Comments Regarding Proposed Rules
for Regulatory Reinvention

Prepared by the Staff of the Federal Reserve Bank of Chicago[1]
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The Commodity Futures Trading Commission (the "Commission") proposes to adopt a new framework for the regulation of:

- Multilateral transaction execution facilities;
- Intermediaries of commodity interest transactions;
- Clearing organizations; and
- Exempt bilateral transactions.[2]

The Federal Reserve Bank of Chicago (the "Bank") welcomes the Commission's decision to ". . . replace the current 'one-size-fits-all' regulation for futures markets with broad, flexible 'Core Principles. . . ."[3] The Commission's proposed regulations are a significant step in implementing that transition.

The following comments address several areas where the Bank believes that the Commission's proposed regulations could be modified or clarified to better achieve the intended objectives.

Core Principles

The Bank believes that the utilization of core principles can foster innovation on the part of market participants. The Commission is to be applauded for seeking oversight in this manner since such an approach clearly can minimize any danger of micro-management. The Commission clearly recognizes that the discipline arising from the self-interested actions of market participants is preferable to the "command and control" style of merit regulation, at least where there is sufficient disclosure to permit market participants to make reasonably informed decisions.[4] The Bank believes that it is possible, and desirable, for the Commission to allow market discipline to play a greater role in the regulation of derivatives markets.

Additionally, it is essential that market participants maintain confidence that the core principles will be applied consistently over time and in a transparent manner. Accordingly, the Bank recommends that the Commission meet this challenge of providing a high comfort level for market participants by considering

[1] This commentary was prepared by Richard Lamm, John McPartland, James Moser and Robert Steigerwald.
[2] 65 Fed. Reg. 38986 et seq. (June 22, 2000).
[3] Id. at 38986.
[4] See, e.g., id. (". . . [T]he proposed framework [for Multilateral Transaction Execution Facilities] to a large degree relies more heavily on disclosure rather than merit regulation.").

the inclusion of new language in the proposed regulations that would highlight the importance of, and note the means to achieve, such consistency.

Clearing Organizations

The Commission's proposed Part 39 rules for clearing organizations is another important step in reforming the regulatory framework for derivatives markets. Among other things, the Commission, citing the recommendations of the President's Working Group on Financial Markets, has concluded that ". . . the development of . . . facilities for the clearing of over-the-counter derivatives should be encouraged." (65 Fed. Reg. at 39028). The Bank concurs with the Commission in that respect.

Therefore, the Bank fully supports the following changes to the existing regulatory framework for OTC derivatives:

- **Credit Risk Intermediation** -- The Commission proposes to extend the exemption it first granted in the SwapClear order[5] to all eligible clearing organizations, making it clear that the ". . . creditworthiness of the counterparty is not a condition of the exemption" for bilateral transactions. (65 Fed. Reg. at 39034). This change is justified by the fact that clearing, while important, does not fundamentally change the nature of the underlying transaction, whether that transaction is subject to the Commodity Exchange Act or not.

- **Standardization of Transactions** -- The Commission proposes to go beyond the position it took in the SwapClear order[6] and ". . . delete the requirement that exempt transactions not be fungible or standardized." (65 Fed. Reg. at 39034). It is unlikely that initiatives for clearing OTC derivatives would advance without such relief.

The Bank believes that a flexible regulatory framework for clearing, including the foregoing proposals, can promote innovation, foster competition, protect the interests of public customers and mitigate systemic risks.

However, the Bank disagrees with the Commission's contention ". . . that the form and degree of regulatory oversight imposed upon a clearing organization should be consistent with the types of instruments and markets for which it clears and the class of market participants for whom it clears." (65 Fed. Reg. at 29028). The Bank recognizes that clearing organizations may provide a wide variety of services -- including trade matching, obligation or payment netting, margining,

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[5] *Order Granting the London Clearing House's Petition for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act*, 64 Fed. Reg. 53346 (Oct. 1, 1999).

[6] The SwapClear exemption was expressly conditioned on the ". . . requirement that the swap transactions to be cleared by SwapClear not be part of a fungible class of agreements that are standardized as to their material economic terms." (64 Fed. Reg. at 53356).

risk management and credit enhancement. However, it is our opinion that market incentives are sufficient to assure that providers of clearing services will implement clearing and settlement arrangements that are consistent with the types of instruments and markets for which they provide those services.

