Bernard W. Dan
President and
Chief Executive Officer

Chicago Board of Trade

September 7, 2006

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BY E-MAIL AND CERTIFIED MAIL

COMMENT

Ms. Eileen Donovan
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Regulatory Governance – 71 Fed. Reg. 38740 (July 7, 2006)

Dear Ms. Donovan:

The Board of Trade of the City of Chicago, Inc. ("CBOT®" or "Exchange") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") Proposed Acceptable Practices for compliance with Section 5(d)(15) of the Commodity Exchange Act ("CEA"). Specifically, the Commission has proposed to include these Acceptable Practices under Core Principle 15 (Conflicts of Interest) in Appendix B to Part 38 of its Regulations, 17 C.F.R. Part 38, Appendix B. Core Principle 15 requires Designated Contract Markets ("DCMs") to ". . . establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest." Section 5(d)(15) of the CEA, 7 U.S.C. §7(d)(15).

The CBOT previously filed comment letters with the Commission in response to its June 9, 2004 and November 25, 2005 Requests for Comments in connection with its SRO review,[1] responded to the Commission's September 30, 2004 SRO governance practices questionnaire, and testified at the Commission's February 15, 2006 hearing on "Self-Regulation and Self-Regulatory Organizations in the U.S. Futures Industry" ("SRO Hearing").

I. Introduction

We commend the Commission for recognizing that ". . . self-regulation continues to be the most effective and efficient regulatory model available to the futures industry; . . . ." 71 F.R. at 38741. We also agree that ". . . the self-regulatory system nevertheless must be updated and enhanced, as appropriate and necessary, to keep pace with the changing marketplace." 71 F.R. at 38741. However, we disagree with the Commission's conclusions regarding what is "appropriate and necessary."

[1] The Governance of Self-Regulatory Organizations, 69 Fed. Reg. 32326 (June 9, 2004) and Self-Regulation and Self-Regulatory Organizations in the Futures Industry, 70 Fed. Reg. 71090 (November 25, 2005).

141 W. Jackson Blvd.
Chicago, Illinois 60604-2994
312 435-3606
Fax: 312 347-4259

Specifically, the Commission has proposed a Board Composition Acceptable Practice, a Regulatory Oversight Committee Acceptable Practice, and a Disciplinary Panel Acceptable Practice that, if followed by a DCM, would provide a safe harbor with respect to compliance with selected aspects of Core Principle 15's requirement that such exchanges minimize conflicts of interest in their decision making. Implicit in this approach is the assumption that in the absence of compliance with the Acceptable Practices, there will be an unacceptable level of any such actual or potential conflicts of interest.

The Commission assumes that heightened competition and demutualization raise questions about the ability of DCMs to function as effective self-regulators without additional safeguards. The Commission cites concerns that such exchanges will engage in lax self-regulation in order to further their commercial interests, as well as concerns that they will engage in discriminatory self-regulation in order to inhibit competition from market participants, including futures commission merchant ("FCM") members, either through rulemaking or disciplinary action. With respect to the former, there has already been much discussion in previous comment letters filed by the Exchange and others, and in testimony by various parties at the SRO Hearing, about the fact that competition and demutualization encourage rather than discourage effective self-regulation because market integrity is key to attracting and retaining business. With respect to the latter, publicly-traded exchanges have numerous safeguards already in place to ensure that such exchanges act in the best interest of their shareholders, and do not act to the detriment of a particular group of shareholders. Moreover, if the concern is that a DCM will adopt rules that will disadvantage members who are competitors, the Commission reviews all self-certified rules in order to ensure that such exchanges have correctly certified that they comply with the CEA and Commission Regulations, including the Core Principles, and specifically Core Principle 18 (Antitrust Considerations). Section 5(d)(18) of the CEA, 7 U.S.C. §7(d)(18).

The CBOT believes that good corporate governance is crucial to the operation of a self-regulating exchange, especially one that is publicly-traded.[2] In particular, we believe that the board of directors of such a DCM should include independent directors as defined by the relevant listing standards, member-directors, and non-member directors, and should be subject to robust conflict of interest policies. However, the Commission's proposed composition requirements for boards of directors and regulatory oversight committees are not only unnecessary to minimize potential conflicts of interest, they are likely to be detrimental to the effective operations of a DCM, and could therefore disserve the public interest cited by the Commission because of the significant loss of relevant experience and expertise that would result from their implementation. Although it is appropriate and beneficial to have some non-member directors on an exchange's board, each DCM

[2] In our case, the publicly-traded shares are those of CBOT Holdings, Inc., the parent company of the Exchange. The boards of directors of CBOT Holdings, Inc. and the CBOT are identical. For ease of reference in this letter, we refer to publicly-traded exchanges rather than distinguishing between an exchange and its publicly-traded holding company.

should remain free to determine for itself what percentage of its board should consist of such directors. Moreover, each DCM should be permitted to define for itself the parameters of the meaning of "public" or "non-member" directors.

