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OFC. OF THE SECRETARIAT

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

COMMENT

Re: Request for Comment on Regulatory Governance (71 F.R. 38740 (July 7, 2006)

Dear Ms. Donovan:

The New York Mercantile Exchange, Inc. ("NYMEX" or the "Exchange")[1] appreciates the opportunity to comment on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc. ("COMEX"), concerning the proposed acceptable practices for Section 5(d)(15) (Core Principle 15 Conflicts of Interest) for designated contract markets ("DCMs" or "exchanges") of the Commodity Exchange Act ("CEA" or "Act") published for comment in the Federal Register ("the Release") by the Commodity Futures Trading Commission's ("CFTC" or "Commission").[2] Core Principle 15, which was added to the Act by the Commodity Futures Modernization Act of 2000, ("CFMA") provides that "[t]he board of trade shall 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."

Introduction and Overview

NYMEX fully supports strong and effective federal oversight as well as strong and effective exchange self-regulation. Furthermore, we appreciate the investment of time and effort by the Commission and Commission staff in the CFTC's self-regulatory organization ("SRO") review ("SRO Study"); we have consistently supported the review, and we have participated at every phase and stage of this process. NYMEX staff has

[1] NYMEX is a for-profit corporation organized under the laws of the State of Delaware. It is the chief operating subsidiary of NYMEX Holdings, Inc., ("NYMEX Holdings"). NYMEX Holdings' shares are not listed on a national market or exchange but are registered with the Securities and Exchange Commission ("SEC"), and as such, are subject to the rules and regulations of the SEC. As a designated contract market and a registered derivatives clearing organization, NYMEX is the largest exchange in the world for trading futures and options contracts on physical commodities. NYMEX previously responded to questions on SRO governance by comment letters to the CFTC dated September 30, 2004, and February 23, 2006. Prior to that filing, NYMEX staff also participated in various meetings and discussions with CFTC staff on the Commission's ongoing SRO Study. In addition, by letter dated October 14, 2004, NYMEX staff responded to follow-up questions posed by CFTC staff on SRO issues. NYMEX also provided testimony at the Commission's February 15, 2006 SRO hearing ("SRO Hearing").

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The New York Mercantile Exchange, Inc., is composed of two divisions. The NYMEX Division offers trading in crude oil, heating oil, unleaded gasoline, natural gas, electricity, coal, propane, platinum, and palladium. The COMEX Division offers trading in gold, silver, copper, and aluminum.

always served a constructive and cooperative role with CFTC staff in a good number of regulatory matters.

The operation of futures exchanges as self-regulatory organizations has a long history in the U.S. Indeed, as was noted by Commissioner Walter L. Lukken at the CFTC's hearing on SRO topics earlier this year, an exchange's regulation of its own markets long predates the commencement of federal regulation of derivatives markets.[3]

In my testimony at the Commission's February 15 SRO hearing, I discussed the reasons for commencing the SRO Study and noted that "[w]e didn't open this discussion in terms of a response to any serious issues that we deemed taking place in the business."[4] Instead, I commented that it had been 15-20 years since the last thorough review and also explained that the Commission deemed it prudent "to take a step back to ensure that the whole self-regulatory structure was working as efficiently and as correctly as the Congress and the Commission had intended." [5]

Under the "safe harbor" of the proposed provisions, the Commission first proposes that exchanges would need to minimize potential conflicts of interest by maintaining governing boards (as well as executive committees or similarly empowered bodies) composed of at least fifty percent "public" directors" as further defined in those provisions. Second, the Release "calls upon exchanges" to establish a board-level Regulatory Oversight Committee ("ROC"), composed solely of public directors, to oversee regulatory functions. Third, each disciplinary panel at "all" exchanges would need to include at least one public participant, and no panel could be dominated by any group or class of exchange members.

NYMEX has fully supported many proposed Commission initiatives in the past and has also provided constructive comments where appropriate to enhance and strengthen specific CFTC proposals. However, after a careful reading of the Release, we believe and respectfully suggest to the Commission that it should reconsider whether its proposals constitute acceptable practices under Core Principle 15, and, more broadly, under a core principles regulatory structure. We believe strongly that Congress' intent in the CFMA was supportive of a more flexible and less prescriptive approach to the application of core principles. We also believe that inclusion of specific, detailed prescriptive requirements as proposed acceptable practices and proposed "safe harbors" severely limits the ability of exchanges to undertake other approaches to achieving the general performance standard set by the core principle itself

In addition, based upon the Release, it is our considered view that there is no clear demonstration in the request for comment of an existing problem. Furthermore, we would also recommend that the Commission revisit its current approach to consideration of applicable costs and benefits, as the request for comment does not appear either to identify fully or to assess adequately the applicable costs and benefits of the proposed

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[3] "Hearing on Self-Regulation and Self Regulatory Organizations in the U.S. Futures Industry, February 15, 2006," SRO Hearing Transcript at 9.

[4] SRO Hearing Transcript at 24.

[5] SRO Hearing Transcript at 25.

regulations. Indeed, in our measured judgment, the CFTC's approach to core principles regulation set forth in the Release, if implemented without change in its current form, would have profound consequences for the ability of regulated futures exchanges to compete with unregulated domestic derivatives markets as well as with exchanges regulated by other jurisdictions.[6] Accordingly, we recommend that the Commission not proceed with these proposals in the form presented in the Release.

Core Principle 15

In identifying the applicable legislative intent, we believe that it is pertinent to consider the statutory and regulatory history in this area and the structure of the CEA, including in particular the role of Core Principle 16 ("Composition of Boards of Mutually Owned Contract Markets") for designated contract markets and the interplay between Core Principles 15 and 16 for DCMs. In addition, we will also review the Futures Trading Practices Act ("FTPA") of 1992, and the CFTC's subsequent history of regulatory actions undertaken in relation to various provisions of the FTPA. We will then focus in detail upon the CFMA, which eliminated certain provisions that had been added to the CEA by the FTPA and in effect provided as substitutes certain of the new core principles.

