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CHICAGO MERCANTILE EXCHANGE

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COMMENT

March 24, 1998

Ms. Jean A. Webb
Office of the Secretariat
COMMODITY FUTURES TRADING COMMISSION
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Proposed CFTC Regulation 1.69 – Voting by Interested Members of SRO Governing Boards and Committees

Dear Ms. Webb:

The Chicago Mercantile Exchange ("CME" or "Exchange") is pleased to comment on the above proposal. We understand that the Commission's rulemaking responds to the 1992 amendment of Section 5a(a)(17) of the Commodity Exchange Act ("CEA") to require that each contract market must "provide for the avoidance of conflict of interest in deliberations by the governing board and any disciplinary and oversight committees." The CEA also requires the Commission to promulgate regulations in this area.

On May 3, 1996, the CFTC published for comment in the *Federal Register* a proposed new Regulation 1.69 that would require members of SRO governing boards and certain committees to abstain from such body's deliberations and voting on certain matters where such members might have a conflict of interest. The CME and other organizations submitted comments that criticized various aspects of the CFTC's 1996 proposal. The CFTC recently published a revised version of its proposal that responds to many of the comments that were made. 63 *Federal Register* 3492 (January 23, 1998) (the "Release"). Before commenting on the particulars of the revised proposal, the CME would like to repeat some general observations that it made in its comment letter on the 1996 proposal.

The CME fully recognizes the importance of preventing conflicts of interest from influencing decisions of its governing board and disciplinary committees. The CME already has rules in place that are designed to prevent persons from voting on matters in which they have a

personal or financial interest.[1] Accordingly, the main effect of adopting proposed Regulation 1.69 would be to supercede existing SRO rules and practices with detailed rules and procedures mandated by federal regulation.

As discussed below, the CME believes that certain provisions in proposed Regulation 1.69 go beyond what is required by the CEA. It is our view that the Commission should not adopt rules that are more intrusive than what is necessary in order to satisfy the provisions of the CEA. It is important to remember that limiting the scope of the proposed CFTC regulation does not mean that more conflicts of interest will be tolerated; it simply means that the SROs' more flexible and individually tailored rules will govern in more areas.

I. Disciplinary Matters

In our letter commenting on the CFTC's 1996 proposal, we made the point that it would be counterproductive to require more elaborate conflicts screening procedures for minor matters that come before certain disciplinary committees. According to the Release, the Commission agreed with our comment and revised the definition of "disciplinary committee" in Regulation 1.69(a)(1) to "exclude committees that summarily impose minor penalties" for violating rules regarding decorum, attire, the timely submission of accurate records for clearing or other similar activities. Release at 3494. However, the text of proposed Regulation 1.69(a)(1) limits that exclusion to cases where "a single person" is authorized summarily to impose minor penalties. We assume that this inconsistency is an inadvertent oversight that will be corrected when the CFTC adopts final rules.

The CME agrees with the comment expressed by the Chicago Board of Trade ("CBOT") that it is undesirable for the CFTC to use different language in two regulations to govern the same conduct. For example, both Regulation 8.17(a)(1) and proposed Regulation 1.69(b)(1) prohibit a member of a disciplinary committee from serving on the committee if he or she has a conflict of interest because of a relationship with the named party in interest, but they use different language to express the same point. In order to avoid any possible confusion or uncertainty as to whether the CFTC intended to create different standards by using different wording, we suggest that the articulation of the standard in Regulation 8.17(a)(1) be replaced by a cross-reference to the more detailed standard set forth in proposed Regulation 1.69.