The Commission's proposed Acceptable Practices conflict with the legislative history of the CEA, fly in the face of the Core Principle approach to regulation, and fail to recognize the changing definitions and increasing breadth of the concept of exchange membership. Moreover, their implementation would necessitate major changes and cause significant disruptions in the corporate governance of U.S. DCMs, virtually none of which currently meet the 50% public standard for boards of directors proposed by the Commission. The Commission is unable to cite any evidence that 50% would be any more beneficial than 30% or 20%, in ". . . promot[ing] the independence of SRO functions", 71 F.R. at 38741, with respect to a board's decision-making,[3] or that regulatory oversight committees are unable to deal effectively with potential conflicts of interest unless they exclude all members of an exchange. Furthermore, these sweeping measures have been proposed without any evidence that self-regulation has suffered in the current market environment.

The Commission stated that ". . . the current market environment mandates enhanced and transparent governance as an essential business practice for maintaining market integrity and the public trust." 71 Fed.Reg. at 38741. However, publicly-traded exchanges are presently subject to the detailed requirements of corporate law and listing standards that address their obligations to address potential conflicts of interest in their decision-making. Therefore, the trend toward demutualization and public listing has already led to "enhanced and transparent governance", thus obviating the need for additional Commission-prescribed safeguards.

The Commission assumes that these conflict of interest standards are irrelevant to the types of conflicts that may arise with respect to a public exchange's exercise of its self-regulatory responsibilities. In other words, the Commission has posited that they do not address an exchange's obligation to act in the public interest. However, as recognized in Section 3(b) of the CEA, 7 U.S.C. §5(b), the public interest is served through a system of effective self-regulation under the oversight of the Commission,[4] and the Commission

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[3] Moreover, as the Commission itself noted, at the SRO Hearing, ". . . industry participants did not agree on what specifically constitutes an appropriate board composition, or whether existing exchange board compositions are adequate." 71 Fed. Reg. at 38745, fn. 38.

[4] Section 3(b) of the CEA, 7 U.S.C. §5(b), states, in part, that "[i]t is the purpose of this Act to serve the public interests described in subsection (a) through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission." Those public interests include ". . . providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities." Section 3(a) of the CEA, 7 U.S.C. §5(a).

has cited no evidence that the effectiveness of self-regulation has been compromised by changes in the corporate structures of futures exchanges.

Commissioner Hatfield has asked a key question in the context of his suggestion that the Board Composition Acceptable Practice may not be necessary, that is, "Is there an existing problem that this proposal addresses?" 71 Fed. Reg. at 38750. However, the CBOT believes that this question should be asked with respect to each of the Commission's proposals. In other words, are all of the proposed Acceptable Practices solutions looking for a problem? As discussed at length in each of the Exchange's previous comment letters, self-regulation in the futures industry has functioned well both before and after the industry changes that the Commission has cited as the impetus for these proposals.

At the SRO Hearing, Dr. James Newsome, President of the New York Mercantile Exchange, Inc. ("NYMEX"), acknowledged that in his former position as Chairman of the Commission, he opened the formal portion of the discussions regarding self-regulation in the futures industry several years ago, but he stated that the Commission did not do so in response to any serious issues that had taken place in the industry, but rather because it had been 15 or 20 years since there had been a thorough review. (Transcript, pgs 24-25).

In all of the debate with respect to these issues, and in the 280-page transcript of the SRO Hearing, there has not been any demonstration that the current composition of any DCM's board has resulted in a specific decision that was compromised by a conflict of interest. Similarly, no such evidence has been put forth with respect to a decision by any DCM's regulatory oversight committee or disciplinary panel, as currently comprised. In his opening remarks at the SRO Hearing, Commissioner Hatfield said that he was interested in ". . . some specific answers as to why the existing structure is either working or why it is not working, *and if so*, what changes need to be made." (Transcript, page 17) (emphasis added). After all was said and done, the panel participants presented a variety of opinions about potential conflicts of interest and proposals for changes, but none were able to point to any specific examples that showed that the existing structure is not working. Therefore, there has been no compelling showing that the particular changes proposed by the Commission need to be made.

II. The Commission's proposed Acceptable Practices are inconsistent with the legislative history of the CEA and the Core Principle approach to regulation.

The proposed Board Composition Acceptable Practice would require that at least fifty percent of the members of a DCM's governing board must qualify as "public" directors, as defined by the Commission. The Commission has also proposed that this requirement should apply to DCMs' Executive Committees (or similarly empowered bodies). The Commission's proposed Regulatory Oversight Committee ("ROC") Acceptable Practice would require a DCM to establish a ROC that is made up solely of public directors. The Disciplinary Panel Acceptable Practice would require each DCM disciplinary panel to

include at least one public participant and to not be dominated by any group or class of exchange members.