Futures Trading Practices Act of 1992 and Implementing Regulations

In Section 206 (Self Regulatory Organization Disciplinary Committees and Governing Boards) of the FTPA, Congress directed that now former Section 5a of the Act be amended to include several new provisions. With regard to board composition, Section 206 mandated that exchanges "provide for meaningful representation" of a diversity of specified interests. In particular, within the group of specified interests, Section 206 included a minimum requirement of no less than ten percent of what might be categorized as trade interests, i.e., "farmers, producers, merchants, or exporters of principal commodities traded on the exchange." In addition, Section 206 also specifically included a minimum requirement of no less than 20% of nonmembers of the exchange who had expertise in futures trading or regulation or other eminent qualifications. With regard to disciplinary committee composition, Section 206 also required that exchanges provide "on all major disciplinary committees for a diversity of membership sufficient to ensure fairness and to prevent special treatment or preference for any person in the

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[6] In recent years, as one legislator or another has considered modifications to the CEA, various segments of the U.S. derivatives community, most typically the OTC markets, have turned with regular frequency to the common refrain that the CFMA constituted a "delicate compromise" and therefore have urged restraint in undertaking actions that would upset the balance achieved in that landmark legislation. While industry observers may differ as to the specific components of that balance struck among industry segments, we trust that there is broad consensus that the U.S. futures exchanges were steadfast in their support for legal certainty for OTC derivatives, even in the face of dramatic increases in trading volume for standardized OTC "look-alike" versions of exchange-traded products. As a result of the passage of the CFMA, the one clear gain applicable to all U.S. exchanges regardless of their relative size or product mix was the shift to the more flexible performance standards codified by Congress in the core principles. In light of the intensifying competition for many U.S. exchanges, particularly from exchanges subject to the more flexible regulatory standards of non-U.S. regulators, any significant retrenchment from the flexible approach afforded to exchanges by Congress in the CFMA, including retrenchment at the administrative level, would wreak real and serious harm on the ability of U.S. markets to compete and would effectively shatter the delicate compromise achieved by the CFMA.

conduct of disciplinary proceedings and the assessment of penalties." (emphasis added.)

Although Section 206 by its terms did not specifically require the CFTC to adopt an implementing amendment, the Commission, following publication for comment, promulgated new CFTC Regulation 1.64 ("Composition of various self-regulatory organization governing boards and major disciplinary committees"), which became effective on August 12, 1993. (58 FR 37644, July 13, 1993.)

Section 206's provisions pertaining to "meaningful representation", when taken together with the provisions concerning diversity of membership "sufficient to ensure fairness," collectively reflect a deeper, more fundamental purpose. Specifically, with the passage of Section 206, Congress sought to address what may be characterized as conceivable structural conflicts of interests that might come into play at an SRO through a specific strategy of having the self-interest of one constituency be countervailed or offset by the self-interest of various other diverse constituencies. In this connection, "as part of its ongoing interest in fair and credible governance," the Commission instructed staff to conduct various reviews of each exchange's governing board structure for compliance with Commission regulations and the Act.[7] The initial report was issued on October 25, 1995. A follow-up report was issued on October 30, 1996.

Congress could have mandated that the board composition of SROs be comprised of 50% or more of independent or public directors. Instead, Congress determined that the "balancing of interests" or "checks and balances" approach was the best course to take in addressing such conceivable conflict concerns.

A companion provision to Section 206 of the FTPA was Section 217 (Prohibition on Voting by Interested Members). In general, Section 206 required exchanges to adopt rules and procedures to address conflicts that might be characterized as specific to a particular governing board or disciplinary committee member, including having a business or family relationship with a named party in interest and also including knowingly having a "direct and substantial financial interest" in the result of a vote. Several years subsequent to the passage of the FTPA, the Commission implemented CFTC Regulation 1.69 ("Voting by interested members of self-regulatory organization governing boards and various committees"), which became effective on March 5, 1999. (64 F.R. 16, January 4, 1999.)

In summary, both in the applicable statutory provisions added by the FTPA and in the Commission's related implementing regulations, there are two complementary but also clearly separate and distinct approaches to addressing conflicts of interest at an SRO: the balancing of interests through diversity approach to conceivable structural conflicts concerns and specific prohibitions relating to conflicts that arise out of certain factual circumstances specific to a particular governing board or disciplinary committee member.

Policy Reports and Other Documents Preceding the CFMA

Subsequent to the FTPA, a consensus developed in the derivatives community during the 1990s regarding the need for a substantial streamlining and modernizing of

[7] Letter from Andrea Corcoran, Director, CFTC Division of Trading and Markets, to R. Patrick Thompson, NYMEX President, dated October 30, 1996 at 1.

the CEA. Two of the more significant issues raised were the need for greater legal certainty for swaps and other derivatives traded in over-the-counter markets and the need for greater flexibility and freedom from overly prescriptive regulations applicable to regulated futures exchange markets. A 1999 report issued by the President's Working Group on Financial Markets ("Working Group Report") was perhaps the most influential report concerning the drafting of the CFMA on the legal certainty issue.[8] Although this report focused primarily on the OTC markets, the Working Group did express its belief that the enactment of its recommendations with respect to OTC derivatives should be accompanied by "explicit authority for the CFTC to provide appropriate regulatory relief"[9] for certain exchange-traded futures.

Another document that played a significant part in the shaping of the CFMA was a report prepared by a special CFTC staff task force, which was titled "A New Regulatory Framework." This report was submitted to Congress in February of 2000.[10] Although the staff task force had been assigned to make recommendations that could be implemented by the Commission within its existing authority, this report was nonetheless used in part as a model in the gestation of the CFMA. In general, then-CFTC Chairman William J. Rainer advised Congress that the task force proposed a new flexible structure that "replaces the current one-size-fits-all style of regulation." In particular, Chairman Rainer noted in the cover letters that the proposed framework "also replaces our prescriptive rules with flexible 'core principles'". The task force report proposed, among other things, a category of "recognized futures exchange" ("RFE"), which was the category that essentially corresponds to the category of designated contract market in the CFMA. That RFE category was subject to 15 core principles, including a core principle pertaining to governance.

That proposed core principle on governance, among other things, included two key sentences. First, the RFE "must have a means to address conflicts of interest in making decisions." This language is clearly directed at rules and procedures to address actual and specific conflicts, rather than broad systemic prescriptions to address hypothetical or potential conflicts. Second, "for mutually owned futures exchanges, the composition of the governing board must reflect market participants." Staffs at futures exchanges engaged in informal discussions during the drafting of this staff task force report, as did other segments of the futures community. At all times during those discussions, it was clearly understood and accepted that the basis for limiting the board composition guidance to mutually owned futures exchanges was because a number of the larger U.S. futures exchanges had publicly announced their intentions to demutualize their corporate structures.

Consequently, CFTC staff clearly realized that a good number of exchanges shortly would be subject to board composition requirements applicable to them under

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[8] "Over-the-Counter Derivatives Markets and the Commodity Exchange Act". Report of the President's Working Group on Financial Markets, November 1999.

[9] Working Group Report at pp. 22-23.

[10] Letter to Senator Richard G. Lugar, Chairman, Senate Committee on Agriculture, Nutrition and Forestry, from William J. Rainer, Chairman, CFTC, dated February 22, 2000; and Letter to Congressman Larry Combest, Chairman, House Committee on Agriculture, from William J. Rainer, Chairman, CFTC, dated February 22, 2000.

state corporate law (and under the listing standards of securities exchanges for entities that began to be publicly traded). Therefore, the judgment at the time by CFTC staff was that it would be inappropriate for the Commission additionally to impose its own standards that could either immediately or eventually conflict over time with the standards applicable to these exchanges under other law.

