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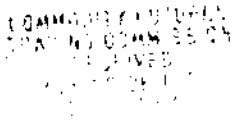

Chicago Board of Trade (2)

Thomas R. Donovan
President and
Chief Executive Officer

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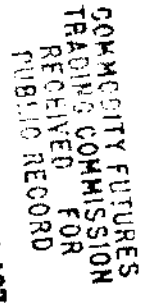
February 23, 1998

COMMENT



Jean A. Webb
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Commodity Futures Trading Commission
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RE: Proposed Rulemaking: Voting by Interested Members of Self-Regulatory Organization Governing Boards and Committees, 63 Fed. Reg. 3492 (January 23, 1998)

Dear Ms. Webb:

The Board of Trade of the City of Chicago ("CBOT") welcomes the opportunity to comment on the abovereferenced proposal, which revises a May 3, 1996 proposal to adopt regulations relating to §5a(a)(17) of the Commodity Exchange Act ("Act").[1] No one has a stronger interest in maintaining the integrity of the decisionmaking process at the CBOT than we do, and our existing procedures to prevent conflicts of interest have served us well. We cannot overstate our concern about the risks that §5a(a)(17) and proposed Regulation 1.69 create for our markets and for our institution. We applaud the Commission for withdrawing many of the more punitive aspects of the original proposal and for providing some latitude for contract markets in formulating and applying the rules required by the Act. However, there remain several aspects of the revised proposal which unnecessarily duplicate the self-executing provisions of §5a(a)(17) or, worse, embellish those statutory provisions in ways which invite litigation, impose unwarranted costs, and offer no reliable guidance on matters which would only arise in high-pressure, crisis situations.

Conform Proposed Regulation 1.69 to §5a(a)(17). We support the approach taken by the Commission in rescinding proposed Regulation 1.69(e), which resembled the disclaimer of liability set forth in the proviso to §5a(a)(17)(A)(iii). The Commission explained:

> Rather than proposing a regulatory provision in addition to the statutory provision in this regard, the Commission has decided to delete this provision from the proposed rulemaking. The Commission believes that this approach would eliminate any confusion between Regulation 1.69 and CEA Section 5a(a)(17).

[1] 61 Fed. Reg. 19869 (May 3, 1996).

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63 Fed. Reg. at 3503. We encourage the Commission to apply this sensible approach to the revised proposal. The cost of promulgating rules which are identical to statutory provisions outweigh any imaginable marginal benefit, and the promulgation of rules which resemble, but are not identical to, statutory provisions sows confusion and invites litigation.

The Discretion To Exceed the Minimum Standards of §5a(a)(17)(A) Belongs To Contract Markets. §5a(a)(17)(A) provides in part:

> "In order to comply with this subparagraph, each contract market shall adopt rules and procedures to require, at a minimum, that (i) any member of a governing board or disciplinary or other oversight committee must abstain from confidential deliberations and voting on any matter where the named party in interest is the member, the member's employer, the member's employee, or any other person that has a business, employment, or family relationship with the member that warrants abstention by the member."

That is, the statute entrusts contract markets with the discretion, but not the obligation, to exceed the minimum requirements of §5a(a)(17)(A)(i). In several instances, however, the revised proposal usurps the discretion entrusted by Congress to contract markets.

Margin Changes. Regulation 1.69(a)(8)(ii) is the second part of the definition of "significant action," and now tracks the language of §5a(a)(17)(B)(ii), with the following two underlined exceptions:

> Any changes in margin levels that are designed to respond to extraordinary market conditions <u>such as an actual or attempted corner, squeeze, congestion or undue concentration of positions or that otherwise</u> are likely to have a substantial effect on prices in any contract traded <u>or cleared</u> at such self-regulatory organization but does not include any rule not submitted for prior Commission approval because such rule is unrelated to the terms and conditions of any contract traded at such self-regulatory organization.

The release mischaracterizes the CBOT's original comment letter, in which we urged the Commission to adhere to the language of §5a(a)(17)(B)(ii). The release explains the revised definition:

> [P]roposed Regulation 1.69(a)(8)(ii)'s definition of an SRO significant action includes changes in margin levels that: (1) are designed to respond to extraordinary market conditions such as actual or attempted corners,

> squeezes, congestion, or undue concentrations of positions or (2) are unlikely to have a substantial effect on prices in any contract traded or cleared at the SRO.