The Commission also invited comment on whether the proposed conflict of interest regulation should be expanded to cover other types of SRO committee action such as revisions in price change registers. The CME strongly believes that the CFTC proposal should not be expanded to any other type of committee action for the following reasons. First, there is no support for such expansion in Section 5a(a)(17) of the CEA, which expressed a Congressional concern with avoiding conflicts of interest only with respect to governing boards and any disciplinary and oversight committees. Second, other types of committee actions, such as

[1] See CME Rules 233, 406, 409, 410, 415, 417, 446, 551.b.2, 579, 608 and 612.

revising price change registers, often need to be accomplished in a very short time. To require conflicts screening procedures in such cases that are more elaborate than those currently used by the Exchange would add extra cost and delay into the process for little or no discernible benefit. Please recall our observation noted above that limiting the scope of the proposed CFTC regulation does not condone conflicts of interest. Instead, the real issue is whether, in areas other than those specified in the CEA, there is any reason to supplant the Exchange's existing policies with a governmental mandate. We believe the answer is no.

II. Emergency Actions

Under the proposed regulation, a heightened level of conflicts screening would be required for any "significant action" that can be taken by the SRO without the Commission's prior approval. The term "significant action" is defined to include:

(i) Any actions which address an "emergency" as defined in Regulation 1.41(a)(4) excluding physical emergencies; and

(ii) "Any changes in margin levels that are designed to respond to extraordinary market conditions such as an actual or attempted corner, squeeze, congestion or undue concentration of positions, or that otherwise are likely to have a substantial effect on prices in any contract traded or cleared" at the SRO.

Proposed Regulation 1.69(b)(2)(ii) requires that, prior to the consideration of any such significant action, each member of the applicable board or committee must disclose to the SRO staff certain position information "that is known to him or her." This represents a substantial improvement over the CFTC's 1996 proposal which required the member to disclose position information which is known "or should be known" to the member. The 1996 proposal also provided that members "shall be presumed to have knowledge" of positions in various categories. We are pleased that the Commission, in response to comments submitted by the CME and others, has seen fit to drop the "presumption of knowledge" from the proposed regulation, and to rely instead on what the member actually knows.

Proposed Regulation 1.69(b)(2)(iii) requires each SRO to establish procedures for determining whether any member of the applicable board or committee has a direct and substantial financial interest in the result of a vote on a significant action based upon positions that reasonably could be expected to be affected by the action. The SRO determination must include a review of: (1) gross positions in the member's personal accounts or controlled accounts; (2) gross positions held in proprietary accounts at the member's affiliated firm; (3) gross positions held in accounts in which the member is a principal; (4) net positions held in customer accounts at the member's affiliated firm; and (5) "any other types of positions, whether

maintained at that self-regulatory organization or elsewhere, that the self-regulatory organization reasonably expects could be affected by the significant action."[2]

The CME has several problems with the above requirement. First, the proposed regulation defines the term "member's affiliated firm" as a firm in which the member is a principal or an employee. But that definition fails to take into account the fact that a mere employee has a much more limited interest in and knowledge of positions at his affiliated firm than does a principal of the firm.[3] When the CME checks for potential conflicts on the part of someone who is a principal (i.e., an officer or ten percent owner) of a firm, it reviews position information (for CME contracts) in the first four categories listed above because the member could be regarded as having a financial interest in actions that might affect the financial situation of the firm. However, that concern does not exist to the same extent when the member is an employee of the firm without an ownership interest or management responsibilities. In that situation, the CME would not review positions in proprietary or customer accounts of the firm. We believe that this distinction reflects commercial reality and should be adopted in the proposed regulation.

Proposed Regulation 1.69(b)(2)(i) provides that a member of an SRO's applicable board or committee must abstain from such body's deliberations and voting on any "significant action" if the member knowingly has a direct and substantial financial interest in the result of the vote "based upon either exchange or non-exchange positions that reasonably could be expected to be affected by the action." This broad language includes positions at the SRO's market, at other exchanges, in OTC derivatives and in the cash market. The CME agrees that if the member knowingly has a direct and substantial financial interest in the result of a vote because of such positions, it is appropriate to require him to disclose such position information to the SRO staff and to abstain from deliberations and voting. However, it is not appropriate to require the same SRO review of positions acquired outside of its market as for positions acquired at its market. Subparagraph (b)(2)(iii)(E) of the proposed regulation requires SRO staff to review any such positions, whether maintained at that SRO or elsewhere. The CFTC recognized that this could

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[2] Although the text of proposed Regulation 1.69(b)(2)(iii) is not completely clear on this point, we assume that the CFTC intended for the SRO review to be limited to positions "that reasonably could be expected to be affected by the significant action." For example, it would make no sense for the CME to review a member's Eurodollar positions in connection with a possible action in pork bellies. We suggest that appropriate limiting language be added to the second sentence of subparagraph (b)(2)(iii).