The Commission's proposal to adopt board and committee composition requirements to address conflicts of interest is inconsistent with the legislative history of the CEA which has treated board composition and conflicts of interest as separate issues, both in the Futures Trading Practices Act of 1992 ("FTPA") and in the Commodity Futures Modernization Act of 2000 ("CFMA"). The proposed Acceptable Practices are also inconsistent with the Core Principle approach to regulation adopted in the CFMA, in that, regardless of statements to the contrary in the Commission's proposal, their effect would be to impose prescriptive requirements.

In 1992, Congress amended the CEA, among other things, to impose specific board composition requirements, conflict of interest standards and disciplinary committee composition requirements on exchanges. Each of these requirements was addressed separately, without any suggestion that the requirement adopted in former Section 5a(a)(14)(B) that at least 20% of the regular voting members of an exchange's board must be comprised of non-members was designed for the specific purpose of preventing potential conflicts of interest. Indeed, this requirement was adopted in the context of the new requirements adopted in former Section 5a(a)(14)(A) that exchange boards must include a meaningful representation of a diversity of interests, including futures commission merchants; producers, consumers, processors, distributors, or merchandisers of principal commodities traded on the exchange; floor brokers and traders; and participants in a variety of pits or principal groups of commodities traded on the exchange, and in former Section 5a(a)(14)(C) that at least 10% of the regular voting board members must include, where applicable, farmers, producers, merchants, or exporters of principal commodities traded on the exchange. Therefore, the amendments to former Section 5a(a)(14), as a whole, required that the directors of an exchange must represent a cross-section of market participants, affected parties, and members of the public.

Separately, the FTPA added former Section 5a(a)(17) to the CEA to require exchanges to prohibit voting by interested members of governing boards and disciplinary and oversight committees in order to avoid conflicts of interest. The statute, and the Commission's implementing Regulation 1.69,[5] prescribed detailed requirements regarding the particular actions to which these requirements applied, the nature of the conflicts addressed, the means for ascertaining the existence of such conflicts, and the circumstances under which conflicted members could participate in deliberations.

The CFMA replaced prescriptive "one-size-fits-all" regulation of the futures markets with flexible Core Principles, and specifically eliminated the board and committee composition requirements adopted in the FTPA. In keeping with the approach of the FTPA to address exchange governance and conflicts of interest as separate issues, two of

[5] DCMs are currently exempt from the application of Regulation 1.69 pursuant to Regulation 38.2.

the Core Principles adopted in the CFMA specifically address governance, while Core Principle 15 separately addresses conflicts of interest. Core Principle 14 (Governance Fitness Standards) requires a DCM to ". . . establish and enforce appropriate fitness standards for directors . . .", among others, Section 5(d)(14) of the CEA, 7 U.S.C. §7(d)(14), and Core Principle 16 requires that a mutually owned contract market must " . . . ensure that the composition of the governing board reflects market participants." Section 5(d)(16) of the CEA, 7 U.S.C. §7(d)(16). Interestingly, Congress chose to limit the application of Core Principle 16 only to those exchanges that would not be governed by the laws applicable to demutualized exchanges, presumably in recognition of the fact that the corporate governance of these entities is addressed, in the first instance, by a significant body of state law and, with respect to publicly-traded exchanges, the relevant listing standards. Core Principle 15 (Conflicts of Interest) requires that a board of trade must ". . . establish and enforce rules to minimize conflicts of interest in the decisionmaking process of the contract market and establish a process for resolving such conflicts of interest." Section 5(d)(15) of the CEA, 7 U.S.C. §7(d)(15). The Conflict of Interest Core Principle refers to "rules" and "process" and there is no suggestion that it was designed to impose any requirements or standards with respect to the composition of boards of directors, regulatory oversight committees or disciplinary committees, or any of their specific duties.

Section 5(d)(1) of the CEA requires that a DCM must have ". . . reasonable discretion in establishing the manner in which it complies with the core principles." 7 U.S.C. §7(d)(1). In keeping with this mandate, the Commission has indicated that exchanges may choose not to comply with the proposed Acceptable Practices, and may demonstrate that their governance policies and practices address potential conflicts of interest in compliance with Core Principle 15 by other means. However, as a practical matter, if the Commission adopts Acceptable Practices that require that a particular percentage of public directors serve on a DCM's board or its regulatory oversight committee, an exchange will be hard-pressed to convince the Commission that its choice of another percentage or a different definition of public is equally acceptable. Indeed, the fact that the Commission has issued its proposal implies that the Commission has already determined that the extensive conflict of interest procedures that are already in place at DCMs are insufficient to comply with Core Principle 15, although it has made no such findings in any rule enforcement reviews of such exchanges.

III. The Board Composition Acceptable Practice is unnecessary if a diversity of membership interests are represented on an exchange's board of directors.

