COMMODITY FUTURES TRADING COMMISSION

ROUNDTABLE ON DERIVATIVES

CLEARING ORGANIZATIONS

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P R O C E E D I N G S

SESSION ONE

CHAIRMAN NEWSOME: Good afternoon. Jim, how are you doing today?

I'm pleased to convene this roundtable of discussion on clearing issues. Certainly, we've got a full afternoon in front of us. So I think that we should get started, so that we can certainly hear all of the discussion later on.

Before we begin I first would like to thank everyone for taking time to join us in Washington, D.C., to provide us with the benefit of your financial knowledge and wisdom on financial markets. I also want to take this opportunity to thank Jane Thorpe and staff within the Division of Clearing and Intermediary Oversight, as well as Pat McCarty and his staff in the Office of the General Counsel for their time and effort in getting us to this point today.

Today's program will consist of two sessions. In the first session our purpose is to obtain views on the best way to design our oversight program for clearing organizations. In the second session we want to provide a

forum for discussion of important issues regarding market structure and competition. I would like to express my deep appreciation to Dr. Susan Phillips, whom all of you know, for agreeing to moderate the second session. Dr. Phillips is currently Dean and Professor of Finance in the School of Business and Public Management at George Washington University.

I should make it clear why we are holding this first session. When Congress enacted the Commodity Futures Modernization Act it created a new category of registrants, derivatives clearing organizations or DCOs. Under the Act the CFTC has an obligation to assess whether DCOs are in compliance with the core principles the Congress deemed appropriate for clearing organizations. These principles address areas such as internal governance, financial resources, systems, operating procedures, treatment of funds, and clearing protocols and procedures.

While the CFTC has an oversight program for exchanges, we have yet to develop a program to assess DCO's compliance with the core principles. As we develop this program, we will be mindful of our obligation to be flexible in applying the core principles. We are here

today to solicit industry views on how to fulfill our Congressional mandate in this area.

Let me assure you that we will continue to work with you as we develop the program and to seek your input.

While we have identified three issues on the agenda, I want to say that all issues are open to discussion. Before I ask my fellow Commissioners for any thoughts or comments that they might have, I just wanted to announce that the rules for securities futures products have been signed off by both Commissions. They are headed to the Federal Register this afternoon for publication hopefully.

[Applause.]

CHAIRMAN NEWSOME: For publication the beginning of next week, and then implemented 30 days after such time.

So with that said, I will ask Commissioner Barbara Holum if she has any comments that she would like to make?

COMMISSIONER HOLUM: Thank you, Mr. Chairman, I would just like to echo the Chairman in welcoming all of you here today and to thank you for your participation and thank Jane and her team for putting it all together, and

especially for picking such a lovely day for all of you to visit our city.

But you're all looking good, nonetheless, and I look forward to the rest of the afternoon. Thanks again.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Commissioner Tom Erickson.

COMMISSIONER ERICKSON: Good afternoon.

I too want to thank everyone for being here and thank the Chairman and his staff for putting together a timely roundtable. We certainly have many interesting presentations and viewpoints on this subject. I'm looking forward to hearing the discussions this afternoon. Thank you.

CHAIRMAN NEWSOME: Thank you, Commissioner.

Now, as I have found during my tenure at the Commission, I do a much better job of learning and listening if I'm not worrying about speaking. So as we go forward throughout this first session, I've asked Jane Thorpe to lead the discussion. So Jane, I'll turn it over to you.

MS. THORPE: Thank you, Mr. Chairman.

I'd like to start by reviewing certain housekeeping rules that I think will facilitate our discussion this afternoon. We've allocated an hour and 50 minutes for each session with a 20 minute break in between. And the second session will start at 10 minutes after 3:00.

There are many issues to cover and we'd like to hear from as many people as possible. And while there is some overlap between the two sessions, we'd appreciate it if you would restrict your comments to the issue at hand. If there are points you would like to elaborate on in writing, I'm certain the Commission would be pleased to receive your comments in writing.

Before starting session one, let me observe that as a new director of a new division I am sensitive to the effect a new oversight program will have on the industry and on the Commission. Let me assure you that our aim is not to regulate for the sake of regulation. Our challenge, I think, is to devise a framework for oversight that will make the most efficient use of the Commission's resources consistent with sound risk management and principles of good government which is why we are here today to initiate

the dialogue with the industry on what we should do and how we should do it.

Before we open the floor for discussion, however, in order to get some perspective on the issue, I'd like to ask Bill Navin of OCC to take a few minutes to describe the SEC's oversight of securities clearinghouses and David Hardy of LCH to provide some insights into the FSA's program of oversight.

