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NEW YORK
BOARD OF TRADE®

September 30, 2004

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

Re: SRO Governance

COMMENT

Dear Ms. Webb:

Board of Trade of the City of New York, Inc. ("NYBOT") hereby submits its response to the Request for Comments appearing in 69 Fed. Reg. 32326 et. seq. (June 9, 2004) (the "RFC").

NYBOT is a designated contract market ("DCM") that is the successor to, and operates the former markets of, the Coffee, Sugar & Cocoa Exchange and the New York Cotton Exchange. Products traded on NYBOT encompass agricultural commodities, foreign currencies and index contracts. The members of NYBOT represent a diverse range of market users including floor brokers, commercial hedgers, futures commission merchants, commodity trading advisors and broker-dealers.

The concept of self-regulation, long embodied in the Commodity Exchange Act, was strongly reinforced and expanded by the Commodity Futures Modernization Act of 2000 (the "CFMA"). That Act among other things recast the role of the Commission from being a primary regulator to becoming the overseer of self-regulation, while at the same time calling for reduced regulation. Specifically, in Section 2 of the CFMA Congress declared that among the purposes of the Act are:

> (2) to streamline and eliminate unnecessary regulation for the commodity futures exchanges and

> other entities regulated under the Commodity Exchange Act; [and]
>
> (3) to transform the role of the Commodity Futures Trading Commission to oversight of the futures markets.

The questions posed by the RFC are thought-provoking, and as such should be carefully studied by SROs in examining their governance structures and determining what, if any, changes are appropriate. However, it would be contrary to the declared purposes of the CFMA for the Commission now to mandate changes in the way SROs are governed. Furthermore, the cultures and philosophies of different SROs may be different in any number of respects, and it is inherent in the concept of self-regulation that SROs should determine for themselves the appropriate way to establish systems of governance that will best respond to their particular circumstances. That the public interest will be protected in this endeavor will be assured by the fact that the Commission has a strong oversight role that it will undoubtedly perform assiduously.

Finally, the existing systems have been in effect for many decades and should not be required to change unless there is a compelling need to do so, based on concrete experience and not mere philosophical theorizing.

With that introduction, we respectfully submit the following answers to the questions posed in the RFC. Paragraph numbers in this letter correspond to the paragraph numbers of the questions as they appear in the Federal Register.

1. <u>What is the Appropriate Composition of SRO Boards</u>?

NYBOT is a designated contract market ("DCM") and is the sole shareholder of New York Clearing Corporation ("NYCC"), a registered derivatives clearing organization ("DCO").

NYBOT believes that any DCM would be well advised to have on its Governing Board representation from each major community in its membership. Typically, this would consist of members who represent the trades associated with the products traded on the DCM, members who trade for

themselves or others on the trading floor (in the case of DCMs having trading floors), clearing members and other members trading for their own accounts or for non-members. The NYBOT By-Laws currently provide for representation of each of those communities.

Diversification of Board membership is beneficial to protect the public interest. It also serves the economic self-interest of each DCM by providing it with expertise that can best be derived from those actively engaged in the trading activities of each community, by making the activities of the DCM transparent to the members of those communities and by giving each community a voice in the conduct of the trading in which they engage. However, whether to have such diversification, and how representation of various communities should be allocated, are matters for each SRO to determine for itself in light of its own particular circumstances.

DCMs are primarily concerned with the trading process, including such things as the design of the products being traded, the trading procedures and the integrity of the trading process. DCOs, on the other hand, are principally concerned with the financial integrity of the markets. Therefore, the issues of concern to the governing board of a DCO are different from those confronting the governing board of a DCM. Consequently the desirability of diversification among governing board members of a DCO is not the same as in the case of a DCM. As it happens, the NYCC By-Laws provide for separate representation from large clearing members and from small clearing members. Furthermore, while the By-Laws do not so require, as a matter of practice NYCC has elected directors from clearing members identified with different trades. This diversity of representation has been an effective means of ensuring that the views of different communities are considered. While NYCC has decided that such diversification is appropriate for itself, we do not believe that there is a demonstrated need for this or any other kind of diversification to be mandated upon DCOs.

We make no comment about the composition of the governing boards of SROs other than DCMs and DCOs.

2. How and by Whom Should SRO Boards Be Nominated and Elected?

If a DCM or DCO determines to have representation from various communities, that SRO should determine for itself whether the communities to be represented should nominate or elect their own representatives. Among other things, we point out that as a matter of general corporate law, the fiduciary duty of a director is to the corporation itself and not to any particular constituency.

