99-20

Chicago Board of Trade

Thomas R. Donovan
President and
Chief Executive Officer

August 16, 1999

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
115 21st Street, N.W.
Washington, D.C. 20581

COMMENT

RE: Proposed Rulemaking: Revised Procedures for Commission Review and Approval for Contract Market Designation and of Related Contract Terms and Conditions [64 Fed. Reg. 40528 (July 27, 1999)] and; Proposed Rulemaking: Contract Market Rule Review Procedures [64 Fed. Reg. 38159 (July 15, 1999)]

Dear Ms. Webb:

The Board of Trade of the City of Chicago ("CBOT" or "Exchange") hereby respectfully submits its comments on two related rulemaking proposals of the Commodity Futures Trading Commission ("CFTC" or "Commission"). In the first, published on July 15, 1999, the Commission is proposing changes to the notice and review procedures for rule filings that involve certain minor, routine changes to exchange rules relating to contract terms and conditions. The second, and more significant but ultimately flawed proposal, published on July 27, 1999, recommends a two-year pilot program under which exchanges could list new contracts for trading prior to Commission approval, but still subject to agency approval.

We are pleased that the Commission recognizes the need to streamline the new product and rule approval processes. The proposals, however, provide nominal relief for only the most routine types of contract and rule submissions. Much more drastic measures are needed to ensure the vitality and competitiveness of U.S. contract markets in the global arena. In lieu of the pending proposals, the Commission should grant the relief jointly requested by the CBOT, Chicago Mercantile Exchange and New York Mercantile Exchange in our June 25, 1999 Petition for Exemption (the "Joint Petition"), in which we ask the Commission to eliminate the contract and rule approval processes entirely.

1. Pilot Program for Listing of New Contracts in Advance of CFTC Approval

The Commission is proposing to allow exchanges to list new contracts for trading prior to designation, without a waiting period. However, the Commission is retaining the requirement of Commission approval, except that now approval would follow listing. An exchange would have forty-five (45) days after listing in which to apply for formal Commission approval of the terms and conditions of the contracts. Upon completion of Commission review, the Commission would continue to designate such contracts if they were found to meet the requirements of the

141 W. Jackson Blvd.
Chicago, Illinois 60604-2994
312 435-3602

CEA. The Commission is proposing the pilot program pursuant to its exemptive authority under Section 4(c) of the Commodity Exchange Act ("CEA").[1]

The proposed pilot program, although a positive step, contains several features that undermine its prospects for successfully attracting broad use. In fact, as a response to ongoing requests for regulatory relief of the type that the U.S. exchanges need to meet the competitive challenges of our lesser-regulated foreign counterparts, it misses the mark.

The first problem is that the Commission is expressly retaining the requirement of Commission review of contract terms, along with the concomitant authority to disapprove or require changes to the contract terms, post-listing. The risk that contract terms could change by Commission fiat during a post-listing review period will discourage market use of any contract listed under the pilot program. Few, if any, traders, customers or firms will want to risk leaving any open positions on a contract when the terms and conditions of that contract may be subject to rejection or change by the Commission at any time during it review. For instance, suppose an exchange listed a "new" contract for trading under this pilot program, and the contract proved successful with a moderate amount of open interest, which is a key element in generating additional trading interest and is an important measure of a contract's success. After the exchange requests formal Commission approval of the new contract, the Commission rejects certain of the contract's terms and conditions and orders the exchange to change or delete them or even de-list the contract. Such a scenario would force traders and other contract users to scramble to exit their open positions causing wild price fluctuations, with the obvious monetary risk that would entail.

Our concerns are well founded, as demonstrated by our recent experience implementing revisions to certain terms of our soybean oil contract. Due to the Commission's protracted review of those changes -- nearly six months -- we had to list new contract months with the revised terms highlighted with an asterisk as "pending Commission approval." Certain market users notified us that the "pending" status of the contract changes discouraged calendar spread trading because of the difficulty it created in pricing such spreads. Even though open interest began to slowly increase while we waited for final Commission action, that growth was slower than anticipated.

The second problem is that the Commission does not state how long it has to review the exchange's contract terms. It is unclear, for example, whether exchanges could select and the Commission would apply the 45-75 day expedited procedures that currently exist for contract terms and conditions. The deleterious affect of the Commission's post-listing review of new contracts is compounded by this problem.

