

To: The Commission

From: The Division of Trading and Markets *JL by WCB*

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Subject: Application of EnergyClear Corporation ("EnergyClear") for Registration as a Derivatives Clearing Organization (DCO) pursuant to Section 5b of the Commodity Exchange Act ("Act") *'01 JUN 29 PM 17 39*
THE SECRETARIAT

Date: June 26, 2001

Recommendation: That the Commission approve the registration of EnergyClear as a DCO.

Consulting: Division of Economic Analysis *me*
The Office of the General Counsel *ORIM*
The Division of Enforcement *PA*

Copied: Office of Inspector General

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I. Overview of the Applicant

By submissions dated May 3, 2001 through June 21, 2001, EnergyClear, a Delaware not-for-profit corporation, applied to the Commodity Futures Trading Commission ("Commission") for registration as a DCO. Transactions cleared would be only between EnergyClear members ("Members") acting on a principal-to-principal basis. EnergyClear intends initially to clear spot, forward, and over-the-counter ("OTC") derivative contracts executed on commercial markets exempt under Section 2(h) of the Act. Contracts initially eligible for clearing involve electricity, natural gas, and telecommunication bandwidths.

EnergyClear meets the definition of DCO under Section 1a(9) of the Act. It is not required to be a DCO and submits its application pursuant to Section 5b(b) rather than Section 5b(a). EnergyClear's credit enhancement function will depend on the desire of the parties to a contract. It will either (1) act as central counterparty permitting a Member to substitute the credit of EnergyClear for that of its counterparty, or (2) act as guarantor for obligations of Members who are parties to a contract. A transaction will be fully novated unless both parties elect to have it guaranteed. EnergyClear expects most contracts to be novated. Contracts will either be settled by delivery or cash-settled, as defined by their terms.

Contracts will be submitted for clearing by Members, or by Participants¹ on behalf of Members, through the internet or by facsimile, or other form of secure transmission. Members will be eligible commercial entities in wholesale energy and bandwidth markets, including utilities, large industrial and governmental consumers of electricity and natural gas, wholesale power marketers, providers and commercial consumers, commercial buyers and sellers of bandwidth, and financial institutions regularly engaged in the business of buying and selling energy or bandwidth products or entering into derivatives contracts involving energy or bandwidth products. EnergyClear estimates it will have initially 10 to 20 members that account for, in the aggregate, approximately 30% of the typical notional transaction volume in the OTC forward and electricity natural gas markets. Participants will be currently existing voice brokers or the electronic trading facilities executing the contracts. Members and Participants must enter into Member and Participant Agreements with EnergyClear.

EnergyClear will contract with a separate entity, EnergyClear Operations LLC ("Service Company"), to provide certain services with respect to its clearing and settlement operations. Service Company is a for-profit limited liability company jointly owned and controlled by the Bank of New York, Prebon Alliance Inc. and Amerex EOC

¹ Participants will basically broker trades between Members and replace currently existing voice brokers. They will not hold Member funds.

LLC.² Service Company will implement clearing software written by and purchased from OnExchange and OnExchange Clearing Corporation, a contract market designated and DCO registered on December 21, 2000. Bank of New York will be the settlement bank for clearing operations and will interface with EnergyClear's computer systems housed and operated by applications systems provider, Usinternetworking, Inc.

The principal financial resources which will support EnergyClear's clearing activities consist of initial and variation margin deposited by Members, EnergyClear's capital and retained earnings, a clearing fund, and a credit facility. Each Member will be required to make an initial capital contribution of \$100,000 in exchange for its ownership interest in the common stock of EnergyClear. The Service Company is funding all of EnergyClear's start-up costs and retained earnings will grow with receipt of Member clearing fees and monthly maintenance charges.