The Commission has proposed to limit member participation on an exchange's board of directors in the interest of minimizing conflicts of interest. Its proposed public representation requirement is based on the premise that non-member directors will serve to protect the public interest, and will counterbalance the self-interests that member-directors may be tempted to serve. However, both member directors and public directors are bound by the same obligations under state corporate law. Under Delaware law, the directors of a public company owe fiduciary duties to the shareholders, including a duty

of loyalty and good faith, which obligates them to act in the best interests of the corporation and its shareholders, and a duty of care, which requires them to make informed, deliberative decisions. Furthermore, Delaware law generally provides that a board owes an equal duty to all shareholders, and it does not prohibit a corporation from having a board that is made up entirely of shareholders.

At the same time, both member directors and public directors are obligated to ensure that an exchange complies with the CEA and Commission regulations as a self-regulatory organization, which will consequently serve the public interest. Therefore, the duties of both member directors and non-member directors are aligned. Assuming, as we should, that directors are honest and trustworthy people who take their responsibilities seriously, public directors and member directors are equally likely to make decisions on behalf of the corporation that will simultaneously serve their corporate and self-regulatory obligations.

Although it is important to have both member and non-member representation on the board of an exchange, the representation of a diversity of interests will go farther in ensuring that no one interest is unfairly advantaged or disadvantaged than an artificial and arbitrary requirement that a particular percentage of board members must be public. Moreover the concept of "membership" has evolved as markets have become increasingly electronic and global, and the definitions of membership now encompass a growing number of new types of market participants. This larger group of members provides for a pool of potential board members with greater diversity and, at the same time, may limit the pool of individuals who would fall within the Commission's proposed definition of public. Exchanges should be permitted to tap these new members for service as directors, who will bring market knowledge and differing perspectives to their boards, rather than having to seek public directors from a correspondingly dwindling pool, who may have no relevant expertise or experience, in order to meet an artificial 50% quota. Moreover, if half of the directors must be public, an exchange may be hard-pressed to include sufficient representation of a diversity of membership interests, and still have a board of a manageable size.

Because there are varying definitions of membership, certain types of membership may raise greater potential for conflicts of interest, while other types of membership may raise very little potential for conflicts of interest with respect to the matters that may be considered by an exchange's board of directors. At the CBOT, individual members may be floor brokers or floor traders. They may trade only on the floor, only electronically, or both. Individual members may trade only for the proprietary accounts of the firms which employ them, or they may not trade at all, and may simply hold their firms' memberships in their names as nominees. Moreover, a significant group of members have leased their memberships to others. In addition, a number of Exchange members have exercised their privileges to trade at the Chicago Board Options Exchange on a full-time basis, and do not trade at the CBOT. The Exchange has a wide variety of member firm categories, including clearing firms, equity member firms that own common stock in the Exchange's holding company; trading member firms that own memberships but do not own stock;

futures commission merchants; proprietary trading firms; pools and hedge funds; firms that only trade electronically; firms that own memberships for the sole purpose of investment and which lease them to others, and member firm affiliates that qualify for reduced transaction fees.

The CBOT also has a number of non-member firms that are customers that have been authorized by their clearing member firms to obtain direct connections to the Exchange's electronic trading system. In addition, the Exchange has contracted with a number of individuals and entities that serve as market makers under various market making programs in exchange for financial incentives and/or fee waivers, some of which are Exchange members and others of which are not members. Finally, the Exchange has had a variety of permit programs over the years, and recently adopted a Global Developing Markets Program, pursuant to which it will grant fee waivers to non-member entities in developing countries. All of these members, member firms, member firm affiliates, non-member entities with direct connections, market makers, permit holders and participants in the Global Developing Markets Program agree to be subject to Exchange rules. However, they have varying degrees of investment in the Exchange, receive varying degrees of financial consideration, and have varying trading rights. In other words, the classifications of members versus non-members are no longer clearly distinct, and instead exist at various points along a continuum.

The proposed Acceptable Practices define a member consistently with Section 1a(24) of the CEA, 7 U.S.C. §1a(24), and Commission Regulation 1.3(q). Section 1a(24) defines a "member" of a DCM as ". . . an individual, association, partnership, corporation, or trust . . . owning or holding membership in, or admitted to membership representation on, the [DCM] . . . or . . . having trading privileges on the [DCM] . . . ." Regulation 1.3(q) contains similar language. Given the evolution of market models, the meaning of "having trading privileges on" a particular market is no longer clear, and different DCMs have varying definitions of membership. What is clear, however, is that the roles, perspectives, knowledge, and experience of members have become increasingly diverse. Therefore, it is far too simplistic to assume that member directors will tend to vote as a block either in the interests of members generally or against the interests of other members unless their voting power is counterbalanced by the votes of 50% public directors. If the exchange members on a board represent a sufficient diversity of interests, this will, in itself, ensure that no one category of members will be able to control board decisions to the detriment of other categories of members, or to the sole benefit of their own interests.