---

[1] It appears that the Commission is making the erroneous assumption that it must proceed under Section 4(c)(2) of the CEA rather than Section 4(c)(1). This distinction is important because Section 4(c)(2) requires the Commission to make three extra findings before it may grant exemptive relief. As explained in Mark Young's August 10, 1999 letter to the Honorable David Spears, the standards of Section 4(c)(1) apply to exemptive relief for existing exchanges with contract designation in place.

Third, the pilot program is designed for routine, plain vanilla contracts where regulatory relief is least needed because they are unlikely to trigger lengthy or intense Commission review. The Commission admits as much when it states that an exchange would "most appropriately" use the new listing procedure "for contracts which clearly raise no legal or practical impediments to trading." [64 FR 40532.] But if no legal or practical impediment exists, what is the value of CFTC post-review? This argues for deferring to the business judgement of exchanges for such contracts. In any event, the Commission's focus on routine contract submissions is misplaced; the exchanges need relief with respect to novel and innovative contracts that are most vulnerable to competition, either through copycat submissions or listings by our less regulated foreign counterparts. Eliminating the requirement of Commission approval of new contracts would not affect the Commission's general authority over a contract's terms and conditions. The pilot program, which is for a minimal two-year period, would provide a better test without the required designation.

The fourth problem, limiting the trading in new contracts listed under the pilot program to only months within one year of the listing, would limit the critical trading interest and activity by calendar spread traders and potential arbitragers. Although historically "back month" trading activity is far less liquid than "front month" trading, the back months, including those months over a year out, do provide useful trading opportunities, particularly for spreaders and arbitrage traders. It is exactly that type and amount of trading activity which may make or break the successful launch of a new contract. Allowing for trading in months over one year out on contracts listed pursuant to the pilot program makes sense from a trader's point of view (trading opportunity) and from the point of view of an exchange (competition).

In today's highly competitive trading environment, exchanges need the regulatory flexibility to allow us to act quickly and decisively. Lengthy Commission review of new product listings, including the threat of a subsequent review, is a cost that domestic exchanges cannot afford. We urge the Commission to adopt the more meaningful relief we request in the Joint Petition. At the very least, the Commission should correct the above deficiencies. In its current form, the proposed pilot will likely meet the same fate as the Commission's never-used Part 36 Rules.

2. Contract Market Rule Review Procedures

CFTC Rule 1.41 currently establishes expedited filing and approval procedures of 10 days or less for certain prescribed types of routine changes to exchange rules relating to contract terms and conditions. The Commission is proposing to reorganize those provisions in a purportedly "clearer and more accessible format" [64 FR 38159] and to modify the approval timeframes and requirements for certain types of rule changes.

The Commission claims that the changes will "streamline dramatically the required filing notice of those rule amendments" [64 FR 38160] and will further its "overall regulatory reform program by reducing unnecessary regulatory burdens and costs on United States exchanges associated with the Commission's review and approval of proposed exchange rules and rule amendments" [64 FR 38159] Based on the CBOT's experience, these claims are vastly overstated. The

proposal, however well intentioned, provides at best marginal relief for certain rule changes that by their very nature are so routine as to demonstrate the waste of resources involved in agency pre-filing or pre-approval. At worst, the proposal actually ***increases*** regulatory burdens in some cases.

If the Commission is serious about providing U.S. contract markets with relief from burdensome pre-approval requirements for contract terms and conditions, it should grant the exemptive relief that the CBOT, CME and NYMEX are seeking through our pending Joint Petition.

To gauge the practical implications of the Commission's proposal, we have reviewed our rule submissions from January 1997 through June 1999 to evaluate how they would have been treated under the proposed standards. That review, covering a period of 2-1/2 years and approximately 230 rule package filings, confirms that the proposed changes will provide only modest benefits, not the "dramatic" streamlining the Commission cites. The following points illustrate the proposal's shortcomings:

Nominal Changes

1. The proposed changes apply primarily to exchange rule filings already covered by expedited review and filing procedures of 10 days or less. The Commission is proposing only a few new categories where expedited procedures would now expressly apply. These new categories would have picked up only 3 to 5 of our rule package submissions during the 2-1/2 year period examined, representing slightly over 2% of our total submissions. Measured in terms of time, that slight improvement becomes virtually meaningless. Moreover, the types of routine rule changes covered by the Commission's proposal are sometimes part of a broader rule package including related rule changes covered by longer review procedures. In those cases, the shorter deadline offers no value because it is subsumed by the longer procedures.