CFMA and Textual Analysis of Core Principle 15

As noted, Core Principle 15 provides that "[t]he board of trade shall 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." The brief cost-benefit section of the Release notes that the anticipated costs of the current proposals include "amending corporate documents." The proposed prescriptive provisions relating to board composition would clearly require significant amendments in the organizing bylaws of exchanges, and the proposed new requirement for regulatory oversight committees likely could require bylaw changes as well. With regard to the passage of the CFMA, Congress understood the basic structure and operation of American corporations. In particular, Congress understood that there are differences in how board of trades may be organized under state law, and that not all exchange boards have the authority on their own to "establish" bylaw amendments. Instead, the board of directors at some exchanges can only propose such changes and it remains to the shareholders to approve or reject such proposed changes. Thus, the terms of Core Principle 15 that provide for a board of trade to "establish" rules, which was intended to apply to all regulated exchanges regardless of the manner of their corporate organization, was focused upon the rules of an exchange and not intended to impose requirements on a board of trade in relation to its fundamental organizing bylaws.[11]

The evident strain between the Commission's reading of Core Principle 15 and the actual language is also reflected in the latter portion of this core principle, which provides for a board of trade to "establish a process" for resolving such conflicts of interest. A new requirement pertaining to board composition is not a "process." Rather, it is a one-time bylaw amendment. In other words, it is a static event. We believe that the fairest reading of the actual language of Core Principle 15 is that Congress intended to reflect the structure and practice of existing exchange rules and procedures pertaining to specific conflicts of interest.[12]

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[11] Moreover, Core Principle 15 also provides for a board of trade to "enforce" the conflicts rules. By couching this requirement in terms of enforcement of a rule, Congress clearly was directing an exchange to take action in relation to a person other than the board of trade itself, such as an individual board member, rather than referring to a provision that a company would merely "apply" as appropriate.

[12] Thus, for example, NYMEX Rule 3.04 (Voting By Board and Committee Members on Certain Matters) is a rule established and enforced by the Exchange to protect the Exchange in conflict of interest situations, including a financial interest by a board member in a "significant action" such as an action or rule change implemented to address an "emergency." In such scenarios, the rule establishes a clear process by which the conflict may be identified and resolved. Specifically, prior to the consideration of any significant action, the process set forth in the rule provides that the board or other governing body must determine the number of positions that may be held in any commodity's delivery month or months that may be affected by the significant action and that shall be considered a *de minimis* position such that a member shall be deemed not to have a direct and substantial financial interest in the result of the vote of such action. A board member must disclose any positions held in the applicable contract, and NYMEX staff also will conduct an

CFTC Adoption of Implementing Rules and Application Guidance

The Commission on June 22, 2000, had proposed (65 FR 38986) and on December 13, 2000, issued (65 FR 77962) final rules promulgating a new regulatory framework to apply to multilateral transaction execution facilities that trade contracts for sale of a commodity for future delivery or commodity options. The final rules were to become effective on February 12, 2001. However, Congress on December 15, 2000, passed, and the President on December 21, 2000, signed into law, the CFMA. The Commission on December 28, 2000, withdrew most of the final rules in order to determine their consistency with the Act as amended. (65 FR 82272 December 28, 2000).

The CFMA, in both its general contours and in many specific provisions, codified the CFTC's own proposed regulatory framework without significant change. It varied from the rules withdrawn by the Commission in certain details and rendered unnecessary other rules by enacting their provisions into statute. The Commission therefore reproposed rules conforming to and implementing the amended statutory scheme. (66 FR 14261-14289 March 9, 2001).

In reproposing these rules, the Commission summarized the legislative design of the CFMA:

> "The Commission's new regulatory framework was intended to "promote innovation, maintain U.S. competitiveness, and at the same time reduce systemic risk and protect customers," 65 FR 38986, and to provide U.S. futures exchanges greater flexibility with which to respond to the competitive challenges brought about by new technologies. (footnote) Specifically, the framework replaced "one-size-fits-all" regulation for futures markets with broad, flexible "core principles," and established three regulatory tiers for markets." (66 FR at 14261)

In the adoption of final rules, the CFTC also promulgated Appendix B to Part 38, which contained the following assurance in the introductory section of that appendix:

> "The guidance for each core principle is illustrative only of the types of matters a board of trade may address, as applicable, and is not intended to be a mandatory checklist."

With regard specifically to Core Principle 15, the Commission provided the following application guidance:

> "(a) Application guidance. The means to address conflicts of interest in decision-making of a contract market should include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a conflict. In addition, the Commission believes that the contract market should provide for appropriate limitations on the use or disclosure of material non-public information

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independent analysis. Upon a review of the position information any board member holding more than a *de minimis* position or who chooses not to make the disclosure must abstain from deliberating and voting on the significant action and must withdraw from the meeting until such time as the matter involving the significant action has been resolved.

gained through the performance of official duties by board members, committee members and contract market employees or gained through an ownership interest in the contract market."

This guidance is entirely consistent with the prior statutory and regulatory actions regarding conflicts of interest, the structure of the CFMA and the plain meaning of the terms of Core Principle 15. In sharp contrast, however, the Commission's Release advances the following assertion:

> "Core Principle 15 requires the exchanges to have systems in place to address not only an individual's personal conflicts of interest, but also the broader potential conflicts of interest inherent in self-regulation." (Release at 38743.)

We have seen no support in any materials relevant to the CFMA that give any indication that this statement fairly reflects the intent of Congress for this core principle.[13] Having worked closely with Commission staff, legislative staff and members of Congress on CEA reform throughout the drafting and passage of the CFMA, it appears to NYMEX staff that there was no Congressional intent to grant the CFTC broad expansive authority to specify board composition standards for publicly traded companies, nor to specify internal corporate structures, such as special regulatory committees.[14] Moreover, we are not aware of any advocacy on the part of any constituency in favor of such sweeping authority, nor are we aware of any demonstration of a problem at the time that would necessitate such a dramatic response. To the contrary, Congress was changing the basic function of the CFTC to an "oversight" agency. Futures exchanges were given broad discretion to exercise their business judgment and the flexibility to determine the manner in which they would comply with broad core principles.

Core Principles, Best Practices and Prescriptive Rules

In addition to the specific provisions in Appendix B to Part 38, NYMEX finds an overview provided two years ago by Commissioner Lukken to be particularly insightful in characterizing the legislative intent underlying the implementation of the core principles approach to futures regulation. In a speech given in early 2004, he noted that:

> "The CFMA also transitioned the regulatory structure of the CFTC from prescriptive rules and regulations to one using a principles-based approach. . . . Instead of specifying the means for achieving a specific statutory mandate, the CFMA set forth core principles that are meant to allow participants in these markets to use different methodologies in achieving statutory requirements. To satisfy these requirements, the CFMA encouraged the development of "best practices." Allowing the industry and self-regulatory organizations, rather than

[13] To the extent that Congress had an interest in such broader perspectives for mutually owned companies, that interest is reflected in Core Principle 16.