The clearing fund will consist of a required contribution of \$2.5 million per Member. EnergyClear will be authorized to increase or decrease any Member's Clearing fund contribution based on a formula that takes into account the member's volume of transactions and/or the average aggregate position risk attributable to that Member. Prior to commencing operations, EnergyClear represents that it will arrange for a revolving credit facility with a group of major U.S. financial institutions which will permit it to draw up to \$100 million to be applied to losses not covered by the clearing fund. In addition to these resources, EnergyClear also intends to arrange an insurance facility to provide coverage of up to \$100 million in case of fraud committed against EnergyClear. EnergyClear believes these resources should be sufficient to support its operations under a range of reasonably foreseeable market conditions.

² The Bank of New York ("BNY") is an internationally recognized provider of global securities and related clearance services. Prebon Alliance Inc. ("Prebon") is an affiliate of Prebon Yamane (USA) Inc. Affiliates of Prebon act as a broker or dealer on a global basis in a broad range of markets, including foreign exchange, OTC derivatives, securities and emerging market and energy products. Amerex EOC LLC ("Amerex") is an affiliate of Amerex, Inc., which is one of the world's largest OTC energy brokers and provides voice and electronic brokerage services to global institutional energy customers. BNY, Prebon, Amerex and their respective affiliates are not expected to own an interest in EnergyClear as a Member but may act as Participants for purposes of submitting contracts on behalf of Members for clearance and settlement.

EnergyClear's application, consisting of, among other things, bylaws, rules, and member and service agreements, has been reviewed in light of the core principles set forth in Section 5b of the Act. The following chart sets forth the Section 5b core principles and how EnergyClear satisfactorily demonstrates compliance with each. It contains relevant supporting references to EnergyClear's May 3rd submission letter ("Letter"), bylaws, rules, and other materials. Staff's analysis of EnergyClear's application is based on these materials, representations made in EnergyClear's letter of May 3, 2001 submitting its application and describing its proposed operations as a DCO, and answers to questions staff has presented to EnergyClear. The chart represents a condensed version of a more detailed 43 page assessment illustrating how EnergyClear satisfies the Core Principles. That document is available upon request.

II. Analysis of EnergyClear's proposed rules with the Act's Core Principles for DCOs.

DCO Core Principle	EnergyClear Application	Comments
<p>Core Principle A:</p> <p>In General - To be registered and to maintain registration as a derivatives clearing organization, an applicant shall demonstrate to the Commission that the applicant complies with the core principles specified in this paragraph. The applicant shall have reasonable discretion in establishing the manner in which it complies with the core principles.</p>	<p>Application dated May 3, 2001.</p>	<p>Acceptable.</p> <p>Staff believes EnergyClear's ("EC") application demonstrates EC's compliance with all Section 5b core principles. EC has, among other things, adequate financial resources, risk management, clearing, settlement and default procedures, safeguards for funds and the operations of its computer systems, rule enforcement procedures and, reporting and recordkeeping requirements.</p>
<p>Core Principle B:</p> <p>Financial Resources -- The applicant shall demonstrate that the applicant has adequate financial, operational, and managerial resources to discharge the responsibilities of a derivatives clearing organization.</p>	<p>Initial and Variation Margin; Capital and Retained Earnings; Clearing Fund; \$100 million Revolving Credit Facility; and \$100 million Insurance policy. Letter, pp.5-8; Rules: Article II, Section 2;</p>	<p>Acceptable.</p> <p>Each Member must deposit \$2.5 million in the clearing fund and make an initial contribution of \$100,000 in exchange for common stock. The credit facility will be</p>