10-Day Review Procedures: Proposed Rule 1.41(b)(3) Increases Review Period

2. Proposed Rule 1.41(b)(3) provides for a 10-business day review period for certain rule changes relating to financial standards for delivery status or deliverable grades or standards set by third parties. These types of changes, however, are currently subject to a 10-calendar day approval period under Rule 1.41(m) and (t). Thus, the proposal takes a step backwards by ***extending*** the review process in these cases. The Commission does not highlight this adverse change in its release nor does it offer any explanation why the deadline should be extended. In any event, while the types of changes covered by the 10-calendar day review procedures are relatively pro forma, from our perspective they do not occur often. We did not make a single filing under Rule 1.41(m) or (t) in the past 2-1/2 years.

3-Day Review Procedures: Proposed Rule 1.41(b)(4) Offers Cosmetic Changes

3. Proposed Rule 1.41(b)(4) would shorten to 3 business days the approval period for certain changes to contract terms relating to option trading months, option automatic exercise procedures, certain other option terms, decreases in minimum tick size, expansion of price limits and futures and options on certain specified currencies. While certainly the shortened approval timeframes are welcome, the exchange rule changes at issue again represent a small portion of our rule submissions to the Commission and, in any event, are routinely acted upon by the Commission in 10 days or less. From January 1997 through June 1999, the CBOT made 11 rule filings with the CFTC that we believe would be covered by the proposed 3 business day procedures, representing fewer than 5% of our total rule filings during that period. Of those 11 filings, 4 were approved within a shorter timeframe -- ranging from same day approval to approval by the 3rd calendar day -- than the 3-business day window the Commission is proposing. The others were approved within 10-12 calendar days.

Exchange Rule Changes Deemed Pre-Approved:
Proposed Rule 1.41(b)(5) Offers Further Cosmetic Changes

4. Proposed Rule 1.41(b)(5) sets out 8 categories of rule changes relating to contract terms and conditions that would be deemed effective when an exchange adopts them. However:

   a. That standard (immediate effectiveness) already applies to 4 of those 8 categories: (1) changes designated by the Commission on a case-by-case basis;[2] (2) changes to a contract's index calculation (other than a stock index), (3) changes to survey lists for cash-settled contracts and (4) non-material rule changes such as correction of typographical errors or renumbering. In the latter case, the Commission seeks to create the illusion that it is offering the exchanges new, meaningful relief by adding a new category that expressly covers non-material changes to contract terms and conditions. [Proposed Rule 1.41(b)(5)(i)(D).] However, this codifies Commission practice which has allowed exchanges to submit such changes under existing Rule 1.41(d), even though by its literal terms that provision applies to non-material rule changes that do not relate to contract terms and conditions. The CBOT has on 4 occasions in the past 2-1/2 years filed minor, typographical corrections to rules relating to contract terms and conditions pursuant to Rule 1.41(d), which the Commission in each case accepted on that basis.

   b. For 1 of the remaining 4 categories -- changes to trading hours [proposed Rule 1.41(b)(5)(i)(E)] -- such changes are already deemed approved 1 business day following the Commission's receipt of notice of the change. [CFTC Rule 1.41(k).] Thus, the proposal to allow trading hour changes to take effect immediately, while welcome, is a

---

[2] See proposed Rule 1.41(b)(5)(i)(A). The proposal also would reserve for the Commission the right to designate on a case-by-case basis that certain types of rule changes to contract terms and conditions could be subject to the proposed 10 business day or 3 business day provisions. See proposed Rule 1.41(b)(3)(A) and (b)(4)(A). The Commission currently has the authority under Rule 1.41(n), which the new provisions presumably would replace, to craft special approval procedures for an exchange on a case-by-case basis, but without any constraint on the review timeframe it may choose to set.

modest improvement meriting little fanfare. Moreover, the Commission detracts from that slight improvement by proposing to ***increase*** the needed qualifications to get the special treatment. In addition to the existing conditions, as proposed a change to trading hours could not "provide for the initial listing of a contract on an automated trading system." The Commission offers no justification for adding this new requirement.

c. The final 3 categories of rule changes that would be deemed effective when adopted by a contract market represent somewhat more of an improvement, in that such changes are today subject either to 10 day or 45 day review procedures under Rule 1.41. For us, the most relevant category, in terms of frequency of submissions, is the one covering changes to listing of contract months within an approved listing cycle. [Proposed Rule 1.41(b)(5)(i)(F).] But even there, fewer than 10% of our rule submissions since January 1997 fall into that category, and almost half of those relate to de-listing of contract months where the distinction between a 10-day review and no prior review has little significance. Common sense dictates that an exchange will only de-list a contract month that does not have any open interest, which means no one is trading that contract month or cares whether it is listed for trading or not. (Not trusting to an exchange's common sense, the Commission has conditioned both the existing 10-day procedures and the proposed pre-approved status for exchange decisions to de-list contract months upon there being no open interest in the months at issue.)