[14] We would note additionally a May 1999 GAO study titled "The Commodity Exchange Act - Issues Related to the Commodity Futures Trading Commission's Reauthorization," which was submitted to the CFTC's House and Senate oversight committees by letter dated May 5, 1999. The study was undertaken at the request of these committees to review topics that the committees planned to cover during the reauthorization process. The study thus considered a broad variety of areas that were eventually addressed by the CFMA. There is no suggestion in this study of any need for broad CFTC authority in this area. Indeed, the topic of conflicts of interest was not raised anywhere in the study.

the CFTC, to develop their own standards and guidelines was thought to better promote the practices reflective of the marketplace. The CFTC ultimately retains the authority to approve such practices, but the genesis for such guidelines is derived from the marketplace rather than the traditional top-down regulatory structure." (Remarks of CFTC Commissioner Walter Lukken, Chicago Bar Association, February 3, 2004 "The State of the CFMA".) (emphasis added.)

In addition, this approach is supported by industry experts who have provided testimony to the CFTC as part of this process. Thus, for example, Professor Roberta S. Karmel, Centennial Professor of Law, Brooklyn Law School (and former SEC commissioner), advised the Commission during the recent SRO Hearing that:

> "My own recommendation, however, during what is clearly a transition period is that regulators such as the CFTC do not force a particular board model on an exchange but rather allow some experimentation and differentiation so that new models of exchange board governors can develop as the business and regulatory structures of these organizations change with the times."[15]

We find the language of the CFMA to be similarly clear and unambiguous. Congress in its wisdom determined that it is the exchange that has the authority to determine how it will comply with the general core principle.

In the Release, the Commission correctly notes that core principles set "standards of performance" for the exchanges, "and at the same time, allow exchanges considerable leeway in how to meet those standards." While we agree with this general statement of the operation of core principles, the Commission's actual proposals seem to be at odds with this approach.

In reviewing the other statements of acceptable practices in Appendices A and B to Part 38 for DCMs, we note that the CFTC has avoided setting forth specific numeric targets but instead sets forth broad provisions. Furthermore, up until the Release, the Commission had consciously avoided embedding specific and highly detailed definitions of new terms in the form of acceptable practices. By contrast, in the Release, under the form of a "safe harbor," the Commission proposes a minimum specified percentage for the level of public directors serving on DCM boards of directors and DCM executive committees. In addition, the Commission then offers a highly detailed and clearly prescriptive definition of a new post-CFMA category of public director. Similarly, the Commission also proposes only one acceptable form of composition for the new category of regulatory oversight committees and includes a very detailed list of each of the specific functions that must be assigned to the ROC by the DCM. For example, the proposals not only require the ROC to generate annual reports to the CFTC, but also specifies precisely what must be included as content for such annual filings.[16]

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[15] SRO Hearing Transcript at 35.

[16] Thus, for example, such an annual report would require the ROC to catalogue disciplinary actions taken during the year even though all such final actions are already filed immediately with the Commission and subsequently reviewed by CFTC staff for rule enforcement reviews.

From our perspective, these provisions do not fit the mold of broad '"standards of performance" but instead in effect would be a retreat to the pre-CFMA world of prescriptive regulation. These provisions are being proposed by the Commission under the form of "acceptable practices." Yet nowhere in the Release does the Commission ever identify any other practices other than the current proposal that would also satisfy the CEA. Moreover, as guidance put forward by the CFTC becomes increasingly detailed and prescriptive, one clearly foreseeable consequence is that the '"considerable leeway" in how to meet those standards becomes increasingly illusory. In particular, in our experience, in the one area of acceptable practices that approaches specific parameters, CFTC staff has demonstrated noticeably greater hesitancy to find other approaches to be acceptable practices. We believe that this understandable tendency would be sharply exacerbated by the Commission's current proposals.

Indeed, although crafted in the form of a "safe harbor," various statements included by the Commission in the Release appear to demonstrate a strong attachment to the current form of the proposals and thus would be expected to provide relatively strong signals to Commission staff (in the event of any eventual adoption of the proposals in their current form) regarding the relative lack of discretion to be retained by DCMs in responding to such provisions. Although the proposals are labeled as "acceptable practices," the Release "calls upon exchanges" to establish a board-level Regulatory Oversight Committee. Turning to the review of costs and benefits included in the Release, NYMEX notes the CFTC's pronouncement that it "has endeavored, in offering these Acceptable Practices to propose the least intrusive safe harbors and regulatory requirements that can reasonably be expected to meet the requirements of Core Principle 15 of the Act." (emphasis added.) (Release at 38748). It is also disconcerting to note the frequent references in the Release to "every" exchange or to "all exchanges" in discussing the so-called safe harbors.

Moreover, we were particularly struck by the Commission's pronouncement that any exchange that does not shift to the "safe harbor" requirements will be required "to demonstrate" that its policies and practices with respect to governance and decision making comply with Core Principle 15 by other means.[17] This would appear to signal that the CFTC is seeking to shift the burden of proof to exchanges to justify departures. Such an approach is inconsistent with the flexible structure established by Congress.

Consequently, implementation of the Commission's current proposals would shift at least a portion of futures regulation back to the pre-CFMA approach of "one size fits all" regulatory standards. Core Principle 1 for DCMs provides in part that "[t]he board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles." The CFTC's proposals in effect would eliminate such discretion.

Lack of Demonstration of Existing Problem and the Need for Change

Commissioner Fred Hatfield, in a statement in the Release made in his individual capacity, requested comment on a number of thoughtful and important questions that he raised, particularly with respect to the board composition requirements. As we see it, the first and most fundamental of his questions was whether this was an existing problem that was addressed by the proposed solution. We begin by considering this threshold

[17] See, e.g., Release at 38743.

question. In the Release, the Commission noted that interviews were conducted with more than 100 industry participants and observers. In addition, as noted, the CFTC conducted one public hearing and several rounds of public comment. Notwithstanding this level of public participation and feedback, the Release does not identify a single instance of abuse by a regulated SRO DCM, nor does it identify even a single instance of a specific, concrete allegation. Notably, the summary of interview comments available on the CFTC's website similarly does not contain any specific references to existing problems.

Notwithstanding the absence of any demonstrated problem, the Commission asserts that "changing ownership structures" pose a "heightened risk" that SROs will not fully carry out their statutory responsibilities. However, it provides no basis for this assertion, nor any original analysis of the impact of demutualization on SRO duties. [18] The Commission cites five studies, which generally concern securities markets, as its basis for the proposition that "self-regulatory functions may be marginalized by potentially conflicting commercial interests." However, the Commission's use of these securities studies may actually further call into question whether there is an "existing problem."[19]

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[18] At its heart, the shift from a not-for-profit corporation to a for-profit corporation allows a company to distribute dividends to the owners of the company. An exchange that is organized as a not-for-profit corporation cannot do that. An exchange that is organized as a not-for-profit corporation and that is having a successful year may determine to return certain revenues to its trading members in the form of a fee rebate, while a profit corporation may determine to distribute dividends. We question whether, and if so how, this basic change affects SRO obligations.