	<p>Admission Criteria; Article V; Margin Article VI, Clearing Fund;</p> <p>Day-to-Day operational resources will be provided by Service Company.</p>	<p>arranged with a consortium of major U.S. financial institutions. EC represents that its financial resources should be sufficient to support its operations under reasonably foreseeable adverse market conditions.</p> <p>Service Company will procure, test, operate, and maintain EC's automated systems and provide a variety of other operational services including, inter alia, margin calculation, execution of risk management procedures, negotiation for custodial services, processing Member applications, compliance surveillance, and provision of the operating facility.</p>
<p>Core Principle C:</p> <p>Participant and Product Eligibility--The applicant shall establish (i) appropriate admission and continuing eligibility standards (including appropriate minimum financial requirements) for members of and participants in the organization; and (ii) appropriate standards for determining eligibility of agreements, contracts, or transactions submitted to the applicant.</p>	<p>Members must be "Eligible Commercial Entities", meet specified financial, operational and regulatory requirements and be approved by the full Board. Criteria for membership governed by EC Rules, Article II.</p> <p>Eligible contracts must satisfy certain criteria relating to their material economic terms and must satisfy EC's "risk analytics." Letter, pp 12-13. Rules, Article IV, Submission and Acceptance of Contracts, Sections I-5.</p>	<p>Acceptable.</p> <p>Generally, only ECEs that are wholesale participants, large industrial or governmental producers or consumers, FERC power marketers, large financial institutions that buy or sell the commodity can be Members, and they must demonstrate sufficient operational capacity and generally have at least \$2 million working capital.</p> <p>Contracts eligible for clearing involve electricity, natural gas, and telecommunication bandwidths between Members acting on a principal-to-principal basis. EC intends initially to clear spot, forward, and OTC derivative contracts executed on excluded electronic trading facilities under the exemption set forth in Section 2(h) of the Act. It may clear futures contracts later. EC represents that it understands that it must either request approval of or self-certify any new contract for clearing in accordance with Section 5c(c) of the Act.</p>

<p>Core Principle D:</p> <p>Risk Management -- The applicant shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures.</p>	<p>EC will determine initial margin requirements using a margining algorithm based on SPAN®.</p> <p>Margin assets are valued daily.</p> <p>EC will have a Risk Management Committee which will evaluate risk on a regular basis.</p> <p>Purchased options will be margined "options-style." EC will impose a higher minimum level of initial margin for short options than would be required by normal application of SPAN.</p> <p>Members must file quarterly financial reports, certified annual report, copies of any regulatory reports, and reports of material events. Rules, Article III, Sections 1-4.</p> <p>Position limits are based on a Member's working capital, and Clearing Fund contribution. Letter, pp.20-21 Rules, Article V, Section 15.</p> <p>A member may be placed on "Advisory Surveillance Status". Letter, pp 11-12. Rules, Article III, Section 4.</p> <p>EC maintains a perfected security interest in the Clearing Fund and margin assets. Member Agreement, Section 11.</p>	<p>Acceptable.</p> <p>In calculating initial margin, EC will use an combined-averaged normal distribution and a nonparametric approach to the estimation of the volatility which results in a more conservative measure of the price risk presented than typical application of SPAN by other clearing organizations.</p> <p>Under options-style margining the option purchaser will be required to pay the full premium of the option at the inception of the transaction. The higher level of minimum initial margin for short options is at a level designed to protect against the additional risk posed if the option becomes deep out-of-the-money.</p> <p>The Risk Committee will employ stress testing (effect of extreme price movements) scenario analysis, and value-at-risk calculations to evaluate credit and liquidity exposure using its margining algorithm the underlying assumptions of which will be tested and updated biweekly to assess the adequacy of financial resources. If insufficient, EC may increase required clearing fund or capital contribution or increase initial margin requirements. EC represents it will research and develop new risk management tools.</p> <p>Assets eligible for margin are cash, government securities, irrevocable letters of credit that can be drawn on same day, and certain transferable corporate debt. Securities are subject to a haircut ranging from 5 to 10%. Variation margin can only be cash.</p>
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<p>Core Principle E:</p> <p>Settlement Procedures – The applicant shall have the ability to (i) complete settlements on a timely basis under varying circumstances; (ii) maintain an adequate record of the flow of funds associated with each transaction that the applicant clears; and (iii) comply with the terms and conditions of any permitted netting or offset arrangements with other clearing organizations.</p>	<p>EC represents that it will implement procedures to effect settlements on a timely basis under varying circumstances and to maintain an adequate record of the flow of funds associated with each cleared transaction. Letter p 21.</p> <p>Settlement procedures and timeframes are addressed fully in the Rules, Article VII, Settlement and Delivery and Article V, Margins. Different procedures apply to cash-settled vs. delivery contracts.</p> <p>Daily variation margin is required.</p> <p>Transfers of funds between EC and Members must be in accordance with standard interbank practices.</p> <p>Although its rules permit, EC does not contemplate any netting, offset, or cross-margining arrangements with other clearing organizations at this time. Letter, p 24.</p>	<p>Acceptable.</p> <p>EC will monitor daily payments and collections. If discrepancies or settlement failures occur, EC will intervene immediately to take corrective action or declare a Member in default.</p> <p>Each Member must maintain an account with Bank of New York , the settlement bank.</p> <p>For physical settlements, members must provide EnergyClear with settlement completion notices</p>
<p>Core Principle F:</p> <p>Treatment of Funds – The applicant shall have standards and procedures designed to protect and ensure the safety of member and participant funds.</p>	<p>Member funds (and non-cash assets) will be held in segregated subaccounts of EC's account with Bank of New York. Member funds may not be commingled with EC funds or counted towards EC working capital. EC may, however, commingle funds and non-cash assets of different Members in the same segregated account. Letter, p 24-25.</p>	<p>Acceptable.</p> <p>Since only ECEs will have transactions cleared, there will be no customers in the traditional sense and so no procedures or rules for the safeguarding of customer vs. proprietary or other funds will be employed. Participants would never hold Member funds (confirmed via 6/5/01 conversation with outside counsel).</p>
<p>Core Principle G:</p> <p>Default Rules and Procedures – The applicant shall have rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the derivatives clearing organization.</p>	<p>Rules Article IX defines events of default and procedures and remedies available to EC. Financial resources are applied to losses in the following order: defaulted member's margin and clearing fund contribution, pro rata assessment of all members' clearing fund contributions, then amounts borrowed under the credit facility.</p>	<p>Acceptable.</p> <p>Members can be suspended upon default (and in less than complete default situations when determined to be in the best interests of the DCO and its Members.) Minimum due process procedures are afforded suspended members. EC may terminate, liquidate, transfer, hedge, or close out a suspended Member's contracts. EC may apply defaulted</p>

