Please note that the comments expressed herein are solely my personal views

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
United States
www.cftc.gov

Chris Barnard
Germany

20 May 2011

- 17 CFR Parts 1, 16 and 38
- RIN Number 3038-AD09
- Core Principles and Other Requirements for Designated Contract Markets

Dear Mr. Stawick.

Thank you for giving us the opportunity to comment on your notice of proposed rulemaking: Core Principles and Other Requirements for Designated Contract Markets.

You are proposing new rules and amended guidance and acceptable practices to implement the new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The proposed rules, guidance and acceptable practices, which apply to the designation and operation of contract markets, implement Dodd-Frank's new statutory framework that, among other things, amends Section 5 of the Commodity Exchange Act (CEA) concerning designation and operation of contract markets, and adds a new CEA Section 2(h)(8) to include the listing, trading and execution of swaps on designated contract markets. The CFTC requests comment on all aspects of the proposed rules, guidance and acceptable practices.

I support the thrust of the proposed rules, which codify and extend existing guidance and introduce new rules in a comprehensive manner. They strike the right balance between a principles-based and a rules-based approach. I agree that some bright-line regulations are necessary to facilitate compliance here, and that this is consistent with the overriding principle that unless otherwise determined by the CFTC, a board of trade shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles as described.

I would support the requirement that all swaps required to be cleared must be traded on Designated Contract Markets (DCMs) or swap exchange facilities (SEFs) unless no DCM or SEF makes the swap available for trading. To facilitate this I would suggest that there should be a level playing field between DCMs and SEFs as far as is possible and relevant given their respective functions.

Trade reconstruction

Subparts C, E, K and M all reference the requirement that a DCM must be able to reconstruct trading and trade activity. § 38.256 (Trade reconstruction) under Subpart E – Prevention of Market Disruption describes this clearly: "The designated contract market must have the ability to comprehensively and accurately reconstruct all trading on its trading facility". I agree with this. For the avoidance of doubt, the reconstruction requirement must include all trading events, including the entry of bids and offers in the order of their occurrence, as well as executed trades in order to allow a proper forensic examination and verification of trading activities.

Subpart C: Compliance With Rules

§ 38.150(b) (Capacity of contract market) states that: "The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market". This is the first of many references to sanctions in the proposed rules. For example under Subpart K Trade Information, § 38.553(b) (Enforcement program required) refers to levying "meaningful sanctions when deficiencies are found". I strongly support the levying of meaningful sanctions. A properly functioning sanctions regime must incorporate the following three main principles:

1) sanctions imposed must be significantly greater than potential benefits derived from a breach of rules;
2) sanctions should be targeted at those parties who stand to gain from a breach of rules, whether natural or legal persons;
3) sanctions imposed should normally include a public reprimand and / or be published.

Although out of scope here, I would also encourage the introduction of a stronger whistleblowing program generally. A well-designed whistleblowing program would reinforce the integrity of internal compliance programs, help to encourage employees to identify violations, and also to assist their companies / entities in taking preventative as well as corrective action.

§ 38.151(b)(2) requires a DCM to charge its members, market participants and independent software vendors comparable fee structures for equal access to, or services from, the DCM. I strongly support this requirement. The only reason for charging different fee structures would relate to differing costs of providing access or service to particular categories. Anything else would be discrimination[1] by definition.

[1] E.g. hidden and unfair cross-subsidiy.

§ 38.152 establishes the prohibition of abusive trading practices. This also refers to the prohibition of "any other manipulative or disruptive trading practices prohibited by the Act or by the Commission". This is important in order to cover new disruptive practices as they emerge.[2]

§ 38.155 requires a DCM to have sufficient compliance staff and resources. I would expect this requirement to include a chief compliance officer, working within a job description, structures, rules and procedures that act to maintain its independence.

Subpart E: Prevention of Market Disruption

I support the proposals here, particularly those under § 38.255 (Risk controls for trading), which require a DCM to pause or halt trading in order to reduce the potential risk of market disruptions. However, the wording here seems to establish the use of this particular market restriction as a requirement, rather than as an option. This is too prescriptive. I would recommend instead that you should clarify that a DCM should establish and maintain appropriate risk control mechanisms tailored to meet risk mitigation needs by product type, business and market circumstances, and which may include pauses or halts, daily price limits or other mechanisms.