[19] The first study cited was released by the Securities Industry Association ("SIA"). The Commission quotes the SIA paper for the assertion that SRO functions "may" be affected by diverse roles, but does not go on to note that there was no specific authority provided by the SIA for that statement. Furthermore, the Release omits reference to the acknowledgement in the SIA paper that "foreign markets that have demutualized believe that they can regulate fairly in spite of potential conflicts." (SIA paper at 8.) More fundamentally, we believe that it is appropriate to observe that the SIA is a trade association that describes itself as "the voice of the industry" and that represents, among other members, investment banks, broker-dealers and mutual fund companies. While the SIA has every right to engage in advocacy to advance the interests and agendas of its members, it is possible that this activity could also be reflected in the SIA's papers as well.

The Release next cites a May 2002 General Accounting Office ("GAO") study to refer to various hypothetical concerns expressed by securities industry SRO members. However, the Release somehow neglects to acknowledge the assessment of SEC officials included in this study that, "because the current self-regulatory structure had been working adequately, immediate action was not needed." (GAO study at 2.) In fact, the only recommendation of that study was for the SEC Chairman to work with the SROs and broker-dealer representatives on a process to identify and address regulatory inefficiencies principally relating to multiple examinations of broker-dealers. (GAO study at 3.) This has not been identified as an issue in the futures industry.

The Release also cites a portion of an introductory sentence in an IOSCO Technical Committee Issues Paper, indicating that competition and demutualization "may" exacerbate SRO concerns. In the remainder of the sentence, the committee goes on to note only that "reexamination" is appropriate. (IOSCO paper at 5). Moreover, the conclusion of this IOSCO committee does not contain any specific recommendations, but instead merely states that "[t]here is no universal right regulatory path to follow." (IOSCO paper at 15)

There are real differences between futures and securities markets. For example, the IMF study lists the concerns as market viability, fair treatment of listed companies,

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The Release also refers to an IMF Working Paper prepared by a staffer, who may not necessarily represent the views of the IMF itself. Once again, the Release cites the Working Paper for a quote pertaining to the "forces that have generated pressure on exchanges." However, the Release neglects to note that much of the emphasis of the paper by this staffer was on the impact on securities exchanges in needing to compete for company listings. This business practice is simply not a concern at present for U.S. futures exchanges, which generally continue to generate their own products for listing for trading and/or clearing on their own exchange. But the Release does not attempt to reconcile how this separate business focus may affect its current analysis of DCM SROs, nor does the Release acknowledge that the IMF paper placed special emphasis upon demutualization in emerging markets where exchanges may not have a long and established business culture of vigorous self-regulation.

The Release then goes on to cite this paper for the possibility that shareholders "may" underfund the exchange's regulatory function. However, it appears to be unfair to cite this statement in isolation without providing greater context, as the thrust of the paper really highlights the very real differences in regulatory structures and approaches from one jurisdiction to another. In other words, the paper actually highlights the dangers of speaking abstractly about demutualization in general without considering the specific regulatory structure in place and analyzing how that structure creates incentives for effective self-regulation or otherwise affects the actions of the SRO.

The final study relied upon by the Release as support for the notion of possible increases in SRO conflicts is a paper prepared by John W. Carson, a consultant for the World Bank, who does not necessarily represent the views of that institution. The Release refers to a paper by Mr. Carson dated January 2003. However, after contacting both the World Bank and the author, NYMEX has confirmed that this version of the paper, which apparently was a preliminary draft, is not publicly available at this time. A final version of this paper has been issued as World Bank Policy Research Working Paper 3183, December 2003, and has been retitled as "Conflicts of Interest in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them?". In the final version of this paper, what is striking is not so much that the consultant acknowledges that "there are no clear right or wrong answers to the issues addressed," (Working Paper at 4) but that the paper emphasizes that its findings "should be seen in the context of broader issues <u>relevant to the development of capital formation</u>. " (emphasis added.) (Working Paper at 4).

We also found striking this assessment in the final paper:

> "Concerns about conflicts of interest are generally lower in futures markets . . . .. Futures market participants are mainly professionals and made up of sophisticated players. Retail investor participation is small. [footnote 5 in Carson paper]. Also the regulatory framework is different because futures exchanges have no capital formation role, and the contracts are a product created by the exchanges." (Working Paper at 7.)

Finally, before leaving this World Bank Policy Paper, the consultant additionally makes the following comments regarding oversight by federal regulators:

> "For instance, U.S. securities and futures exchanges have a legal obligation to regulate their markets under applicable legislation, and the SEC and the CFTC are obligated to ensure that the exchanges carry out their responsibilities diligently. <u>In the case of the CFTC, the Commission concluded that the overall regulatory risk level was no higher post-demutualization, although the nature of certain risks changed, and they adjusted their oversight accordingly.</u>" (Working Paper at 8.) (emphasis added.)

and fair execution of regulatory functions. These were not the concerns expressed by futures industry participants. The SIA study references investor protection, the high-tech bubble bursting and failure of corporate governance, none of which has been a product of or issue in the futures arena. Beyond NYMEX's more specific comments on these studies noted above, any conclusions drawn in the securities studies do not readily translate to futures markets because, while similar in some ways, the two types of markets serve very different purposes, i.e., capital formation vs. risk shifting. Customers are different, trading goals are different, and regulatory focuses are different. Rules for futures markets should not necessarily mirror rules for securities markets. Consequently, the CFTC's reliance on these studies to support this rulemaking is misplaced.

The Release indicates that commenters have suggested that evolving business models and other changes were "capable" of adversely impacting SRO behavior. As examples of this point of view, the Release noted four commenters who had participated at some point in the SRO Study. Two were academics, one was the FIA and one was a registered futures commission merchant ("FCM"). Beyond whatever self-interest may possibly have been advanced by the comments from the FIA and the particular FCM, what is striking about all four commenters is that none of them acknowledged the impact of the CFTC's current and vigorous oversight role through Commission staff rule enforcement reviews ("RERs") or through review of exchange rule filings.

In our view, we believe that CFTC Chairman Reuben Jeffery III correctly summarized matters when he noted during the Commission's SRO Hearing that "[w]ith proper checks and balances, self-regulation can fulfill its ultimate role of promoting market integrity and customer protection." (emphasis added.)[20] In connection with the Commission's oversight role under the CEA, CFTC staff regularly conducts detailed reviews of an exchange's SRO functions, including a review of the size of the compliance staff assigned to such duties.[21] To date, neither the Release nor any commenter that we have identified has attempted to explain why an exchange would underfund its SRO activities if it knew that it would need to justify its SRO programs several months later in the course of an exhaustive CFTC staff RER. Similarly, we question why the Commission's current review of SRO rule filings for compliance with the Act, including compliance with Core Principle 18 ("Antitrust Considerations"), would not adequately address possible concerns regarding an SRO's actions toward a possible competitor that is also subject to the exchange's jurisdiction.

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[20] SRO Hearing Transcript at 6.