63 Fed. Reg. at 3496 (emphasis added). This explanation illustrates the confusion created by the proposal's departure from the statute. The unnecessary costs of resolving this confusion will inevitably fall on contract markets. "To eliminate any confusion between Regulation 1.69 and CEA Section 5a(a)(17)," proposed Regulation 1.69(a)(8)(ii) should be deleted or should be identical to §5a(a)(17)(B).

Second, with respect to contracts "cleared" at a self-regulatory organization, we support the views of the Board of Trade Clearing Corporation that section 5a(a)(17) applies on its face to contract markets, not to clearing organizations.

Confidential Deliberations. In another example of its departure from the statute, the revised proposal continues to omit the modifier "confidential" from the term "deliberations" in proposed Regulation 1.69(b)(1); the release explains:

> "Because CEA Section 5a(a)(17) merely sets a minimum baseline as to the application of conflict of interest requirements, the Commission has decided to propose the more prophylactic approach of applying Regulation 1.69(b)(1)'s requirements to all deliberations, whether confidential or not."

Id. at 3497. However, on its face, §5a(a)(17)(A) leaves it to the contract market in the first instance to decide, when adopting the rule to be required by proposed Regulation 1.69(b)(1), whether it should apply to "confidential deliberations" or to all deliberations.

The release continues:

> "The Commission notes that this approach also is consistent with the existing requirements of Regulation 8.17(a)(1) which do not distinguish between confidential and non-confidential disciplinary committee proceedings [footnote omitted]."

Id. Regulation 8.17(a)(1) does not make that distinction because it only applies to disciplinary proceedings, which are required by CEA §8c(a)(2) to be confidential. If proposed Regulation 1.69(b)(1) only applies to disciplinary proceedings, then we withdraw our objection. But on its face, that proposed regulation would apply to "any matter," and we believe that the statute entitles a contract market to decide whether its rules should apply to non-confidential proceedings. If Regulation

1.69(b)(1) is necessary, we urge that its language be conformed to the statute and made applicable only to confidential deliberations.

Conform Regulation 8.17(a)(1) to §5a(a)(17)(A)(i). This confusion illustrates the difficulty of treating proposed Regulation 1.69(b)(1) as a clarification of Regulation 8.17(a) in the manner suggested by the release. Id. The two regulations do not cover the same ground. Regulation 8.17 applies to disciplinary proceedings, Regulation 1.69(b)(1) would apply to all proceedings. Regulation 1.69(b)(1) applies to situations when a member has a disqualifying interest with respect to "a named party in interest;" Regulation 8.17 applies when a member has a "financial, personal or other direct interest in the matter under consideration." Regulation 1.69(b)(1) requires an exchange to adopt rules conforming to the standards it describes. Regulation 8.17(a)(1) applies directly to exchange disciplinary committees. Does Regulation 8.17(a)(1) supersede the exchange rule required by Regulation 1.69(b)(1), or did Congress intend §5a(a)(17)(A)(i) to overrule Regulation 8.17(a)(1)? The cost of answering this question now is less than the cost of litigating it. Rather than hiding the notion that Regulation 1.69 "clarifies" Regulation 8.17(a)(1) in the half-light of a Federal Register notice, we propose that the second sentence of Regulation 8.17(a)(1) be amended to read:

> The hearing may be conducted before all of the members of the disciplinary committee or a panel thereof ^ in accordance with the rules required to be adopted by section 5a(a)(17)(A)(i) of the Act.

Exclude Bodies That Make Recommendations: Governing Board Subcommittees and Oversight Panels. In the revised release, the Commission expresses the beliefs "that the recommendations of governing board subcommittees often are adopted in full by governing boards because the boards rely heavily on their subcommittees' recommendations," 63 Fed. Reg. at 3494, and that "often the recommendation of an oversight panel with respect to self-regulatory policies or procedures can be tantamount to the establishment of such policies or procedures because the adopting authority relies on the panel's recommendation." Id. at 3495. Based on those beliefs, the revised proposal includes in the definition of governing board "any subcommittee thereof, duly authorized . . . to recommend the taking of action on behalf of the self-regulatory organization" (proposed Regulation 1.69(a)(3)) and in the definition of oversight panel "any subcommittee thereof, authorized. . . to recommend . . . policies or procedures" (proposed Regulation 1.69(a)(4)).

