

MEMORANDUM

TO: Anne Chafer
FROM: Michael Lefever *ML*
SUBJECT: CFTC Authority Over Futures Clearinghouses

This responds to your question regarding the authority of the Commodity Futures Trading Commission ("CFTC") to regulate futures clearinghouses. Each board of trade has as an affiliated organization a separate clearinghouse. A principal function of the clearinghouse in the futures markets is the comparison and clearing of futures transactions, a process which includes severance of the privity between the original parties to a futures contract and substitution of the clearinghouse as buyer to the seller and seller to the buyer. _/ The clearinghouse also collects original margin from both buyers and sellers and transfers variation margin between accounts. Finally, the clearinghouse is the entity through which financial settlement is made in the event of delivery.

Like boards of trade, clearinghouses are not registered with the CFTC. However, Sec. 4 of the Commodity Exchange Act ("CEA") makes it unlawful to engage in the purchase or sale of a commodity for future delivery unless the transaction

_/ The precise manner in which this process takes place is prescribed by the rules or bylaws of either the board of trade or the clearinghouse.

is executed by or through a member of a board of trade which has been designated as a "contract market" by the CFTC. In accordance with Sec. 5a(12) of the CEA each contract market must submit to the CFTC for approval "all bylaws, rules, regulations, and resolutions made or issued by such contract market * * * which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements except those relating to the setting of levels of margin." CFTC Reg. § 1.41(a)(3) promulgated pursuant to Sec. 5a(12) of the CEA which governs the submission of rules to the CFTC defines the term "contract market" to include "a clearing organization that clears trades for the contract market."

Similar to the requirements of Sec. 19(b) of the Securities Exchange Act, and the rules thereunder, Sec. 5a(12) and Reg. § 1.41 generally require pre-effective approval of contract market rules _/ in some cases following publication of notice for public comment. _/ The only exception

_/ In an emergency situation, a temporary emergency rule can be put into effect without prior CFTC approval, but cannot continue in effect for more than 30 days without express CFTC authorization. Reg. § 1.41(f). The regulation details types of emergency rules which may be necessary some of which relate to matters involving settlement.

_/ Unlike the securities laws only proposed rule change "of major economic significance" require notice and comment. Proposed rule changes require CFTC approval whether or not they are of major economic significance.

to the foregoing requirements not based on circumstances is with respect rules which are "operational or administrative in nature." _/

In addition, Sec 8a(7) of the CEA authorizes the CFTC to alter or supplement the rules of a contract market upon refusal of a contract market upon request of the CFTC to do so. Such rules may relate to, among other things, the "terms or conditions in contracts for sale", as well as "the form and manner of handling, recording, and accounting for customers' orders, transactions, and accounts."

The definition of contract market in Reg. § 1.41 to include the clearinghouse for purposes of Sec. 5a(12) originally was proposed for public comment in 1976 and generated considerable opposition both from contract markets and clearing organizations. The CFTC concluded, however, that "in light of the importance of [CFTC] review of the substantive reviewable rules to the regulatory scheme of the Act" the arguments presented were not persuasive. _/ In particular,

_/ Reg. § 1.41(c). Such rules nevertheless must be submitted to the CFTC for a determination of whether the rule is subject to the approval process.

_/ See 41 F.R. 40091 (September 17, 1976), reprinted in [1975-77 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,208 at 21,140-1. The portion of the CFTC release discussing the application of Reg. § 1.41 to clearing organizations is attached.

the CFTC concluded: (1) transactions for future delivery not secured through a clearing system would be "contrary to the public interest" and accordingly, that the existence of a clearing organization was a "necessary prerequisite to receiving and retaining designation as a contract market"; (2) the fact that a clearing organization may be a separate corporate entity from a designated contract market does not detract from the CFTC's "broad regulatory power to oversee contract market efforts" to "insure the integrity of the contracts for which they are designated;" and (3) defining a clearing organization as a contract market is for purposes of Reg. § 1.41 only and therefore would not have the effect of exposing the clearinghouse guaranty funds to unrelated liabilities of the contract market. _/

_/ The CFTC also rejected the argument that because the terms "clearing organization," "clearinghouse" or "clearing agency" were used at other places in the CEA, and that those terms were absent in §5a(12), Congress did not intend that such entities be subject to the requirements of the provision.

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