The Bank believes that it is possible, and desirable, for the Commission to allow market discipline to play a greater role in the regulation of clearing organizations. In particular, the interposition of a centralized clearing facility should not trigger regulatory requirements that are not directly related to the Commission's interest in: (1) assuring that clearing organizations maintain adequate books and records to enable the Commission to audit clearing activities; (2) assuring that any customer (or clearing member) property held by a clearing organization is subject to adequate financial safeguards; and (3) mitigating systemic risk arising from the clearing or settlement process.

Therefore, the Bank believes that the Commission should tailor its core principles for clearing organizations to meet those objectives and leave to market forces the discipline necessary to assure that appropriate services are provided to different types of instruments and markets. Such a regulatory approach is, we believe, reflected in the Federal Reserve's Policy Statement on Privately Operated Multilateral Settlement Systems (the "Policy Statement").

The Policy Statement sets binding standards that are intended to mitigate systemic risks associated with the clearing and settlement of large-value U.S. dollar payments. However, in adopting the Policy Statement, the Board of Governors recognized that it is desirable:

> . . . to permit market participants to determine the best means of addressing risks, within the guidelines provided. As a general rule, risk management measures should be commensurate with the nature and magnitude of risks involved. (63 Fed. Reg. at 34892).

The Bank believes that the Board's approach in the Policy Statement is particularly relevant because, with certain amendments, that policy would seem to bear directly on the Board’s approach to its potential supervisory oversight of authorized clearing organizations that might be formed as banks, bank subsidiaries or affiliates or Edge corporations.[7]

It is unclear why the Commission believes that the core principles for recognized clearing organizations, and the guidelines that accompany them, must be so detailed and go beyond the basic objectives of assuring audit controls, financial

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[7] The Policy Statement ". . . does not apply to clearing and settlement systems for securities or exchange-traded futures and options, and is not intended to apply to bilateral relationships between financial institutions, such as those involved in traditional correspondent banking." The Bank believes that an entity that provides multilateral clearing or settlement services in connection with transactions that are exempt under the proposed Part 35 or 36 rules would not be exempt from compliance with the Policy Statement.

safeguards and mitigating systemic risk. The Bank believes that the core principles, if adopted in their current form, would represent a departure from the Commission's plan to allow market discipline and innovation to play a larger role in the regulation of derivatives markets. The Bank recognizes that the core principles would only be directly applicable to recognized clearing organizations. However, under circumstances of vigorous international regulatory competition, it is particularly important to avoid unnecessary regulatory impediments to the competitiveness of a wide range of clearing organizations, including recognized clearing organizations.

The Commission also proposes to allow "authorized clearing organizations," including securities "clearing agencies" and certain banking organizations and foreign regulated clearing organizations to clear any transaction that qualifies for exemption under the Part 35 or Part 36 rules. The Bank notes, however, that the President's Working Group unanimously recommended that ". . . Congress enact legislation to provide a clear basis for the regulation of clearing systems that may develop for OTC derivatives."[8] Until Congress acts, however, the Commission should consider whether its proposal might inadvertently undermine the legal certainty that the new regulatory structure is intended to afford exempt transactions by suggesting that clearing does fundamentally change the nature of transactions that are otherwise exempt from the Commodity Exchange Act.

Customer Funds

The Bank has several suggestions meant to improve or clarify the proposed rules concerning permissible investments of customer funds.

- General comments.

In general, eligible securities for the investment of customer funds should (1) be highly rated, (2) have either a CUSIP or ISIN number and have a reasonably transparent secondary market enabling futures commission merchants ("FCMs"), clearing organizations, regulators and outside audit authorities to accurately and efficiently revalue all eligible securities, and (3) settle on a same day or next day basis.

- The investment of non-dollar customer funds should be addressed.