We renew our objection to the inclusion of bodies which are not authorized to act on behalf of an SRO. We are not aware of any factual basis which supports these beliefs, particularly in the context of a "significant action." Our experience at the

CBOT strongly suggests that the opposite presumption is more accurate: no member of the Board of Directors would allow a recommendation for "significant action" to pass without his or her rigorous, independent examination of the issue. The presumption that, on a matter as serious as a temporary margin rule or a critical margin change, a director would "rubber-stamp" a committee recommendation undervalues the hard work and dedication of those who spend countless hours in service to SROs.

Accordingly, we respectfully suggest that if our existing conflict of interest procedures fail to detect a conflict in a body that makes recommendations, the potential for harm is cured by the independent review of a body authorized to act for the exchange. In other words, the marginal benefit of applying proposed Regulation 1.69 to bodies that are not authorized to act for an SRO is minimal, and the cost of doing so is substantial. Those costs include the cost of conducting the position review, and the risk that compliance will delay and impair the SRO's ability to address the crisis at hand.

Committees Versus Committee Members. In the release, the Commission explains that committees that impose minor penalties summarily would be excluded from the definition of disciplinary committee, whether the penalty was imposed by the full committee or by a single authorized person. 63 Fed. Reg. at 3495. The text of newly proposed Regulation 1.69(a)(1), however, only excepts "a single person," not a committee. Id. at 3504. We believe that the text of the regulation should conform to the explanation in the release.

Family Relationship. Proposed Regulation 1.69(a)(2) has been expanded to include a former spouse, grandparent, grandchild, uncle, aunt, nephew and niece. The inclusion of former spouses seems inconsistent with the approach taken in proposed Regulation 1.69(b)(1)(D) that prior relationships are not disqualifying.

Named Party In Interest. In proposed Regulation 1.69(a)(6), a "named party in interest" is defined as "a party who is the subject of any matter being considered by a governing board, disciplinary committee or oversight panel."[2] The definition does not require that the party in interest be named, or that his or her identity be disclosed to the governing board, disciplinary committee or oversight panel. Obviously, a captioned disciplinary proceeding will have an easily identified named party in interest, but suppose the Board of Directors is asked to consider temporary

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[2] 63 Fed. Reg. at 3504. The text of the release incorrectly notes that the definition of a "named party in interest" as "'a party who is identified as the subject of any matter being considered' by an SRO committee" was retained in the revised proposal. Id. at 3496 n.18.

emergency action in connection with a congested expiration. If the matter is presented to the Board without identifying the market participants by name,[3] are those participants "named parties in interest?" Finally, would a governing board's commercial representatives be disqualified as "named parties in interest" if the board were asked to consider a matter which affects all commercials? To do so would deny commercials the right to be represented on issues which affect them most. We understand the Commission's view that the revised proposal does not unnecessarily impair the diversity goals of Regulation 1.64, but this cannot be what was intended by §5a(a)(17). In view of the unwarranted costs and unintended consequences presented by the proposed definition, we suggest the following definition of "named party in interest:"

> (6) Named party in interest means a person who is identified by name to a governing board, disciplinary committee or oversight panel as the subject of a matter to be considered by it.

Positions at Other Exchanges or OTC. Proposed Regulation 1.69(b)(2)(iii)(E) also requires an SRO to review those positions which the exchange reasonably expects could be affected by the significant action. We believe that the positions described in Regulations 1.69(b)(2)(i) and 1.69(b)(2)(iii)(E) should be limited, in the manner described in the release,[4] to those positions owned or controlled by the member.

Markets can be moved on news that an SRO board is meeting to consider "significant action." If the position review required by Regulation 1.69(b)(iii) requires an SRO to request documents and/or information from external sources, there is a credible risk that market participants will infer that significant action is about to be considered. To prevent market-disrupting rumors from being started or spread as a result of SRO requests for information about directors,we believe that an SRO should only have to ask for information about non-exchange positions from the Commission.