Even if directors who were members were tempted to ignore their fiduciary duties, and to attempt to subvert the conflict of interest policies that are in place, the interests of members are too varied, as are the nature of their competitors, for them to be successful in doing so. Exchange boards which represent diverse categories of membership and market participants have enabled, and will continue to enable, DCMs to fulfill their self-regulatory responsibilities. Moreover, given the increasing complexity of the business of an exchange, it is even more imperative that exchanges be permitted to decide for

themselves how to constitute their boards in order to obtain the necessary knowledge, experience, and expertise that will permit them to continue to serve their economic functions, and consequently, the public interest.

IV. Proposed definition of public

We continue to believe that the definition of "independence" contained in the New York Stock Exchange's listing requirements, and adopted by CBOT Holdings in its Bylaws, is sufficient to ensure the appropriate level of independence in the Exchange's decision-making. However, the Commission has rejected this position, and has proposed to define a public director to exclude members; officers, directors or employees of members; individuals who receive certain payments from members or officers or directors of members; and individuals whose immediate family members fall into any of these categories. In addition, the Commission has proposed that these disqualifying circumstances should be subject to a one-year look back. If the Commission determines to adopt its proposed definition of public, or any modified definition, a one-year look back is more than sufficient. The longer the look-back period, the more likely that individuals will not plan to return to the industry, and their knowledge base will become less relevant with the passage of time.

The Commission has requested comment regarding whether members should be precluded from serving as public directors if they engage in de minimis trading or if they lease their seats to others and do not trade. As discussed above, there are many different types of members, some of whom trade and some of whom do not. In light of the expanding definitions of members and market participants described above, it is important that the Commission not cast the net too wide. We agree with the suggestion that, at a minimum, members who do not trade on a particular market or who engage in de minimis trading, should be permitted to serve as public directors for that market.

The proposed definition of a public director would exclude directors who are also directors of an affiliate of the contract market. As noted above, the boards of directors of CBOT Holdings and of the Exchange are identical. Other major exchanges that have a holding company structure also have exchange boards that are identical with the boards of such holding companies. Therefore, the Commission should clarify that a director of an exchange would not be considered non-public because he or she was also a director of the exchange's holding company.

The Commission has also proposed to exclude from the definition of public, individuals whose spouses, parents, children or siblings are officers, directors or employees of a member. This category is too broad. For example, it would prohibit an individual from serving as a public director if his adult child who lives in another state works as a mail clerk for a member firm. Moreover, it would also exclude a person whose mother serves as an independent director for a member firm that is a public company. An individual should not be prohibited from serving as a public director of an exchange, based on the affiliation of an immediate family member with a member firm, unless the family

member is an executive officer of a member firm. Moreover, the exclusion should not apply to any family members who do not live in the same household as the director.

The Commission has further proposed that a director should not be considered to be public if he or she has received more than $100,000 in payments from the exchange, any affiliate of the exchange, or a member or anyone affiliated with a member, within the past year. The Commission has stated that compensation for services as a director will not be counted toward this amount. The Commission should also clarify that pensions and other forms of deferred compensation for prior services that are not contingent on continued service would not automatically disqualify a person from serving as a public director.

V. A 50% public requirement should not apply to Executive Committees.

Even if the Commission were to adopt its proposal that an exchange's board of directors should include 50% public directors, it should not impose this same standard with respect to Executive Committees, or their equivalents. At the CBOT, the function of the Executive Committee is to review proposals that will be presented to the Board of Directors and to make recommendations. However, the Board has the opportunity to independently review each proposal that has passed through the Executive Committee, and the Board is free to accept or reject the Executive Committee's recommendations. It is especially important that the Executive Committee have as much industry expertise as possible so that it may make informed recommendations to the Board. Moreover, unlike the Board, which may serve as an appellate forum for exchange disciplinary cases in limited circumstances,[6] the CBOT's Executive Committee has no such role.

Executive Committees are generally small in size. At the CBOT, the Executive Committee is made up of six individuals, including the President/Chief Executive Officer (who is also a director), the Chairman of the Exchange, the Vice Chairman of the Exchange, and three other Board members. However, some exchanges' Executive Committees are smaller than the CBOT's and consist solely of the President, Chairman and Vice Chairman of the Board. Therefore, each DCM should be permitted to determine the appropriate size and composition of its Executive Committee to ensure the efficient functioning of its board of directors and its market.

VI. The Board Composition Acceptable Practice proposed by the Commission would require major changes in board structure that would take time to implement.

