing

The JAC's functions go beyond FCM audits and allocation of responsibility for such audits. The JAC also is an important vehicle for sharing of information related to FCM audits and, most significantly, sharing of audit findings that may flag areas of concern about a particular FCM. The Clearing Corporation believes strongly that such audit findings should be shared on a timely basis with clearinghouses that clear positions of the particular FCM at issue. Today, audit findings may be shared with clearinghouses on an ad-hoc, informal basis. For example, if The Clearing Corporation receives information from a member firm or from another source indicating a possible risk issue, The Clearing Corporation can seek additional information regarding recent audit findings from the member's designated self-regulatory organization ("DSRO"). The DSRO may choose to share this information with The Clearing Corporation or it may not. However, the same audit findings may well be discussed at a JAC meeting but neither The Clearing Corporation nor other independent clearinghouses clearing transactions of the particular FCM would be apprised of that information on a timely basis because such clearinghouses are not invited to JAC meetings.

In contrast, a clearinghouse that is a division or affiliate of a JAC member ("captive clearinghouse") can readily access information from a JAC meeting by simply speaking to the entity's JAC representative. This disparity of access to key information flies in the face of sound risk management practices for the industry, where the goal is to reduce systemic risk. Clearly, it is fundamentally unfair that independent clearinghouses do not have the same access to JAC-related information that captive clearinghouses have. Given the globalization of the derivatives markets and recent events in the market, it is critically important that the central counterparties in the industry, the clearinghouses, all have access to the same material risk-related information regarding their participating clearing members.

The Amended Agreement permits, but does not require, sharing of audit finding information with clearinghouses that clear trades of any market of which the FCM is a member. (See Section 8(b) of the Amended Agreement.) The Clearing Corporation believes strongly that the sharing of such information on a confidential basis should be mandatory. Access to information should not be a competitive issue. Market integrity depends on the sharing of this information with independent clearinghouses that clear for the firm at issue.

C. Participation on Key Issues

As noted above, the JAC also addresses financial, reporting and related issues and is influential in setting industry standards in these areas. For example, in the first half of 2003, the JAC worked with Commission staff on developing appropriate guidelines for risk management audits of member firms by SROs. At the time, The Clearing Corporation was clearing trades executed through the facilities of the CBOT. CBOT staff representatives sought input from Clearing Corporation staff on the risk management audit guidelines because certain of the information expected by the Commission was more readily available

through The Clearing Corporation's systems than through the CBOT's systems. However, The Clearing Corporation's participation on this important issue was limited by the JAC to participation in a portion of certain JAC meetings on specific invitation of the JAC. In addition, the JAC has regularly reviewed and set standards for financial reporting and net capital computations. The Clearing Corporation has a keen interest in participating in these discussions because risk management and ensuring the safety and soundness of the marketplace are fundamental to The Clearing Corporation's business.

In the past, The Clearing Corporation has sought to participate in JAC meetings on issues of interest to The Clearing Corporation. The Clearing Corporation has suggested that The Clearing Corporation be given a copy of the agenda for upcoming JAC meetings and, at a minimum, be granted permission to attend JAC meetings on matters of interest to The Clearing Corporation. This status would be akin to an "observer" and would not carry formal voting rights. The Clearing Corporation's request has been made informally to members of the JAC but to our knowledge, it has never been formally considered by the JAC. The unofficial response of JAC members to The Clearing Corporation has simply been that clearinghouses cannot become JAC members because clearinghouses do not have DSRO responsibilities.

D. Standard for CFTC to Approve the Agreement

As noted in the Release, the standard set forth in CFTC Reg. 1.52(g) for adoption of the Amended Agreement is that: (i) it is necessary or appropriate to serve the public interest; (ii) it is for the protection and in the interest of customers; (iii) it reduces multiple monitoring and auditing for compliance with the minimum financial rules of the SROs; (iv) it reduces multiple reporting of required financial information; (v) it fosters cooperation and coordination among the contract markets; and (vi) it does not hinder the development of [an RFA] under Section 17 of the Commodity Exchange Act. As the Commission considers approving the Amended Agreement, The Clearing Corporation also urges the Commission to consider the JAC policies for admission to the JAC because approval of the Amended Agreement is tantamount to approving the continuation of such policies.