		<p>Member's margin first to cover losses and then the Member's clearing fund contribution.</p> <p>A bankrupt Member's margin payments to EC cannot be avoided as a preference since payments made by or <i>to</i> a commodity broker are exempt from being voidable preferences under Section 546(e) of the Bankruptcy Code. DCOs are commodity brokers for this purpose under Section 101(6) and 761(9) of the Bankruptcy Code.</p>
<p>Core Principle II:</p> <p>Rule Enforcement – The applicant shall --(i) maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with rules of the applicant and for resolution of disputes; (ii) have the authority and ability to discipline, limit, suspend, or terminate a member's or participant's activities for violations of rules of the applicant.</p>	<p>EC represents that it will have a program to monitor and enforce compliance with its rules and to resolve disputes among Members, and will discipline, limit, suspend or terminate a Member's activities for rule violations. Letter p 29. Rules Article VIII contain the disciplinary procedures.</p>	<p>Acceptable.</p> <p>Service Company will run the rule violation surveillance program. A Disciplinary Committee will determine if a violation has taken place based on evidence provided by Service Company or an EC official. Penalties include censure, fine, and suspension. Minimal due process such as notice, opportunity to answer, a hearing, and appeal are provided.</p>
<p>Core Principle I:</p> <p>System Safeguards – The applicant shall demonstrate that the applicant (i) has established and will maintain a program of oversight and risk analysis to ensure that the automated systems of the applicant function properly and have adequate capacity and security; and (ii) has established and will maintain emergency procedures and a plan for disaster recovery, and will periodically test backup facilities sufficient to ensure daily processing, clearing, and settlement of transactions.</p>	<p>The Applications Systems Provider (ASP) that will provide and operate all automated systems meets the IOSCO standards. EC represents that it, the ASP, and onExchange (the author/vendor of the clearing software) will maintain an oversight and risk analysis program to ensure adequate capacity and security, and will maintain emergency procedures and a plan for disaster recovery and will periodically test backup facilities. Letter pp 31-35.</p>	<p>Acceptable.</p> <p>Staff conducted an on-site review of the ASP on May 22. The ASP satisfactorily demonstrated how it will meet each of the applicable IOSCO standards including, among others, those involving physical security, environmental controls, network management, capacity and systems testing.</p>
<p>Core Principle J:</p> <p>Reporting --The applicant shall provide to the Commission all information necessary for the Commission to conduct the oversight function of the applicant with respect to the activities of the derivatives clearing organization.</p>	<p>EC undertakes to provide the Commission with all information necessary for the Commission's oversight function. Letter, pp.35-36. Rules Article XII.</p> <p>A daily clearing report of all transacted business will be made available to Members. Article IV, Section 6.</p>	<p>Acceptable.</p> <p>EC states it will produce a daily data file at least as comprehensive as a trade register available to the Commission on a daily basis. EC rules do require EC to keep certain proprietary Member information confidential.</p>
<p>Core Principle K:</p> <p>Recordkeeping - The applicant shall maintain</p>	<p>EC represents it will maintain for at least five years records of all activities related to its business as a</p>	<p>Acceptable.</p> <p>For the first two years all records</p>