[21] These reviews are undertaken to analyze an exchange's overall compliance capabilities. As stated in one review of NYMEX, in the course of such reviews, CFTC staff reviews among other things "numerous documents, including computer reports and other documentation used routinely for audit trail enforcement and trade practice surveillance; trading card and order ticket reviews; trade practice investigation and inquiry files; disciplinary action files; investigation, inquiry, recordkeeping, audit trail, disciplinary, and floor surveillance logs; minutes of disciplinary committee meetings held during the target period, and Compliance guidelines." Rule Enforcement Review of the New York Mercantile Exchange, Division of Market Oversight, September 30, 2004 at 2. Commission staff also conducts extensive interviews with senior compliance department officials both during the on-site visits and in follow-up sessions.

The absence of an existing problem is particularly evident in the discussion of the composition of disciplinary committee panels. The Release notes that the Commission is "generally satisfied" with the composition and performance of most SRO disciplinary committees and panels. The Release further notes that the Commission has found that disciplinary committees typically have adequate diversity, sometimes including FCMs and nonmembers, and seek to balance expertise with impartiality. In addition, the CFTC noted that periodic rule enforcement reviews conducted by the Commission's Division of Market Oversight, which carefully examine disciplinary sanctions, typically find that they are fair and do not discriminate among different classes of exchange participants. Rule enforcement reviews also examine exchange disciplinary procedures, and consistently find that these are adequate. Disciplinary committees are thus aware that their actions eventually will be reviewed by CFTC staff. In light of these findings, the need for affirmative change is not readily apparent.

As an exercise of the business judgment of an exchange's board of directors NYMEX applauds the addition of public members on key exchange disciplinary committees. Indeed, NYMEX now has several (a minimum of three) public members on its Business Conduct and Adjudication committees.[22] We are mindful, however, of the broader questions regarding the scope of the Commission's role as an oversight agency under the core principles regulatory regime established by the CEA. The Release notes the Commission's belief that "a public member's presence on disciplinary panels will enhance the appearance as well as the reality of fairness and impartiality in exchange disciplinary proceedings, and thus promote confidence in our markets among the public and market participants." NYMEX believes that enhancing the "appearance" of exchange proceedings or promoting "confidence" in a particular market may be appropriate exercises of an exchange board's business judgment in keeping with its fiduciary duties. However, these aims are not included in the core purposes of the Act under Section 3 and thus would not seem to be included in the CFTC's core mission.

In summing up, the CFTC's SRO Study was not initiated because of any concrete problem, but rather in the spirit of a timely reassessment of one area of Commission regulation. No concrete instances have been advanced to demonstrate that there is an existing problem. To address the question of whether there is an existing problem that is addressed by the proposed solution, we conclude after careful reading of the Release that there is no existing problem. Thus we find it difficult to conclude how the proposed solutions would address problems that appear not to exist.

Specific Comments about Board Composition Provisions

As stated, the Release proposes as acceptable practices that exchanges must maintain governing boards (as well as executive committees or similarly empowered bodies) that would need to be composed of at least fifty percent "public" directors" as

[22] Similarly, our rules and procedures also reflect a disciplinary composition that incorporates the various market constituencies at NYMEX, as well as unaffiliated public members. NYMEX's Business Conduct Committee ("BCC"), which meets to review Compliance Department investigation reports and to determine whether or not to issue a formal complaint, and the Adjudication Committee, which meets to hear and decide the matter, both provide for diversity in composition across various representative categories. Composition requirements have been subject to ongoing review by our Compliance Review Committee and Board.

defined by the Commission.[23] As a company organized under the laws of Delaware, NYMEX is subject to Delaware state corporate laws, which establish adequate standards for the conduct of corporate directors. Thus, for the Exchange, like other exchanges, board composition requirements are already addressed by state law. Moreover, under state corporation law, the board of directors has a duty to exercise its business judgment to act in the best interest of the company and its shareholders. Directors owe a fiduciary duty to their shareholders, which must be fulfilled in full compliance with applicable laws and regulations.

As a note, on July 17, 2006, NYMEX Holdings filed with the SEC a preliminary proxy statement in connection with our proposed public offering for review by the SEC pursuant to SEC Rule 14A. This proxy document remains preliminary in form and thus still subject to SEC review and approval by stockholders. Nonetheless, it may be worth noting that NYMEX Holdings, which would continue to have an overall board size of 15, is proposing to modify its board structure so as to have eight independent directors in order to satisfy the independence requirements of applicable regulatory and listing standards. Because the directors of the parent NYMEX Holdings also serve as the directors of the subsidiary, the New York Mercantile Exchange, Inc., the listing standards applied to the parent company would be applied as well to the subsidiary, the New York Mercantile Exchange, Inc.

With regard to specific conflicts of interest, for SEC registrants, including publicly listed companies, related party transactions need to be disclosed in SEC quarterly and annual reports, pursuant to Section 404 of Regulation SK. In addition, it has long been a bedrock of U.S. futures regulation that the CEA and CFTC regulations impose strict SRO responsibilities on all DCMs, including the requirement to maintain an affirmative action program to ensure compliance with the CEA and to enforce the DCM's rules.

As noted above, Congress clearly determined that the exchange determines how it will comply with the general core principle. Beyond the fundamental clarity of the law on that discretion, NYMEX believes strongly that the case has not been made for a sweeping expansion of regulation in this area. We find no demonstrable evidence that, in the absence of any existing problem, there is a need for any additional regulations.

As previously discussed, in response to the FTPA, the CFTC implemented Regulation 1.64, which contained specific provisions relating to board composition. As detailed in the Federal Register release promulgating the final rule, the CFTC analyzed the circumstances pertaining to the eligibility of non-member board representatives. Following the CFMA's passage, the CFTC then exempted DCMs from application of Regulation 1.64 in furtherance of the legislative intent of the CFMA. (CFTC Rule 38.2.) Indeed, there can be no real dispute that this action was undertaken as the CFTC interpreted the specific terms of Core Principle 15 and the legislative intent to move away from prescriptive regulation. We find no support in the Release for the Commission's departure from its own prior working interpretation of the applicable law.

[23] As the Commission knows from its SRO Study, exchanges generally have an odd number of members on their boards as well as on their executive committees (presumably in order to avoid the possibility of a tie vote). Thus, although couched as a requirement for a minimum of at least 50% public directors, in the event of any implementation of this proposal, the practical effect would be to mandate board composition comprised of a majority of public directors.

In connection with Core Principle 16, because the Commission is proposing to adopt a one-size-fits-all "safe harbor," the guidance proposed under the rubric of Core Principle 15 would have a special impact on those exchanges who continue as "mutually owned" corporate structures and thus are subject to the requirements of Core Principle 16. The application guidance on Core Principle 16 provided to date by the Commission provides only that the governing board should "fairly" represent the diversity of interests of the contract market's participants. The imposition of a new regulation effectively requiring a majority of board members to be public directors could very well compromise and hinder the ability of the DCM to "fairly" represent its participants. NYMEX believes that further review and analysis is necessary in this area.