Group Submissions of Pre-Approved or Pre-Effective Exchange Rule Changes: Proposed Changes to Proposed Rule 1.41(b)(5)(ii) and Rule 1.41(d) "Fix" a Non-Existent Problem

5. The Commission is proposing to add special provisions to Rule 1.41 that would expressly allow a contract market to file rule changes covered by proposed Rule 1.41(b)(5) or existing Rule 1.41(d) on a weekly basis, in group submissions. [See proposed Rule 1.41(b)(5)(ii) and 1.41(d)(2).] The rule changes at issue are ones that the Commission has determined may take effect when adopted by an exchange, in the case of proposed Rule 1.41(b)(5), or are exempt from pre-filing requirements of the CEA, in the case of Rule 1.41(d).

The Commission disingenuously attempts to portray these post-filing procedures as providing significant regulatory relief to the exchanges. The Commission states:

> "The Commission also is proposing to reduce the associated filing requirements for automatically approved exchange rule amendments. Specifically, the Commission would replace the current requirement that the exchange file a separate notice of each such amendment, with a single, summary filing of all automatically approved rule amendments adopted by an exchange during the preceding week. The proposal should significantly streamline the filing process for exchanges." [64 FR 38160.]

Nothing in Rule 1.41 currently requires a contract market to submit a separate notice for each of its rule changes covered by Rule 1.41(d). The Commission's statement to the contrary is

simply wrong and should be corrected to avoid the implication that contract markets must in the future start filing a separate submission for each rule change covered by Rule 1.41(d). The Commission's statement ignores common sense and the established precedent that exists for contract markets to group Rule 1.41(d) changes together into a single rule filing, just as we do for far more substantive rules changes. Over the past 2-1/2 years, the CBOT made 12 rule filings under Rule 1.41(d), 7 of them covering changes to multiple rules. Four of those 12 filings (3 covering multiple rules) would fall under the Commission's proposed Rule 1.41(b)(5)(i)(D) for non-material changes to rules relating to contract terms and conditions. In any event, the minor rule changes at issue make up only a small portion of the CBOT's rule filings, representing approximately 5% of the rule package filings we made during the period examined and a substantially smaller percentage of the total time we spent preparing rule submissions and dealing with Commission staff follow-up.

Increased Penalty for Misfiled Submissions

6. Currently, if the Commission decides that an exchange rule submission filed under one of the expedited provisions of Rule 1.41(i) through (t) is not consistent with the cited provision, the Commission will notify the exchange and the filing will be treated under the provisions of 1.41(b), which today includes the 45-75 day expedited review procedures for contract terms and conditions. Under the proposed rule changes, if the Commission disqualifies an exchange's submission under any of the proposed 10-day, 3-day or immediate approval procedures, the exchange's filing would be treated under the non-expedited procedures of proposed Rule 1.41(b)(1) and Section 5a(a)(12)(A) of the CEA, giving the Commission 180 days to 1 year to act upon the filing. The Commission does not highlight this adverse change in the release or offer any explanation for the change. (This may indicate that the change was inadvertently caused by the proposed reorganization and renumbering of Rule 1.41's provisions.)

In light of the protracted process the CBOT went through to modify the delivery terms for our corn and wheat contracts, and more recently to modify our soybean oil contract, the Commission's proposed streamlining of procedures for only the most routine types of exchange rule changes is clearly little more than tinkering around the edges.

Conclusion

For years, the CBOT and other domestic exchanges have been urging the Commission to take bold steps to reduce unnecessary and overly burdensome regulations, which prevent us from operating on a level playing field with non-domestic exchanges. We are somewhat encouraged that the Commission is starting to address our concerns, especially by recognizing that pre-approval of contracts is not required. However, more forceful and commercially practical initiatives are needed. The Commission should grant the exemptive relief requested in the Joint Petition. In light of the Commission's stated intention to seek public comment on the Joint Petition and the fact that the Joint Petition covers the very issues that the Commission is purportedly seeking to address through the pending proposals, we urge the Commission to

publish notice of the Joint Petition without further delay for a comment period of 30-days or less. As always, the CBOT stands ready to provide whatever expertise and assistance the Commission may request in its search for a more streamlined and effective regulatory oversight role.

Respectfully submitted,

Thomas R. Donovan