Bill, can I turn it over to you?

MR. NAVIN: I think there are five basic components to the SEC's regulation of clearing agencies, at least from our perspective. The first of them is the initial examination for compliance with the SEC's clearing agency registration standards. Under the '34 Act the SEC has to make certain findings before it can register a clearing agency. And those findings go to matters similar to the core principles in the Modernization Act, but they're a little bit more general.

The SEC's staff or Division of Market Regulation back in 1980 adopted a set of formal standards or guidelines, if you will, to indicate the things they would be looking at in making recommendations to the SEC as to

whether it should or shouldn't register an applicant. Those go to such matters as the applicant's rules on participation, governance, capacity to enforce its rules, safeguards against risk, operational capacity.

Once a clearing agency is registered, the remaining components of the program come into play. And there are four of them. One is the process for reviewing material rule changes. The second is regional office inspections. Third is automation review policy inspections. And fourth is review of disciplinary and suspension decision.

Going back to the first of those, review of rule changes, all changes in a clearing agency's rules have to be filed with the SEC. There are certain categories of a rule change, such as changes in fees, that could be made effective on filing. And there are other sorts of non material rule changes that fall under similar category.

Normally rule change proposals have to be published for public comment. Typically what happens in practice is that a period of time goes by after the, after the filing takes place in which the staff reviews the proposal, asks whatever questions it has. And sometimes

changes in the proposals are made in response to staff comments and questions in that stage.

The next thing that happens is that the rule change gets published for comment. Then following the expiration of the comment period, the Commission approves the rule change. The Commission has the authority to grant accelerated approval if it chooses. And it does so in situations where that's warranted.

The inspection program has two parts to it. The first is the SEC's regional office comes in--it used to be every two years, now, more recently it's every three years--and they spend about two to three weeks with us. Typically in the last couple they've brought people from Washington here, from the Office of Compliance Inspections. They have joined in and I think that the CFTC has done the most recent.

These inspections cover a broad range of things, including the membership process, financial surveillance, any disciplinary proceedings we may have had. They review our information memos to clearing members. They review our board and committee packages. They review new items in our annual report. They examine our collateral management, the

way in which we administer our margin rules, the way in which we administer the clearing fund. And they do all this in the context of going through selective clearing members and what our requirements were with respect to them. They also talk with our internal audit people and review internal audit reports.

The second, the second inspection element is the so-called automation review program inspection. That's annually. Each year we make a report to the automation review people regarding developments in the IT area during the past year. That's supplemented by filing reports of systems changes, when we change anything material in our EDP systems. We're also required to file reports when there is a non trivial outage.

Then once a year the automation review staff comes in. They give you one day to go over our report on recent developments. Then there is a three day examination at which they do things like examining all of our internal audit reports relating to EDP matters, compliance with their past recommendations, information security, any changes that may have taken place in our data center and the steps that we've taken to prevent recurrence of any

outages. They also look at our emergency and contingency plan. This inspection typically culminates in a few written recommendations.

Occasionally we get calls on specific issues that are of interest to the automation people who are examining a particular area of our clearing.

Finally they do have authority to review any suspension of a clearing member or any disciplinary action, final disciplinary action taken. It's a relatively rare occurrence to change its findings.

That's basically it.

All I have to say now is that that's it.

I'm sorry. If there's anything anyone would like me to repeat, I'll be happy to do it.

MS. THORPE: David, could you go next, please?

Thank you very much, Bill.

MR. HARDY: Jane, I will with pleasure. I will try and make this as coherent as possible, given that Jane explained my role in this early part of the proceedings about three seconds before the meeting began.

We have new legislation in the United Kingdom which came into being midnight on the 30th of November last

year, our new Financial Services and Markets Act. Within that legislation, an organization such as London Clearinghouse is a recognized clearing house. There are, though, very few specific requirements in the Act relating to the requirement of such an organization as a recognized clearinghouse. I mean, there are some very broad financial requirements, but nothing terribly specific.

The way in which the oversight, though, is being developed--and I emphasize being developed because, again, the Act is quite new, the role of the Financial Services Authority is being somewhat thrown together now. Rather like is the case over here in the event of the new Act.

The expectations of the FSA are set out in what's known as a source book, again, not terribly specifically. There was, though, an extremely onerous and extensive review of the operational capabilities, the risk management standards, the business continuity, disaster recovery provisions of the clearinghouse during a grandfathering process, LCH being a Recognized Clearing Act under the former Financial Services Act. And we were grandfathered under the new Act, following a very substantial review process in which some external consultants were used

particularly in expert areas such as systems and disaster recovery.

