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OFFICE OF THE SECRETARIAT

**To:** The Commission

**From:** The Division of Trading and Markets *ADG*

**Subject:** Application of BrokerTec Clearing Company, L.L.C. ("BCC" or "BrokerTec Clearing") for Registration as a Derivatives Clearing Organization ("DCO") pursuant to Section 5b of the Commodity Exchange Act ("Act")

**Recommendation:** That the Commission approve the registration of BCC as a DCO, and simultaneously approve its proposed Bylaws and Rules.

**Consulting:** The Division of Economic Analysis *jm*  
The Division of Enforcement *BA*  
The Office of the General Counsel *DEM*

**Processing Information:**

Responsible Staff		
Official Receipt Date: 3/29/01	Duane Andresen	418-5492
Review Period Stayed: No		

## **I. Background of the Applicant**

By letters dated May 8, 2000, through June 8, 2001, BCC, a Delaware limited liability company and an indirect affiliate of BrokerTec Global, L.L.C. ("BrokerTec Global"), applied to the Commodity Futures Trading Commission ("Commission") for registration as a DCO. BCC also applied for Commission approval of various proposed rules and bylaws necessary to the establishment of a DCO. BCC's application was accompanied by a designated contract market application from BrokerTec Futures Exchange, L.L.C. ("BTEX" or "Exchange"), another indirect affiliate of BrokerTec Global.<sup>1</sup> BrokerTec Clearing would be responsible for clearing and settlement functions for the proposed Exchange. In this connection, BCC has contracted with the Board of Trade Clearing Corporation ("BOTCC") to provide certain clearing processing services for trades executed on or through BTEX.<sup>2</sup>

BrokerTec Clearing would establish and maintain a Guaranty Fund, which BCC represents is presently expected to be capitalized in an amount of at least \$50 million upon commencement of operations. The amount to be deposited and maintained in the Guaranty Fund by each clearing member would be an amount equal to the clearing member's proportionate percentage of volume and open interest, which BCC would recalculate periodically. BCC also would have the ability to impose assessments on nondefaulting clearing members to meet a shortfall caused by the default of another clearing member, subject to specified limitations.

BrokerTec Clearing's application includes proposed bylaws and rules pertaining to BCC governance, clearing membership, financial requirements, clearing procedures, margins and

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<sup>1</sup> BTEX would utilize an automated trading system that would be accessed through a dedicated network, rather than the Internet. The Exchange's application included a proposal to list four U.S. Treasury securities futures contracts.

<sup>2</sup> As part of its application, BCC submitted to the Commission a redacted version of the BCC-BOTCC Processing Services Agreement. In order to assure the completeness of BCC's application, Commission staff reviewed unredacted copies of that agreement in the Washington, DC, office of BCC counsel on March 29, 2001.

premiums, deliveries, defaults, disciplinary procedures, and various other materials to meet the requirements for an applicant seeking registration as a derivatives clearing organization.

As set forth in Section II of this memorandum, the BCC application demonstrates compliance with the Act's Registration Requirements and Core Principles regarding registration of derivatives clearing organizations. Accordingly, staff recommends that the Commission approve the registration of BCC as a DCO and simultaneously approve the following BCC Bylaws and Rules: BCC Bylaws Sections 1.1, 1.2, 2.1 - 2.7, 3.1 - 3.19, 4.1 - 4.5, 5.1 - 5.15, 6.1 - 6.12, 7.1 - 7.5, 8.1 - 8.5, 9.1 - 9.5, 10.1, and 11.1 - 11.13 and BCC Rules 101 - 110, 201 - 209, 301, 302, 401 - 404, 501 - 507, 601 - 603, 801 - 805, and 901 - 907.