Currently the identical boards of the Exchange's holding company and the Exchange are comprised of 17 directors, divided into two classes of nine and eight directors, with each class elected to serve two-year terms in staggered years. Eleven are designated as "parent directors" and six are designated as "subsidiary directors." The subsidiary directors are

[6] Under CBOT rules, the Board may review, on a discretionary basis, an adjudicated disciplinary matter that has previously been appealed to, and heard by, the Appellate Committee. Alternatively, if the Hearing Committee has heard a disciplinary matter and recommends that the subject should be expelled, the matter would be referred to the Board, which has the sole authority to impose the penalty of expulsion.

elected by the Series B-1 (Full) and Series B-2 (Associate) members of the Exchange, and four are required to be Series B-1 members and two are required to be Series B-2 members. At least nine directors must meet the definition of independence set forth in CBOT Holdings' Bylaws. This definition is consistent with New York Stock Exchange listing standards. If the Commission were to superimpose a requirement that 50% of an Exchange's board must meet its separate definition of public, the CBOT would be required to, at a minimum, amend the Certificate of Incorporation of CBOT Holdings, which under Delaware law must be approved by a majority vote of the shareholders. In addition, since directors are only elected at the annual meetings of CBOT Holdings and the Exchange, with classes of directors elected in alternate years, the Exchange would be unable to fully comply with the Commission's proposed board composition requirement until its 2008 annual meeting, without removing current duly-elected directors. Under CBOT Holdings' Certificate of Incorporation, directors are removable by the shareholders only for cause. Therefore, if the Commission were to adopt its proposed Board Composition Acceptable Practice, the CBOT would strongly urge the Commission to recognize the time that would be necessary for exchanges to comply given their corporate charters and board structures.

For exchanges like the CBOT, which have an odd number of directors, the Commission's proposal would, in effect, require a majority of public directors. These exchanges would have to decide whether to accept this result in order to comply with the Commission's proposal, or to change their board models to provide for an even number of directors. Regardless of their current numbers of directors, all exchanges would have to carefully consider whether it would be necessary to enlarge the size of their boards in order to allow for greater non-member representation while retaining sufficient member representation to ensure that their boards include the necessary knowledge and experience. In each instance, exchanges that choose to change their board structures will need sufficient time to implement such modifications. If the Commission adopts its proposed Board Composition Acceptable Practice, the CBOT proposes that an appropriate phase-in period should include a time period extending at least to each exchange's second annual election of directors after its adoption.

VII. <u>The Board Composition Acceptable Practice is unnecessary if an exchange establishes a Regulatory Oversight Committee to oversee regulatory functions.</u>

The Commission has proposed that DCMs should establish a ROC to separate the oversight of the self-regulatory function from the business considerations that are normally addressed by the board of directors of an exchange. As described by the Commission, such a committee would have the responsibility for overseeing an exchange's programs for trade practice and market surveillance, audits, and investigations, the regulatory budget and staffing, the hiring and compensation of the regulatory staff, and disciplinary committees and panels. We believe that an exchange should be permitted to determine for itself whether to establish a ROC, and if it does so, the extent of its responsibilities.

However, if a DCM were to dedicate a ROC to oversee its regulatory functions, this approach would be more than sufficient to address any perceived potential for conflicts of interest between business and regulatory considerations, and there would be no need for an additional arbitrary requirement that the Board of Directors must be composed of at least 50% non-member directors. Moreover, in light of the fact that board composition is generally and appropriately within the realm of state law and stock exchange listing standards, and the fact that Congress repealed the FTPA's mandates with respect to board composition when it adopted the CFMA, the Commission should not seek to impose requirements in this area through Core Principle guidance.

VIII. The Commission's proposal that a ROC should be comprised solely of public directors is inconsistent with its proposal that an exchange's board of directors should have a 50% public composition.

The Regulatory Oversight Committee Acceptable Practice would require DCMs to establish ROCs that would be comprised solely of public directors. The CBOT understands that the Commission's intent is to ensure that a ROC has sufficient independence of commercial interests in order to effectively function as an overseer of regulatory functions. However, a requirement that only public directors may serve on a ROC is too drastic a means of accomplishing this goal. By eliminating all persons who are, or have been, a member or associated with a member within the past year, an exchange would be eliminating virtually all of the necessary expertise and would, indeed, remove the "self" from self-regulation. Particularly with respect to decision-making about the SRO function, it is necessary to rely upon the participation of individuals who have relevant knowledge and experience. Therefore, we believe that the Commission should permit DCMs to determine for themselves the most appropriate composition of any regulatory oversight committees that they establish.

The CBOT's Regulatory Compliance Committee ("RCC") is made up of three Board members and the Chairmen of the Arbitration, Business Conduct, Floor Governors, Financial Compliance, Floor Conduct and Membership Committees. Currently, all of these individuals are members of the Exchange and represent a diversity of interests. Our RCC reviews rule proposals and regulatory policies, which is also a function that the Commission anticipates would be fulfilled by the ROCs that it describes in its proposal. We have found that the knowledge and experience that is represented on our RCC has been invaluable in permitting the Committee to make informed, considered decisions and recommendations with respect to these matters. A ROC whose members were all public, as defined by the Commission, would not have the expertise to do the same.