In further consideration of the basis for this new requirement, one industry expert noted during the SRO Hearing that "the only legitimate issue that can be raised has to do with the funding of the self-regulatory function."[24] She then went on to express skepticism about the impact (of demutualization) on such funding.[25] We agree with Professor Karmel's skepticism and reiterate the significance of the CFTC's active oversight role through its routine RERs of exchange regulatory functions.

NYMEX uses various nomination categories in order to achieve a diversity of representation on the board, each of NYMEX's owners is entitled to cast a vote for <u>all</u> of the applicable categories and, once elected, each director serves the entire exchange community. Moreover, each director has fiduciary duties under state law to ensure that the corporation complies with all applicable legal and regulatory requirements, including full compliance with the CEA.

Exchange Executive Committees

The Commission also proposes to extend this composition requirement to exchange executive committees. It is generally accepted among public reporting companies that the executive committee of the company must have real expertise in the applicable business lines and must be actively engaged in the operation of the company. This is particularly the case for futures exchanges. Certain situations will inevitably arise, such as a physical emergency or the financial default by a large trading entity to its carrying clearing member, which can necessitate an immediate meeting by the executive

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[24] Professor Karmel, SRO Hearing Transcript at 43. Although the impact of demutualization of SROs was, in fact, one reason that the SRO Study was initiated, demutualization was anticipated by Congress and, therefore, would not seem to provide support for any sweeping new requirements at this time. The Chicago Mercantile Exchange demutualized on November 13, 2000, and NYMEX followed suit within a few weeks. Thus, the demutualization trend in the futures industry was well underway when the CFMA was being considered and ultimately approved by Congress in December of 2000.

[25] SRO Hearing Transcript at 44. In this regard, we find it necessary to note that, in recent weeks, there have been one or more press reports regarding possible changes in staffing levels at NYMEX. These reports have been wildly erroneous and frankly reckless. We trust that no commenters on the Commission's current proposals would give any serious credence to such unsubstantiated and obviously misinformed reports. The fact of the matter is that NYMEX has a deep and abiding commitment to providing sufficient resources and staff so as to continue to ensure strong and effective self-regulation at the Exchange. Thus, for example, the current staff size of 73 employees in the NYMEX Compliance Dept. constitutes an increase of more than 25% from the staffing levels then in place as of the end of 2005.

committee to review possible courses of actions, such as the implementation of temporary emergency rules.

Imposition of the composition requirement on exchange executive committees would sharply limit the pool of possible directors to those directors who were already working in close proximity to the exchange and who could be available on a moment's notice for an emergency meeting. In addition, service on the executive committee now would be added to the other duties applicable to public or independent directors at any company subject to Sarbanes-Oxley ("SOX") requirements, including service on the company's audit, compensation and corporate governance committees. The Commission is further proposing that only public directors also would be serving on the regulatory oversight committee. In view of this range of responsibilities, it is not clear to the Exchange how any individual could satisfy all of these time commitments and still maintain gainful employment beyond their duties to NYMEX (absent the continuing expansion of the size of exchange boards to an inefficient and largely unworkable size).

Definition of Member for Purposes of Board Composition Requirements

The definition for public director contained in the proposed guidance specifically prohibits any "member of the contract market, or a person employed by or affiliated with a member." For purposes of this definition, the Release clarifies that the term Member would be defined according to Section 1a(24) of the CEA[26] and Commission Regulation 1.3(q). Exchanges tend not to adopt a rigid approach to membership definitions; instead they typically consider within a specific context whether it is appropriate to deem an individual or firm to be a member, such as whether it is appropriate for an individual to be subject to the Exchange's full disciplinary jurisdiction. In addition, with the trend toward expanding direct access on exchanges via electronic trading, we also believe that any previously distinct lines pertaining to "having trading privileges" or other membership on a DCM may be increasingly blurred.[27]

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[26] Under Section 1a(24), "[t]he term 'member' means, with respect to a registered entity or derivatives transaction execution facility, an individual, association, partnership, corporation, or trust--

(A) owning or holding membership in, or admitted to membership representation on, the registered entity or derivatives transaction execution facility; or

(B) having trading privileges on the registered entity or derivatives transaction execution facility.

A participant in an alternative trading system that is designated as a contract market pursuant to section 5f is deemed a member of the contract market for purposes of transactions in security futures products through the contract market."

[27] For example, some exchanges continue to provide on a limited basis their own front-end application to an electronic trading platform. Yet, the clear trend at the moment seems to be for active traders to establish connectivity to the electronic trading system using the FIX protocol and a front end trading application that has been developed on their own or is being provided by an independent service provider. If, for example, an individual establishes his own FIX connection to the system and executes all applicable user documentation, it is arguably conceivable to identify that individual as having trading privileges on the exchange, at least with respect to products traded electronically. However, the same individual may choose to forgo the expense of independently obtaining a FIX connection and instead trade directly through the FIX connection established by another company, such as a carrying clearing member. For such individuals, their

Moreover, the Release notes that various commenters have suggested that members should not be precluded from serving as a "public" director, citing as examples persons who engage in de minimis trading, or members who lease their seats to others. The Release seeks the public's views on whether these or similar circumstances could rebut the presumption of member disqualification as a "public" director. As noted above, these types of issues were addressed by the CFTC in the promulgation of Regulation 1.64. We believe that the Commission, acting under authority of the CFMA, correctly followed the will of Congress at that time in exempting exchanges from such requirements.

Time Frames

Commissioner Hatfield also asked, in the event of possible Commission adoption of the proposed board composition acceptable practice, whether it should be accompanied by a phase-in period and if so, what would be the appropriate length of time for exchanges to modify their boards. As stated above, we are convinced that any such adoption would not be consistent both with the specific legislative intent for Core Principle 15 and the broader legislative intent underlying the shift to a core principles regulatory regime for regulated markets and clearing organizations. We also believe that the very real and substantial costs related to this new oversight approach far outweigh any hypothetical benefits. In our view, corporate governance requirements currently applicable to publicly traded exchanges, combined with the reasonable exercise of discretion by exchanges pursuant to Core Principle 1, do in fact provide sufficient assurance that conflicts of interest will be kept to a minimum in the decision making process for such exchanges.

Nonetheless, assuming solely for the sake of argument that some version of these proposals were to be ultimately adopted, we do not believe that it would be appropriate for the Commission to compel existing exchange board members, who had been duly elected by the shareholders or members as applicable, to resign from their current positions. Instead, we believe that a more gradual phase-in approach would be appropriate. This process could take more than one election cycle and there could be difficulty in recruiting and selecting qualified public directors. Accordingly, we believe a process that is phased in over several years would be necessary.