Position Reviews and Abstention Determinations Should Be Limited to Positions Whose Value Could Reasonably Be Expected to Be Affected by the Significant

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[3]For example, the identities of market participants were redacted from written materials presented to the CBOT Board when it considered emergency action with respect to July 1989 soybean futures.

[4]"The Commission believes that any positions held by a committee member that can be impacted by a committee action, whether or not it is held at the member's home SRO, has the potential to influence the member's views on committee members. Id. at 3500 (emphasis added).

Action. The disqualifying interest identified in Regulation 1.69(b)(2)(i) is "exchange or non-exchange positions that reasonably could be expected to be affected by the [significant] action." The positions required to be reviewed under Regulation 1.69(b)(2)(iii) and on which the abstention determination should be based under Regulation 1.69(b)(2)(iv) should likewise be limited to positions "that reasonably could be expected be affected by the significant action." An SRO should not have to be distracted by collecting and reviewing Treasury bond futures positions when its governing board is preparing to consider significant action relating to soybeans.

Latitude in Exigent Circumstances. The delays caused by complying with the rules adopted pursuant to §5a(a)(17) will arise in the collection and review of position information more than in the abstention decision. To "provide SROs with the flexibility to make conflict decisions in an expeditious manner that would not prevent SRO committees from promptly handling significant actions,"[5] the last sentence of proposed Regulation 1.69(b)(2)(iii) should begin:

> "Taking into consideration the exigency of the circumstances, such determination should include a review of. . ."

Also, the information on which the abstention determination should be made, which is described in proposed Regulation 1.69(b)(2)(iv), is much narrower than the range of information required to be reviewed under proposed Regulation 1.69(b)(2)(iii). If the information described in Regulation 1.69(b)(2)(iv) is sufficient to determine whether abstention is warranted, then the cost of obtaining and reviewing additional information under Regulation 1.69(b)(2)(iii) outweighs the benefit of doing so. For that reason, we believe that Regulation 1.69(b)(2)(iv) should be conformed to Regulation 1.69(b)(2)(iii).

Procedure. Proposed Regulation 1.69(b)(1)(iii) and (b)(2)(iv) require an SRO to establish procedures to determine whether a disqualifying relationship exists, and to base that determination on information provided by the member himself and "any other source of information that is reasonably available to the self-regulatory organization," a standard which the Commission believes, "appropriately accommodates the time and resource constraints that SROs often face when administering SRO committee members." Id. at 3498. We are concerned that, in the context in which this provision will be applied, this provision simply lacks content and offers no meaningful guidance to those who will be bound by it. In that respect, this provision will be useful only to those who disagree with the decision of a governing board or committee and who have the benefit of hindsight. As an

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[5] Id. at 3500.

alternative, we suggest that proposed Regulations 1.69(b)(1)(iii)(B) and (b)(2)(iv)(C) be amended to read:

> "Any information of which the self-regulatory organization has actual knowledge."

Deliberation Exception. Before granting a "deliberation exception," the deliberating body would have to consider all of the position information which served as the basis for the member's conflict of interest. Id. at 3501 (including all of the information required to be disclosed (position information from large trader reports, clearing records and other sources reasonably available to the SRO, id. at 3501 n. 34). The CBOT seeks clarification that actual documents need not be distributed to the deliberating body, that the identity of customers need not be disclosed and that a general description of the disqualifying position will be sufficient for purposes of proposed Regulation 1.69(b)(3)(iii). If the other members of the committee are advised of the general nature of the conflict, they can still come to appropriate judgements about the applicability of the exception and the weight to be given to that member's views.

Summary Recusal. Regulation 1.69 should permit a member to recuse himself or herself without making the disclosures called for by proposed Regulation 1.69(b)(1)(ii) and (b)(2)(ii). In addition, once a member recuses himself or herself, the self-regulatory organization should have no further obligation to commence or complete the position review or to make the determination called for by proposed Regulation 1.69(b)(1)(iii) or (b)(2)(iii) for that member.

We remain of the view that the rules required by §5a(a)(17) and proposed Regulation 1.69 will one day impair the ability of SROs to respond to crises, with horrible consequences. We urge the Commission to limit the harm imposed by this ill-conceived law.

The CBOT appreciates the opportunity to comment on this proposal.

Respectfully submitted,

Thomas R. Donovan