The trading, market, and financial surveillance programs and investigative programs of U.S. DCMs have become increasingly sophisticated and complex. Therefore, if a ROC were expected to review the effectiveness of these programs, it would be crucial for an exchange to be permitted to include members on its ROC who have had experience in administering the disciplinary processes of the Exchange, in as many of these areas as possible, or who have at least had experience as market participants.

The Commission's proposal that a ROC should be made up entirely of public directors is both inconsistent with its proposal for a 50% public requirement for boards of directors, and its proposed requirement that one member of the public should serve on disciplinary panels. Therefore, at the very most, if the Commission determines to specify the percentage of public directors that should serve on a ROC, it should not require a greater percentage than the 50% that it has suggested is acceptable for board composition.

IX. The Commission should clarify the meaning of its proposal that the Chief Regulatory Officer should report directly to a ROC.

The Commission's proposal states that ". . . the proposed [Regulatory Oversight Committee] Acceptable Practice envisions that the CRO of the SRO will report directly to, and regularly consult with, the ROC" but it also states that ROCs ". . . are not expected to assume managerial roles." 71 Fed. Reg. at 38745. Indeed, it is common and proper that a Chief Regulatory Officer would report to the Chief Executive Officer in the same manner that other officers of the company would report to the CEO, and the Commission should clarify that its proposal with respect to a CRO's relationship with a ROC is not intended to supplant this reporting line. In particular, the Commission should remove the language that states that the ROC shall ". . . supervise the contract market's chief regulatory officer . . ." in subparagraph (b)(3)(B)(iv) of its proposed Acceptable Practices, in that it is inconsistent with the Commission's stated position that it does not expect a ROC to function as the CRO's manager.

We understand that the Commission's intent is to insulate the regulatory function from perceived conflicts of interest that members may have, but the establishment of a ROC should not have the effect of removing the CRO from the appropriate direction and input of management of an exchange. Of course, if the CRO had a disagreement with management regarding the appropriate exercise of self-regulatory responsibilities, he or she should be able to report such disagreement to the ROC.

The Commission has proposed that a ROC should oversee the size and allocation of regulatory budgets and resources; the numbers of, and the hiring and termination of regulatory officers and staff; and the compensation of regulatory officers and staff. An exchange's CEO is normally involved in making recommendations to the Board regarding all departmental budgets, and in hiring and compensation decisions, particularly with respect to officers. This role is appropriate and must be retained with respect to regulatory budgets and regulatory personnel, including the CRO. Moreover, an exchange's board of directors must retain its role in approving all budgets, including the regulatory budget that is recommended by a ROC. Since the proposed ROC would be a board committee, without its own independent authority over an exchange's funds, it cannot be otherwise. Therefore, the Commission should clarify that if a ROC were to have any authority with respect to these matters, it would supplement rather than replace these normal management and board responsibilities.

X. The responsibilities of a ROC should be more narrowly defined.

The Commission has proposed that a ROC should have oversight authority with respect to the conduct of investigations, and that it should have the authority and resources to conduct its own inquiries, interview employees, officers and members, and review relevant documents. If the Commission is suggesting that the ROC itself should be permitted, for example, to independently conduct trade practice investigations, such authority is too broad and unnecessarily duplicative of the function of the regulatory staff.

The role of the proposed ROC appears to be modeled on the role of an Audit Committee of a public company. Although CBOT Holdings' Audit Committee Charter states that the purpose of the Audit Committee is to ". . . assist the Board in overseeing the integrity of the Corporation's financial statements and financial reporting processes . . .," among other things, it further states that:

> The Committee is not responsible for planning or conducting audits or determining that the Corporation's financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles and applicable rules and regulations. These activities are the responsibilities of management and the external auditors.

Similarly, the Commission has stated that "[t]he ROC's primary role is to assist the board in fulfilling its responsibility of ensuring the sufficiency, effectiveness, and independence of self-regulatory functions." 71 Fed. Reg. at 38744. Therefore, the Commission should clarify that it is not the function of a ROC to plan or conduct trade practice investigations or market surveillance or to review the results of particular investigations or audits, but rather to serve as an oversight body.

XI. Disciplinary Panel Acceptable Practice

The proposed Disciplinary Panel Acceptable Practice would require that each disciplinary panel of a DCM must include at least one public participant, as defined by the Commission. For this purpose, the Commission has proposed to define public in the same manner as it has for members of the board of directors. It would also require that a panel could not be dominated by any group or class of exchange members.