Regulatory Oversight Committees

We wish to re-emphasize that Congress determined that the exchange should decide how it will comply with the general core principle.[28] There are a broad variety of ways, including but not limited to use of a ROC, by which a DCM can monitor and promote the effective self-regulation of its own markets. Moreover, even within the ROC mechanism, there are a broad number of approaches as to structure, composition,

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order flow is identified to the Exchange only by a sender sub-id number, and absent investigation after the fact, the Exchange has no specific information regarding the identity of such traders. Is the Commission proposing that these individuals also would be deemed to have trading privileges on an exchange? This and other line-drawing complications are issues that should be addressed.

[28] To our knowledge, Congress has never intended for the CFTC to regulate (or even to opine as to) the internal committee structure of regulated exchanges.

duties, etc., which could develop over time. In previous comment letters to the Commission, NYMEX has noted that ROCs overseeing regulatory functions with review by the board may provide value to the exchange. But we have also emphasized that there are other approaches and structures that may be equally effective. We are primarily concerned that the "safe harbor" that would go into effect would be administered by CFTC staff as a hard and inflexible rule.

In the Release, it is proposed that disciplinary panels would only need at least one public director because of the clear need for expertise. By contrast, the Release proposes that the ROC apparently reviewing their activity must be entirely comprised of public directors.[29] We believe that the same need for real expertise would apply to the ROC as well. In the absence of such consistency, there would seem to be an internal contradiction in the CFTC's proposed approach.

Therefore, a board should be free to make its own judgment as to, for example, whether to establish a ROC, and, if so, whether to have a ROC that is comprised of 50% representation by public members (or perhaps a majority of public members). These alternative approaches would allow for a real opportunity for input by exchange members with relevant expertise. Moreover, exchanges vary significantly in their overall size, including with respect to staffing levels. A ROC composed solely of non-members can be very time-intensive for exchange staff, and so this approach may not be practicable for all exchanges An exchange may also weigh whether a ROC composed solely of non-members in the execution of its obligations might place undue reliance on exchange staff. Finally, we would also note that, in our experience, concomitant with effective self-regulation is the need to empower members in the SRO process both through responsibility and accountability.

We also question how the duties of the ROC would interact with other staff and segments of a regulated exchange. Thus, for example, how would the ROC's duties in reviewing budgets not conflict with the broad responsibility placed on a chief executive officer ("CEO") to make recommendations to the Board on budget decisions? Similarly, how would the ROC's duties regarding compensation of regulatory personnel not conflict with the responsibilities of the CEO and of an exchange's compensation committee under applicable SOX requirements? In addition, the Release proposes that the ROC would be responsible for reviewing regulatory proposals and advising the board as to whether and how such changes may impact regulation. How would this ROC function not conflict with the traditional role of advisor provided by an exchange's general counsel?

Disciplinary Committee Composition

Congress determined that it is the exchange that determines how to comply with the general core principle. As a matter of general SRO practice, each of the specific provisions relating to disciplinary committees could constitute a reasonable exercise by a DCM board of the discretion provided to exchanges by Congress pursuant to Core Principle 1. NYMEX is generally supportive of the concept of diversity on disciplinary panels. In particular, prior to the issuance of this Release, our Board voted unanimously

[29] The Release suggests that individuals with trading expertise, such as floor traders, could be utilized from time to time as consultants. We do not believe that this approach would be either practical or cost or time effective at all exchanges.

to approve increasing the number of public directors required at any meeting of the BCC or Adjudication Committee from two to three. Those rule changes are now in effect.

Our issue is less with the merits of these specific practices than with the imposition of these practices as a "safe harbor." Again, we question how the new proposal is not inconsistent with the prior exemption of exchanges from the requirements of Regulation 1.64. In this area as well, we observed no discussion or consideration in the Release of other approaches that may also satisfy the CEA. As a general matter, in providing any guidance under the core principles, we believe that, in establishing safe harbors, the CFTC should indicate other circumstances that would also satisfy the applicable requirements.[30]

Cost-Benefit Analysis

In the Release, the CFTC invited public comment on its application of the criteria contained in the Act. We believe that meaningful public comment would be enhanced by the approach used by the CFTC in 2001 (for its proposed rules implementing the CFMA), where the CFTC separately addressed each of the five factors contained in the CEA, indicated the extent to which it was applicable and explained how the proposal would further that interest. Also, where practicable, the CFTC should endeavor to apply the relevant factors to each major proposal included in the release.[31] We also would respectfully suggest that meaningful public comment is promoted by a detailed review of possible costs.[32] Furthermore, we would encourage the Commission to consider regulatory alternatives to its proposals under its cost benefit considerations. We believe that this approach is generally appropriate, but is especially necessary when the Commission is proposing new regulations that are intended to be "acceptable

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[30] The Release emphasizes the CFTC's finding that "FCMs are more likely to appear before clearing house risk committees or financial compliance/surveillance committees (where FCMs are typically well-represented) than on business conduct committees or similar committees (which may include broker, local, commercial, FCM, and public panelists)." We believe that a variety of approaches could support effective disciplinary panels, including enhancing further the diversity of such panels, for example, by promoting greater service on these panels by FCM representatives.

[31] From our review of the practices of other U.S. agencies, it appears that other federal financial regulators, such as the SEC, do frequently undertake analysis of the relevant factors to each rule change included in their proposed rule-making.

[32] The Release notes that the proposals may entail "some costs," including "amending corporate documents." The process of preparing such bylaw changes requires a commitment of time both by in-house exchange staff as well as by specialized outside legal advisors. This process can be fairly time-intensive with regard to review by such professionals of various drafts of amendments and other materials for shareholders in relation to the successive SEC filings. There are the obvious costs generated by numerous runs by the applicable print shop specializing in SEC filing productions as well as the not inconsiderable costs of overnight shipping of the shareholder materials to hundreds if not thousands of shareholders of record. When combined with the costs for outside counsel, such an initiative can result in substantial costs to an exchange. Also, the implementation of board composition standards would result in indirectly impacting board composition of entities that are not subject to CFTC jurisdiction, such as the holding companies of regulated exchanges. This impact warrants further review.

practices." [33]

In general, as there is no clear existing problem, the CFTC's focus upon hypothetical harm necessarily means that any benefits are likewise similarly hypothetical. It is difficult for us to weigh the significance of hypothetical and thus essentially subjective benefits against real and substantial costs of the current proposals, including, among other things, the loss of flexibility to the regulated exchange.

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In closing, NYMEX thanks the Commission for the opportunity to submit comments concerning the proposed acceptable practices for Section 5(d)(15) of the Act and strongly urges the CFTC not to proceed with these proposals. If you have any questions, please do not hesitate to contact me.

Sincerely,

Jim Newsome

Dr. James E. Newsome
President

cc: Chairman Reuben Jeffery
Commissioner Walter Lukken
Commissioner Fred Hatfield
Commissioner Michael Dunn

[33] As a note, the SEC investigated the effectiveness of its own cost-benefit analysis as part of an audit on the SEC's rulemaking process. See Securities and Exchange Commission Audit No. 347 (July 12, 2002). The audit, in implementing outside comments, suggested that such analyses should consider, among other things, regulatory alternatives to the proposed action.