Subpart J: Execution of Transactions

This section is very significant and represents a dramatic shift in the direction of rulemaking. § 38.500 Core Principle 9 states that: "The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade." I fully agree with this principle. § 38.502 then establishes the minimum centralized market trading requirements for all contracts listed on a DCM, and requires at least 85% of the trading in a listed contract to occur on the DCM's centralized market, the 85% threshold being determined from a review of certain data.[3] This proposal is not consistent with the requirement to protect the price discovery process, but rather attempts to "enhance" or "promote" the price discovery process. It is a stretch to argue that protecting the price discovery process implies that 85% of trades must occur on exchange. I would argue that protecting the price discovery process should apply to the (existing) traded contracts, and not to promote non-traded contracts to be traded, although I would actually be in favour of this.

As an aside, I would agree that off-exchange transactions should be permitted where necessary and appropriate for bona fide business purposes. I agree with the permissible off-exchange transactions proposed here.

[2] Consider for example "spoofing". Refer to the proposed interpretive order on Antidisruptive Practices Authority, CFTC, March 2011.
[3] The review considered the amount of off-exchange transactions in 570 listed DCM contracts over a three month period. The time period covered in particular seems rather short.

Concerning § 38.504 (Block trades on swap contracts), I would refer to the previous comments that I have made on this issue.[4] Clearly a DCM must have rules that comply with the requirements under part 43.

Subpart M: Protection of Markets and Market Participants

A board of trade must establish and enforce rules to protect market participants from abusive practices. Such rules should also apply to internal abusive practices. For example the commentary states that a DCM must promote fair and equitable trading by "providing to market participants, on a fair, equitable and timely basis, information regarding prices, bids and offers". This is just and reasonable. In order to facilitate this, I would specifically recommend that you should amend the wording of § 38.650 and § 38.651 to reference such fair, equitable and timely provision of information regarding prices, bids and offers. The current wording would only implicitly capture this requirement, and this is not good enough.

Subpart N: Disciplinary Procedures

I agree with these common sense rules that ensure a fair, prompt and effective disciplinary program. Concerning possible sanctions, § 38.714 refers to disciplinary sanctions in some detail. I would suggest again that such sanctions should comply with the three principles stated above. For example sanctions imposed should normally include a public reprimand and / or be published.

Subpart Q: Conflicts of Interest

I have commented on this in some detail before.[5] I believe that mitigating conflicts of interest is critical to promoting transparency and market integrity. I support that a mixture of governance requirements and control, ownership and voting limits would optimally address conflicts of interest issues in this arena.

Subpart S: Recordkeeping

§ 38.950 establishes the recordkeeping requirements. I would recommend that records should be required to be kept indefinitely rather than the "at least 5 years" proposed here. Original documents should be scanned after five years. There is no technological or practical reason for limiting the retention period, and it would be useful to keep this information for future analytical purposes.

[4] Please see my comment letter on your notice of proposed rulemaking: Real-Time Public Reporting of Swap Transaction Data, RIN 3038-AD08, CFTC, December 2010.
[5] Please see my comment letter on your notice of proposed rulemaking: Requirements for Derivatives Clearing Organisations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, RIN 3038-AD01, CFTC, October 2010.

Subpart V: Financial Resources

I support the requirement that a board of trade must maintain financial resources exceeding the total amount that would enable the contract market to cover the operating costs of the contract market for a 1-year rolling period. I would also recommend that a DCM should calculate and regularly publish its Solvency Ratio, which is:

Solvency Ratio = [Available Financial Resources / Financial Resources Requirements].

The CFTC should be immediately notified when the Solvency Ratio falls below 105%.

Summary

The proposed rules are sufficient for implementing the required compliance with DCM core principles B through X. I would specifically recommend some minor changes in order to fully facilitate the proposed rules in accordance with their intention. I have outlined these recommendations under my comments on Subparts E, M, S and V above. I have also made some general comments that should add to a wider debate on various issues.

Yours sincerely

Chris Barnard