The 1992 amendments to the CEA provided that a major disciplinary committee which was hearing a disciplinary matter must include qualified non-members, where appropriate to carry out the purposes of the CEA, pursuant to rules adopted by the Commission. Former Section 5a(a)(15)(B). The Commission adopted Regulation 1.64(c)(1) to implement this provision.[7] Although the Commission has exempted DCMs from the

[7] Regulation 1.64 (c)(1) required self-regulatory organizations to adopt rules that required that at least one member of each major disciplinary committee or hearing panel must be a non-member when the committee or panel was acting with respect to a disciplinary action in which the subject was a member of the board or

application of Regulation 1.64 pursuant to Regulation 38.2, the proposed Acceptable Practice goes further than Regulation 1.64(c)(1) in requiring that a public participant must serve on major disciplinary panels in all cases, and not just in those limited circumstances delineated in that Regulation.

Some exchanges may choose to include one or more non-members on disciplinary panels or appellate bodies in all significant cases, or a subset of such cases. However, this is not the only manner in which an exchange may promote fair disciplinary procedures. Although the CBOT does not currently have non-member representation on its disciplinary panels, the Commission's Division of Market Oversight ("DMO") has consistently found that the Exchange's disciplinary programs are adequate, and in its most recent Rule Enforcement Review report issued on August 25, 2005, the DMO had no recommendations for improvement by the CBOT in this area. Since the evidence in disciplinary matters is often highly technical, we believe that an exchange should be permitted to determine the composition of its own disciplinary committees in order to ensure that decisions are informed by the necessary knowledge and experience.

The text of the Commission's Proposed Disciplinary Panel Acceptable Practice, in setting forth the standard that one public individual should serve on disciplinary panels, specifically excludes "cases limited to decorum and attire." 71 Fed. Reg. 38749. However, the Federal Register release indicates that ". . . cases limited to decorum and attire" are excluded in one reference, 71 Fed. Reg. at 38747, and that ". . . cases limited to decorum, attire, [and] the timely submission of accurate records required for clearing or verifying each day's transactions or other similar activities" are excluded in another reference. 71 Fed. Reg. at 38745. The Commission should clarify the Acceptable Practice, if is adopted, to specifically exclude these recordkeeping matters.

The Commission has proposed to define the non-member who would serve on a disciplinary panel as an individual who would qualify as a "public director" as defined in the Proposed Acceptable Practices. In the context of board members, the Commission's definition of public director requires that the board determine, on the record, that the individual has no material relationship with the exchange, and it also requires the exchange to disclose to the Commission which members of its board are public directors, and the basis for those determinations. Even if the Commission determines that the same material relationship criterion should apply, the board determination and reporting requirements with respect to public directors are unnecessary in the context of public disciplinary panel members, and the Commission should clarify that they are not part of the definition of public for this purpose.

We agree that a disciplinary panel should not be dominated by any group or class of exchange members. As with the Board of Directors, the Exchange believes that a diversity of representation on a disciplinary committee or panel serves to protect a

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a major disciplinary committee, or any of the alleged violations involved manipulation or attempted manipulation or conduct which directly resulted in financial harm to a non-member.

decision from any potential bias that one group of members may have against another group of members. However, we do not believe that it is necessary for the Commission to prescribe such diversity through Acceptable Practice guidance.

The Commission acknowledged that the Rule Enforcement Reviews conducted by its Division of Market Oversight have typically found that DCMs' disciplinary sanctions are fair and non-discriminatory and have consistently found that exchange disciplinary procedures are adequate. The Commission cited this fact in support of its conclusion that there is no basis for additional measures with respect to the composition or functioning of exchange disciplinary committees or panels beyond those that it has proposed. However, in light of these findings, it is apparent that there is no need for the Commission to adopt any portion of its proposed Disciplinary Panel Acceptable Practice.

XII. Conclusion

The Commission has described its proposed Acceptable Practices as "measured steps – in the form of carefully-tailored internal safeguards and checks and balances – to promote the independence of SRO functions." 71 Fed. Reg. at 38741. The proposed Board Composition Acceptable Practice would force drastic corporate governance changes at the major futures exchanges, and we do not believe it is a measured or necessary step. The Exchange agrees with the view expressed in Commissioner Hatfield's question, that ". . . the corporate governance requirements currently applicable to publicly traded exchanges, combined with properly structured ROCs and disciplinary panels and continuing Commission oversight, provide sufficient assurance that conflicts of interests will be kept to a minimum in the decision making process of those exchanges." 71 Fed. Reg. at 38750. However, the fact remains that the Commission has not identified any instance where self-regulation has been compromised by a conflict of interest, or where an exchange has otherwise failed to fulfill its self-regulatory responsibilities under the CEA or Commission regulations as a result of demutualization or increasing competition in the industry. Therefore, the CBOT also believes that the proposed Regulatory Oversight Committee and Disciplinary Panel Acceptable Practices are unnecessary, and that exchanges should remain free to determine if, and how, best to implement and utilize a ROC, and how to constitute their disciplinary panels.

The CBOT appreciates the opportunity to comment on these significant issues. If you have any questions, please feel free to contact Anne Polaski, Assistant General Counsel, at (312) 435-3757 or apolaski@cbot.com.

Sincerely,

Bernard W. Dan