**II. Analysis of BCC's proposed Bylaws and Rules for compliance with the Act's Registration Requirements for Derivative Clearing Organizations.**

DERIVATIVES CLEARING ORGANIZATION REGISTRATION REQUIREMENTS	BROKER/DEALER CLEARING COMPANY PROPOSAL	COMMISSION
<p><b>Sec. 5b(c) Registration of Derivatives Clearing Organizations</b></p> <p><b>(1) Applications</b> – A person desiring to register as a derivatives clearing organization shall submit to the Commission an application in such form and containing such information as the Commission may require for the purpose of making the determinations required for approval under paragraph (2).</p>	<p>Application Complete.</p>	<p>Acceptable.</p> <p>See Attachments.</p>
<p><b>Sec. 5b(c)(2) – Core Principles</b></p>		
<p><b>Core Principle (A) -- In General:</b> 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</p>	<p>Application Complete.</p>	<p>Acceptable.</p> <p>BCC would have its own financial resources, market protection mechanisms (as described in its Bylaws and Rules), risk management staff, and internal controls in place to monitor risk exposure and maintain the financial</p>

<p>the manner in which it complies with the core principles.</p>		<p>integrity of BTEX and BCC.</p>
<p><b>Core Principle (B) – Financial Resources:</b> demonstrate that the applicant has adequate financial, operational, and managerial resources to discharge the responsibilities of a derivatives clearing organization.</p>	<p>BCC Bylaw Article VII (Clearing Members), Sections 7.2 (Guaranty Fund), 7.3 (Monetary Defaults; Use of Guaranty Fund; Assessments), 7.5 (Original Margin). BCC-BOTCC Processing Services Agreement. February 15, 2001 letter to the Commission.</p>	<p>Acceptable.</p> <p>BCC would commence operations with initial capital of at least \$3 million and a Guaranty Fund of at least \$50 million. Until a date set by the Board at least six months after BCC clears its first contract, each clearing member would deposit and maintain at least \$300,000 in the Guaranty Fund. Commencing six months following the date on which BTEX is open for trading, each clearing member would deposit and maintain in the Guaranty Fund an amount equal to the member's proportionate percentage of volume and open interest as determined quarterly. Guaranty Fund deposits could be made in cash or securities that are direct obligations of the US Government, provided that at least \$50,000 of each deposit would be in cash.</p> <p>BCC would be appropriately staffed and has entered an agreement with BOTCC to provide trade and data processing services and related operational support.</p>
<p><b>Core Principle (C) – Participant and Product Eligibility:</b> 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>BCC Bylaws Section 7.1 (Status of Clearing Members); BCC Rules 201 (Eligibility Requirements), 202 (Procedure for Becoming a Clearing Member), 203 (Obligations of Clearing Members), 205 (Documents Submitted to the Company), 206 (Records and Information); 301 (Reporting [Financial Requirements]), 401 (Acceptance for Clearance), 402 (Trade Data Submission). February 15, 2001 letter to the Commission.</p>	<p>Acceptable.</p> <p>A clearing member would have to be an entity, be a member of BTEX, and be approved by BTEX to be a clearing member. A clearing member would have to either (1) have capital of not less than \$50 million, (2) have a guarantee of the applicant's obligations from an affiliate of the applicant which has capital of not less than \$50 million, or (3) be either a category 1 Dealer Netting Member (net worth of at least \$50 million and excess net [or liquid] capital of at least \$10 million) or a category 1 FCM Netting Member (\$50 million in net worth and \$10 million in excess adjusted net capital) of the Government Securities Clearing Corporation.</p> <p>A member would have to have, in</p>