The proposed rule governing the investment of customer funds does not provide guidance regarding the appropriate discretionary investment of non-dollar customer funds. FCMs and clearing organizations should be permitted to invest customer funds in the sovereign debt of the currency so denominated. Doing so

[8] “Over the-Counter Derivatives Markets and the Commodity Exchange Act" Report of The President’s Working Group on Financial Markets, November 1999 at 20.

neither increases sovereign risk nor currency risk[9]. The issuer (default) risk of such sovereign debt securities is markedly less than virtually all of the additional securities that the Commission is proposing for the discretionary investment of customer funds. Given other restrictions that the Commission has historically placed on both the type and location of bank accounts in which such non-dollar funds may be deposited, the Commission should permit FCMs and clearing organizations to invest such non-dollar balances in identically denominated sovereign debt securities.[10]

- The proposed expansion of eligible securities does not address the respective settlement conventions (settlement liquidity characteristics) of those securities.

Performance collateral is held by FCMs and clearing organizations for only one purpose, to be promptly liquidated in the event of non-performance and for the liquidating proceeds to be promptly applied to any financial loss incurred. While the Commission's proposed expansion of permissible investments addresses issuer risk (the risk that the issuer of the security will default on all of its debt obligations as they mature or pay interest), it does not address the timeliness with which the liquidating proceeds would customarily be made available to the liquidating FCM or clearing organization. The respective secondary markets for different categories of securities have different settlement conventions, some of which would appear to be inappropriate for the discretionary investment of customer funds.

It is our opinion that FCMs and clearing organizations should not invest customer funds in any securities that do not customarily settle either on the date of the (liquidating) trade (T+0) or on the next business day (T+1). Currently in the U.S., virtually all corporate and municipal debt securities settle on a T+3 basis, that is, the trade date plus three business days.[11] In reality, T+3 securities actually only settle in three calendar days if liquidated on a Monday or Tuesday; under all other circumstances, an FCM or clearing organization would customarily receive the liquidating proceeds no sooner than five calendar days. This delay could deprive the FCM(s) or clearing organization(s) of the emergency liquidity so important in times of market stress or events of specific non-performance.

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[9] See Zagorski & McPartland, "Multicurrency Regulatory Encumbrances Affecting the U.S. Futures Industry." *Derivatives Quarterly*, Summer 1999.

[10] The Commission's average portfolio limitations could still be applied. However, issuer concentration limitations should not apply as the sovereign risk and FX risk of investing customer funds in the sovereign debt of the same currency are identical to holding such funds in deposit accounts.

[11] The Bank recognizes that Section 4d of the Commodity Exchange Act permits investment of customer funds in municipal securities. Nevertheless, for the reasons discussed in the accompanying text, the Bank does not believe that the Commission should extend the class of permissible investments to include other securities that do not settle either on trade date or the next business day.

- The Commission should expressly approve the use of certain "sweep" accounts in connection with the investment of customer funds.

Subject to the foregoing comments, the Bank supports the Commission's proposal to expand the range of permissible investments in which FCMs and clearing organizations may place customer funds. The Bank specifically supports the proposal to permit customer funds to be invested in money market mutual funds.

Additionally, the Bank interprets this proposal to suggest that an FCM or clearing organization would be permitted to move funds between a demand deposit account and a money market mutual fund, or one of the other forms of investment permitted under the proposed revisions to Rule 1.25. Accordingly, the Bank suggests that the Commission expressly endorse the use of "sweep" accounts involving money market mutual funds or other permissible forms of investment.[12]

- Scope of Rule 1.25

The Bank presumes that the limitations upon permissible investments of customer funds in the proposed rules apply exclusively to the discretionary investments by FCMs and clearing organizations. However, several of the (issuer) concentration restrictions and the average portfolio maturity refer to the “amount required to be segregated”. It should be clarified that the restrictions placed on FCMs and clearing organizations by the proposed modifications to Rule 1.25 apply only to the portfolio of securities (required to be segregated) reflecting the discretionary investment of customer funds by FCMs and clearing organizations and do not extend to the larger “amount required to be segregated” reflecting all customers’ performance collateral received by FCMs and clearing organizations.

Conclusion

The reinvention of the Commission's role in the regulation of derivatives markets is a huge undertaking and of great importance. The Bank hopes that its comments will be helpful as the Commission refines its proposed regulations to better achieve the intended objectives.

[12] A "sweep" account is a demand deposit account that typically is linked with a money market mutual fund. At the end of each business day, balances are "swept" out of the demand deposit account and invested overnight in the mutual fund.