<p>records of all activities related to the business of the applicant as a derivatives clearing organization in a form and manner acceptable to the Commission for a period of 5 years.</p>	<p>DCO and will comply with all of the requirements of Commission Regulation 1.31. Letter p 37.</p>	<p>will be readily available for electronic downloading</p>
<p>Core Principle L:</p> <p>Public Information – The applicant shall make information concerning the rules and operating procedures governing the clearing and settlement systems (including default procedures) available to market participants.</p>	<p>EC represents it will provide to Members EC's Rules and operating procedures including default procedures. Members will be made aware of all new developments through posting on EC's web site, e-mail or other communication. Letter p 38.</p>	<p>Acceptable.</p> <p>Since Members must be ECEs, no public dissemination of trading data or other information to anyone other than Members is contemplated.</p>
<p>Core Principle M:</p> <p>Information Sharing -- The applicant shall (i) enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements; and (ii) use relevant information obtained from the agreements in carrying out the clearing organization's risk management program.</p>	<p>EC is authorized to enter information-sharing agreements under Rules Article XII. Although EC has not yet entered into any information-sharing arrangements, EC states that it is prepared to enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements and to use relevant information obtained from such agreements in carrying out its risk program. Letter pp 37-38.</p>	<p>Acceptable.</p> <p>EC states that it recognizes the importance of these arrangements to monitor Members' ability to perform and is exploring arrangements with other clearing organizations to obtain pay and collect information as well as coordinated surveillance groups, such as, among others, the Intermarket Financial Surveillance Group and the Unified Clearing Group. EC states it will advise the Commission of its entry into arrangements.</p>
<p>Core Principle N:</p> <p>Antitrust Considerations -- Unless appropriate to achieve the purposes of the Act, the derivatives clearing organization shall avoid (i) adopting any rule or taking any action that results in any unreasonable restraint of trade; or (ii) imposing any material anticompetitive burden on trading on the contract market.</p>	<p>EC agrees to avoid adopting any rule or taking any action that results in any unreasonable restraint of trade or imposing any material anticompetitive burden on trading in the relevant markets for cleared contracts, unless such action is appropriate to achieve the purposes of the Act. Letter p 38.</p>	<p>EC believes that its clearing structure is open and transparent and will not create any anticompetitive burden or restraint on trading in the energy or bandwidth markets and, by reducing counterparty credit risks in those markets, may enhance the efficiency and competitiveness of such trading.</p>