		<p>the judgment of the Board of Directors, appropriate qualities of financial responsibility, operational capacity, experience, business integrity, reputation, and competence as the Board may consider necessary.</p> <p>A member would also have to be a Class B shareholder of BCC or an affiliate of such a shareholder. To become a Class B shareholder an applicant would have to be, among other things, an "accredited investor" as defined in Rule 501(a) of Regulation D of the Regulations of the SEC under the Securities Act of 1933.</p> <p>Clearing members would be required to routinely file financial statements and to provide other financial and non-financial information as requested.</p> <p>BCC would clear contracts matched by BTEX and submitted by or for BTEX on behalf of the clearing members that were the parties thereto.</p>
<p><b>Core Principle (D) – Risk Management:</b> 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>Risk Management Policy and Procedures. BCC Bylaws Section 7.5 (Original Margin). BCC Rules Part 5 (Margins and Premiums). BCC-BOTCC Processing Services Agreement. October 26, 2000 and February 15, 2001 letters to the Commission.</p>	<p>Acceptable.</p> <p>Each clearing member would be required to deposit with BCC initial and variation margin in amounts and forms determined by the Board of Directors. Original and variation margin would be calculated and collected daily. A clearing member could substitute for cash on deposit as original margin securities, approved foreign currencies, and/or letters of credit meeting Rule requirements. Variation margin would be required to be in cash.</p> <p>BOTCC would make available online to BCC and to each participant, not later than certain specified deadlines, reports that would identify margin and collateral requirements and deposits. BOTCC would revalue all collateral as appropriate. BCC would calculate intra-day and end-of-day settlements and SPAN margin requirements.</p>

		BCC would establish a Risk Management Committee, supported by a risk management staff, which would recommend to the Board margin requirements, acceptable forms of margin deposit with appropriate haircuts, guaranty fund levels, and other risk-related issues.
<b>Core Principle (E) – Settlement Procedures:</b> 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.	BCC Rules 503 (Cash Margin Deposits), 203 (Obligations of Clearing Members), 205 (Documents Submitted to the Company), 206 (Records and Information). BCC-BOTCC Processing Services Agreement. Agreements with Approved Financial Institutions. October 26, 2000 and February 15, 2001 letters to the Commission.	Acceptable.  BCC and clearing members would establish and maintain margin and settlement accounts with approved financial institutions. BOTCC would issue margin and collateral transfer, delivery, settlement and payment instructions to settlement banks for BCC and participants. BOTCC would notify BCC of failures by a settlement bank, clearing organization, or other entity confirming payment or delivery to timely confirm any delivery, transfer or payment or other failure to timely make any delivery, transfer or payment in respect of contracts for which BOTCC was responsible.
<b>Core Principle (F) – Treatment of Funds:</b> have standards and procedures designed to protect and ensure the safety of member and participant funds.	BCC Rules Part 5 generally (Margins and Premiums). BCC Rules 503 (Cash Margin Deposits), 505 (Deposits of Securities, Approved Foreign Currencies, and Letters of Credit as Original Margin). February 15, 2001 letter to the Commission.	Acceptable.  Clearing members would be required to maintain separate clearing accounts for proprietary and customer accounts with Approved Financial Institutions. BCC would invest customer funds only in instruments permitted under Commission regulations and would segregate such instruments. Depository institutions would be required to acknowledge that such funds belonged to customers and were being held according to the Act and Commission regulations.
<b>Core Principle (G) – Default Rules and Procedures:</b> 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.	BCC Bylaw Section 7.3 (Monetary Defaults; Use of Guaranty Fund; Assessments). BCC Rules Part 8 (Defaults); BCC Rule 208 (Obligations of Suspended Clearing Member). February 15, 2001 letter to the Commission.	Acceptable.  If a clearing member, among other things, failed to make a required margin, premium, or other payment when due, that failure would constitute a monetary default. The defaulting member's original margin on deposit, its Guaranty Fund deposits, and any of its other assets under the control of BCC would be applied to pay the defaulted