[3] In a related context, the CFTC determined, under proposed Regulation 1.69(b)(2)(iii)(C), to limit the review of positions to those held in accounts in which the committee member is a principal, as opposed to requiring a review of positions held in all accounts in which the member has an interest. We support the CFTC's decision to limit the review to positions in accounts in which the member is a principal because such positions are the ones in which the member "would probably have the greatest economic interest." Release at 3500, n.26. However, the CFTC did not apply the same reasoning with respect to positions at the member's affiliated firm.

be a problem for SROs, but felt that the problem was mitigated because the SROs could take "into consideration the exigency of the significant action"[4] and would only have to base conflict determinations "on the limited sources of information specified in proposed Regulation 1.69(b)(2)(iv)." Release at 3500. Yet, that section offers little comfort or guidance to SROs; it directs them to make conflict determinations based upon, among other things, "any other source of information that is reasonably available" to the SRO.

The following example will illustrate our concern. Assume that the CME's Executive Committee is to meet in two hours to consider possibly taking a "significant action" that could affect the value of S&P 500 futures contracts. By checking large trader reports and position information provided by the committee members, CME staff can ascertain whether any committee members have positions in the CME's S&P 500 futures contract. However, unless disclosed by the member, the CME would not know whether the member held positions in stock index futures contracts at other exchanges, in OTC equity swaps or in securities or securities options that might also be affected by the CME's action. Under these circumstances, what duty does the CME have to make further inquiries? Must it call the member's clearing firm to ask whether the member has related positions in other markets? Must it call other futures exchanges and securities markets to ask whether the member has positions at any of them?[5] If the CME makes such calls, it runs the risk that news of the impending significant action will leak out, thus causing further market disruption. It also runs the risk that the additional time needed to attempt to check a member's positions in other markets could cause a delay in the meeting to consider the possible significant action – a delay that could have serious adverse consequences. On the other hand, if the CME does not make such calls, it could be exposed to a possible lawsuit alleging that making such calls would have provided information that was "reasonably available" and that, with the wisdom of hindsight, might have caused the particular member to be disqualified from the vote. In order to avoid this dilemma, the CME believes that subparagraph (b)(2)(iv) should be amended to make clear that the SRO has no responsibility to request information from external sources other than the committee member himself.

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[4] Similar language regarding exigent circumstances should also be added to the second sentence of subparagraph (b)(2)(iii).

[5] The CFTC suggests that it will have its staff determine whether it would be feasible to provide each SRO with access to position information maintained by the CFTC with respect to positions held at other SROs. Release at 3500, n.27. The CME believes that position information is extremely confidential, and we would have serious concerns about any proposal in which position information was shared with other exchanges. In any event, this suggestion would at most provide information relating to positions at other markets under the CFTC's jurisdiction, but not about positions held in markets outside its jurisdiction.

The CBOT's comment letter suggests that proposed Regulation 1.69 should permit a member to recuse himself or herself without making disclosures of position information and without requiring the SRO to review position information for that member. The CME supports that suggestion. As we understand it, the purpose of the proposed regulation is to prevent members with a conflict of interest from participating in the applicable board or committee deliberations and voting. If that purpose can be accomplished through a voluntary recusal, then there is no point in requiring the member to disclose confidential position information or to require the exchange to spend precious staff time in an emergency situation to review position information for a member who will not be participating in the action.

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We appreciate the opportunity to comment on the Commission's proposed rulemaking in an area that is of great importance to us.

Respectfully submitted,

Carl A Royal

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