As to independent directors, we believe that their independence would be better established if they were appointed by the Governing Board (as is the case on NYBOT) rather than by either the SRO membership as a whole or any particular community within the membership. The NYBOT Board considers the expertise, independence, reputation and public sector awareness of the candidate when selecting its independent directors. However, we believe that how and by whom independent directors are chosen is a determination that each SRO should make for itself.

3. Should SRO Boards Include Independent Directors?

The NYBOT Board consists of 25 voting governors and one non-voting governor. Five of the voting governors are denominated as "Public Governors," who are individuals that are not NYBOT members or affiliated with NYBOT member firms. These Public Governors are appointed by the Board. The current Public Governors include a faculty member of a prestigious school of business administration, a principal in a merger and acquisition firm, a consultant on legislative affairs, a senior official at a bank and a commodity trading advisor.

We believe that the standard articulated in the New York Stock Exchange Constitution as quoted in the RFC is appropriate, and all of our Public Governors meet that standard. This has been as a result of the way in which the Board has filled those positions and not because of an express provision in our By-Laws. In response to the RFC, we will be considering whether it would be desirable to amend our By-Laws explicitly to set forth such a standard.

The NYBOT By-Laws do not distinguish between "public directors" and "independent directors," and we are not sure whether any useful purpose would be served by drawing a distinction between those two categories.

4. Are Governance Standards Applicable to Listed Companies Sufficient for Futures Exchanges or their Listed Parent Companies?

NYBOT does not believe that governance standards applicable to listed companies are relevant to futures exchanges which are not themselves listed or which do not have parent entities that are listed. Since we fall into neither category, we have no experience in addressing this question and accordingly make no further comment.

5. Should an SRO's Regulatory Functions Be Overseen by an Independent Body Internal to the SRO?

While the establishment of such a body would not be inappropriate, in our experience there is no need for such a body at NYBOT. NYBOT has enlisted its Public Governors in a variety of matters where an independent viewpoint was deemed important or when the Non-Public Governors would have an obvious conflict of interest in deciding the matter under consideration. For example, a majority of the Audit Committee members are independent directors. The regulatory oversight supplied by the Commission is thorough and effective, and we are not aware of any need to add yet another layer of oversight.

6. Should Rule Enforcement, Disciplinary or Other Functions Be Performed by an Independent Regulatory Services Provider?

NYBOT uses such services for its designated self-regulatory organization ("DSRO") responsibilities, but fulfills its rule enforcement and disciplinary obligations directly. The decision to delegate DSRO audit responsibilities to a service provider was based on cost efficiency and not on any regulatory need. Because of the comprehensive nature of the Commission's oversight of rule enforcement and disciplinary programs, we see no reason to suggest that a service provider should be performing those activities or that they

would do any better job than the exchanges are currently doing. The decision of whether to use independent regulatory services providers for any purpose should be made by each SRO for itself.

7. What Impact Do Varying Business Models Have on SRO's Self-regulatory Behavior?

We do not believe there has been sufficient experience with different business models to determine what impact the differences may have.

8. Would an SRO Be Subject to New Influences in the Performance of its Self-regulatory Functions if It Were to Demutualize?

The concept of self-regulation has been a core element of the regulatory framework under which our markets have successfully evolved for decades and, as such, should be jealously guarded. While it is possible that the objective to maximize profits could affect the quantity of resources dedicated to regulatory activities, it is at least equally possible that such will not be the case. We are not aware of any showing that regulatory standards have been compromised at any SRO that has demutualized. Therefore, we believe it is premature to make any policy judgments until the compilation of sufficient empirical evidence from which it can be determined whether in fact a problem exists, and, if so, what the appropriate response might be.

9. How Should SRO Disciplinary Committees Be Structured so as to Ensure Both Expertise and Impartiality?

NYBOT has a disciplinary committee composed of both members and non-members, called the "Business Conduct Committee" (or "BCC"). This Committee serves several functions, including: receiving and reviewing written reports concerning possible rule violations from the Compliance Department staff and determining whether a rule violation may have occurred in any particular instance. Each review as to whether a rule violation may have occurred is conducted by a subcommittee of the BCC consisting of one non-member of NYBOT and seven NYBOT members drawn from different exchange communities. The subcommittee may refer the matter to the Compliance Department for further action, or enter into or approve a settlement agreement with the accused or refer the matter to a formal hearing. If a matter is referred to a formal hearing, the proceeding is conducted by a separate panel, consisting of

three or five BCC members (not including any of those involved in the preliminary determination to refer the matter for a formal hearing), one of whom is a non-member and the others of whom are drawn from different exchange communities. Individuals having a relationship to the respondent are excluded from both the subcommittee and the trial panel. In this way each pre-trial subcommittee and each trial panel has both expertise and impartiality.