		<p>obligation. If the default relates to a contract carried in the clearing member's proprietary account, the Guaranty Fund deposit and only that portion of such margin and such other assets as are held for the proprietary account would be applied to pay the obligation.</p> <p>If the Guaranty Fund deposit and other assets of the defaulting clearing member were less than the obligation, and the defaulting clearing member failed to pay the deficiency on demand, BCC could meet the deficiency by applying other sources of funds including any BCC surplus, any loan proceeds, the balance of the Guaranty Fund, any insurance proceeds, and assessments imposed upon clearing members pursuant to formulas set forth in the Bylaws.</p>
<p><b>Core Principle (H) – Rule Enforcement:</b> (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>BCC Rule 203 (Obligations of Clearing Members). BCC Rules Part 9 (Disciplinary Proceedings). BTEX Rules Parts 7 (Disciplinary Proceedings) and 8 (Arbitration). NFA-BTEX Regulatory Services Agreement.</p>	<p>Acceptable.</p> <p>Suspected Bylaw or Rule violations would be referred to BTEX Enforcement staff for appropriate action in accordance with BTEX Rules and NFA-BTEX Regulatory Services Agreement. With authorization of BTEX's Compliance Director, NFA would investigate possible rule violations and present written investigation reports to the BTEX Business Conduct Committee for consideration of appropriate disciplinary action, if any.</p> <p>BCC could impose summary fines for certain financial and reporting violations. Dispute resolution would be accomplished pursuant to BTEX arbitration procedures.</p>
<p><b>Core Principle (I) – System Safeguards:</b> 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</p>	<p>Bylaws Article IX generally (Emergency Powers). Disaster Recovery Plan (Exhibit O to BTEX Application for Designation). BCC-BOTCC Processing Services Agreement.</p>	<p>Acceptable.</p> <p>During a demonstration and mock trading session of the BTEX system on April 20, 2001, Commission staff observed the successful generation and transmission of trading data to the BTEX clearing agent, BOTCC. Subsequent to BOTCC's processing activities, the Commission received printed reports from BOTCC that</p>

<p>periodically test backup facilities sufficient to ensure daily processing, clearing, and settlement of transactions.</p>		<p>confirmed the proper operation of their clearing system.</p> <p>Earlier reviews by Commission staff of the BOTCC clearing system coupled with years of successful operation have shown that system meets the standards for functional capability, security, and capacity that are established in the IOSCO principles for screen-based trading.</p>
<p><b>Core Principle (J) – Reporting:</b> 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>Affirmative Representation from BCC dated February 15, 2001, that it would comply with Core Principle.</p>	<p>Acceptable.</p> <p>BCC would provide information to the Commission upon request and would participate in the Exchange Database System project.</p>
<p><b>Core Principle (K) – Recordkeeping:</b> maintain 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>BCC Rule 206(Records and Information). Affirmative Representation from BCC dated February 15, 2001, that it would comply with Core Principle.</p>	<p>Acceptable.</p> <p>All records required under BCC Bylaws and Rules would be retained for the time and in the manner specified by the Act and Commission regulations.</p> <p>Data would be safely stored and retained pursuant to Commission Regulation 1.31.</p>
<p><b>Core Principle (L) – Public Information:</b> make information concerning the rules and operating procedures governing the clearing and settlement systems (including default procedures) available to market participants.</p>	<p>Affirmative Representation from BCC dated February 15, 2001, that it would comply with Core Principle.</p>	<p>Acceptable.</p> <p>Bylaws and Rules would be available to clearing members and all other market participants on the website.</p>
<p><b>Core Principle (M) – Information Sharing:</b> (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>Affirmative Representation from BCC dated February 15, 2001, that it would comply with Core Principle. International Information Memorandum of Understanding and Agreement.</p>	<p>Acceptable.</p> <p>BCC would become a party to the International Information Sharing Memorandum of Understanding and Agreement dated March 15, 1996, and the Unified Clearing Group’s Information Sharing Agreement.</p>
<p><b>Core Principle (N) – Antitrust Considerations:</b> Unless appropriate to achieve the purposes of the Act, 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>BCC Bylaws Articles I - XI and BCC Rules Parts 1 - 9. Affirmative Representation from BCC dated February 15, 2001, that it would comply with Core Principle.</p>	<p>Acceptable.</p> <p>BCC would be cognizant of antitrust considerations in adopting Bylaws, Rules or taking actions.</p> <p>Staff did not identify any antitrust issues in reviewing the application.</p>