As noted above, independent clearinghouses do not have the same access to information shared in a JAC meeting that a captive clearinghouse (division or affiliate of a JAC member) has. Indeed, the JAC has never permitted an independent clearinghouse to become a member of the JAC and has never even permitted regular attendance at JAC meetings by an independent clearinghouse. Thus, if audit findings shared at a JAC meeting indicated an on-going or potential risk/reporting concern about a member firm, an independent clearinghouse clearing trades of that member firm would not necessarily have any knowledge of, much less any right to demand access to, those audit findings. The Amended Agreement would permit sharing of information with such an independent clearinghouse but it does not require such information sharing, nor does it provide the clearinghouse with a means of procuring this information from a JAC member.

This type of exclusionary practice creates serious systemic risk concerns. The information shared in JAC meetings is important to management of on-going and potential risks raised by a particular member firm. It is critical that all clearinghouses that clear trades of such a member firm have access to such information and the right to demand such access if it is not voluntarily given. Lack of access to key risk management information is clearly not in the interest of the public.

In addition, as to voting rights, the Amended Agreement distinguishes between members of the JAC who joined the group before 2000, on the one hand, and those who joined after 2000 and who have subcontracted out auditing responsibilities. (See Section 3 of the Amended Agreement) It is difficult to imagine a reasonable basis for allocating voting rights based on how long a SRO has been a member of the JAC. Any entity that is a member of the JAC, by definition, is a CFTC-approved entity that has met all of the core principles and other regulatory requirements established by the CFTC. Moreover, withholding voting rights from more recent JAC members who have elected to subcontract out auditing responsibilities also is inappropriate because the subcontractor remains responsible for meeting its regulatory duties, the same as other JAC members. This type of provision is another example of exclusionary practices that are not based on public interest or protection of customers or facilitation of audits and reporting. Instead, it appears designed to perpetuate control of the JAC in the hands of the JAC members who were admitted to the club before 2000.

The provision of the Amended Agreement applicable to the admission of new members to the JAC, Section 13, is another example of a provision that perpetuates exclusionary practices. Section 13 provides that "After the effective date of this Agreement, designated contract markets and registered futures associations may become Parties to this Agreement, subject to the approval of the majority of the Parties which are eligible to vote." (emphasis added) Clearly, the JAC does not intend to admit independent clearinghouses to the JAC – clearinghouses are not even contemplated as possible parties to the Amended Agreement. Moreover, even designated contract markets and registered futures associations that desire to become members of the JAC must be approved by majority vote. Again, this vote will be taken by members of the JAC who were members before 2000 and other members who joined after 2000 and that have not contracted out their auditing responsibilities. This type of approval process again more closely resembles that of an exclusionary club than that of an equal-access organization.

Public interest and protection of customers are best served by fostering an environment in which key risk management information is shared in confidence by the exchanges, clearinghouses, and registered futures associations, as well as with the Commission. The best industry practices and standards are those derived from input from the experienced entities in the market, as well as from recently established entities, who may bring new ideas and concepts to the table. To foster this type of environment, The Clearing Corporation urges the Commission not to approve the Amended Agreement unless it is revised to

provide equal access and participation to independent clearinghouses and to more recently established SROs. Public interest and protection of customers are not furthered by sanctioning continuation of an exclusionary club that acts under the auspices of government approval.

Summary

In summary, The Clearing Corporation urges the Commission not to approve the Amended Agreement in the form submitted to the Commission. In the form submitted, it does not meet the requirements of CFTC Reg. 1.52(g) because certain discriminatory provisions of the Amended Agreement and the certain exclusionary practices of the JAC do not serve the public interest or the protection of customers.

The Clearing Corporation appreciates the opportunity to comment on the Amended Agreement. If you have any questions with respect to this matter, please contact the undersigned or Nancy K. Brooks, Vice President and General Counsel, at 312-786-5711.

Very truly yours,

Nancy K. Brooks

Nancy K. Brooks

cc: Dennis A. Dutterer
Thomas J. Smith
Natalie A. Markman