This system has worked successfully for years, as is evidenced by the fact that NYBOT has repeatedly received favorable commentary on its disciplinary proceedings from the Commission in its rule enforcement reviews. Most cases presented to the BCC are very technical in nature and require a strong knowledge of our rules and understanding of trading practices. To change this system by requiring a majority of the disciplinary subcommittees or trial panels to be non-members would deprive the system of needed expertise.

While the NYBOT system has worked successfully for many years, undoubtedly other systems might be employed at other SROs to equally good effect, and it should be the decision of each SRO as to what system to employ. There is no demonstrated need to mandate otherwise.

10. Should SRO Disciplinary Committees Have Independent, Non-SRO Member Chairs and/or Committee Membership?

Under the NYBOT system, the status of the Chair of the Business Conduct Committee is no greater than that of any other committee member, except that the Chair has the additional administrative function of appointing the subcommittees and trial panels ( which may include the Chair as a member). As indicated above, each subcommittee and trial panel has diversity of representation that is dictated by the Rules. Although non-members of NYBOT serve on BCC panels, we are not aware of any demonstrated reason why that should be mandated.

11. How and by Whom Should SRO Disciplinary Committees Be Appointed?

In NYBOT's case, the entire Business Conduct Committee is appointed by the Board every year for one year. Committee members may be reappointed, and there are no term limits.

While this arrangement has worked successfully in the case of NYBOT, undoubtedly there are other possibilities, and each SRO should be entitled to make that decision for itself.

12. What Additional Information, if any, Should SROs Make Available to the Public to Increase Transparency?

Information regarding the staffing and budget for the various NYBOT regulatory functions is provided to and is available to the Commission. We have never been asked for such information by members of the public, and we do not see why it would be relevant to them. Other information, such as Board member affiliations and disciplinary committee membership and affiliations is available to the public on the NYBOT web site and in the materials published by the Commerce Clearing House service containing the NYBOT Rule Book and other information.

Whether additional information should be made public is a matter to be decided by each SRO for itself, according to its structure.

13. Would Additional Core Principles or Regulatory Guidance Be Helpful?

NYBOT does not feel the need for either at this time.

14. What Steps Should Be Taken to Manage or Eliminate Conflicts of Interest?

The basic approach taken by NYBOT is to require disclosure of conflicts. In the case of a proceeding involving a "named party in interest," NYBOT Rule 6.05 provides that any person having any one of a number of specified relationships with such named party in interest is barred from participating in the proceeding. In cases not involving a named party in interest, NYBOT Rule 6.06 provides that persons having one of a defined category of conflicts of interest may participate in a discussion but may not vote on the outcome. In addition, NYBOT is, and presumably other SROs are also, subject to conflict of interest principles contained in state corporate law.

Core principle 15 imposes a general requirement to deal with conflicts of interest. The details as to how that is done should be left to each individual SRO.

Attempts to inject into the SRO governance discussion concepts derived from the Sarbanes-Oxley Act ("SOX") are misconceived. That Act is designed to protect investors by improving the accuracy and reliability of disclosures made pursuant to the securities laws. It is not intended to protect the users of the company's products or services. For example, the audit committee of an automobile manufacturer is charged with assuring the integrity of the manufacturer's financial reporting – not the quality or safety of its cars. Similarly, while SOX concepts apply to any futures exchange that demutualizes and becomes a public company for the protection of investors in that exchange, they do not apply to the services supplied by that exchange, i.e., its trading facilities. Furthermore, no reason has been demonstrated as to why yet another layer of bureaucracy should be required for exchanges in the form of an independent committee to oversee the operations of the exchange. Of course, if an exchange considers it appropriate to create some sort of independent regulatory oversight committee for purposes of enhancing the credibility of its markets, it is free to do so. However, there has not been a need demonstrated for the Commission to mandate taking such a course of action.

15. Should Registered Futures Associations that Are Functioning as SROs also Be Subject to Governance Standards?

Registered futures associations should be subject to governance standards, but they should not necessarily be the same as standards applicable to DCMs and DCOs, and the details as to how compliance with those standards is achieved should be left up to the sound discretion of each association.

NYBOT and its staff would be pleased to answer any questions you or any members of the Commission or its staff might have, and would welcome the opportunity to discuss further any of the questions presented in the RFC.

Sincerely yours,

Fred W. Schoenhut
Chairman