Very much the onus for compliance with the requirements of the Act is placed on the board of the recognized body, the recognized clearinghouse. And I would say that the role of independent non-executive directors on the board of the organization is particularly important and the Financial Services Authority will have direct access and will meet regularly with the independent non-executives. It will be expected, and it's made pretty clear to them before they take on such a role, that whilst they're not exactly a whistleblower, they are nonetheless seen very much as helping guard the regulatory compliance of the organization. And it would be expected that if they have, you know, found something that they consider to be inappropriate, if it was raised at a board meeting, if nothing particularly happened, it would be expected that they would make their feelings known directly to the Financial Services Authority.

The way in which the FSA considers the RCH, the Recognized Clearinghouse in question is to look at it on a risk based assessment, to look at the risks that the

clearing organization could pose. And the way it's expressed is the risk it could pose to the fulfillment of the objectives set out under law for the Financial Services Authority itself. So is there something that we could do that would undermine their ability to fulfill the objectives under the Financial Services Act that have been set out in statute?

And they look at the Clearinghouse under a number of different risk areas. I'll take an example, market integrity. There will be a rating of the clearinghouse's impact in the area of market integrity. That might be high, medium high, medium low, low. In essence, were something to go wrong with the governance and the operational procedures of the clearinghouse, what would be its impact on market integrity? Well, that's almost certainly likely to be high, particularly because of the very broad spread of operations of LCH in the UK and European region.

But then there will be a probability of the impact made by way of an assessment. And, you know, that hopefully would be low. In other words, the operational systems and procedures of the clearinghouse are such that

it's thought extremely unlikely that the sort of impact that would be high if it took place would actually happen.

Now, in order to then consider how to keep that at a low level, we have what's known as a risk mitigation program. It's not saying there are high risks, but it's a question of looking at various areas in the clearinghouse's operations and keeping in close contact with the regulatory body around those various areas for risk mitigation, looking at, I don't know, banking, collateral handling, business continuity, all kinds of areas. But there are no set requirements.

What that leads to is an agenda for communication such that the regulatory authority is, on a quarterly basis, monthly basis, annual basis, whatever it is in relation to each one of those areas of risk mitigation, is keeping in close touch and understanding the sort of actions and protections and risk mitigation initiatives of our own that we have in place.

So it's a question of being open, making sure that we keep in very close communication and the regulatory organization knows the way in which we are operating. And through that type of relationship, maintaining what has

always been a pretty light touch without the need for extensive or onerous requirements and standards being set. So there's a sort of grown-up relationship between the organizations, which has worked very well for the 15 years since we've had the modern standard regulation in London.

I think that's about all I'd like to go into at present.

MS. THORPE: Thank you very much, David.

Would any of the participants at the table like to add their commentary on this issue?

[No response.]

MS. THORPE: Is Dennis Dutterer at the table? Dennis?

MR. DUTTERER: Ma'am?

MS. THORPE: I know you submitted a comment before the hearing which addressed generally how you thought the CFTC should proceed in terms of designing the oversight program.

Would you like to share some of that with us?

MR. DUTTERER: Certainly. Thank you.

My comments are largely directed to what I think is the second agenda item. So I'll reserve those for the appropriate time.

In terms of general focus on oversight a few of my observations would be that the CFTC and the industry has before it a number of reports and examinations of general oversight. That is, we have the statute, the legislative history behind it, the initial rules that have been prepared. We have things such as the Klein Report that has looked at difficulties in the past. We have other reports that focus on clearing and settlement issues such as the BIS and so forth. And I think that those are all very, very good points to build from. And I would believe that an appropriate approach is to take those things and begin to build from that rather than focusing on, if you will, yet, again, a new program or new rules, policies, and procedures. So I think that should be the starting point for what the Commission would do.

A second observation that we have seen over time with our opportunity to work with other market places and provide services is that everyone says, but it is so true, that clearly one solution is not necessarily applicable to

all the problems. And I think that when one looks back at the BIS Report or Klein Report or other things, that really comes through. So my thought as we begin the first session here today of the agenda items would be that we have a very, very good beginning. And we should really look at that and focus on that as apart from focusing on developing yet another set of solutions.

MR. NASTRO: Jane, if I could have Bill and David give us their analysis of the governance of those two organizations, the OCC and the LCH, I think that would be very helpful for all of us.

MR. NAVIN: The OCC has a kind of a unique governance structure. It's a for profit corporation. Its stock is held by the 5 options exchanges. However, its board is controlled by its users. We have 16 directors. One is our chairman. Five--each of the exchanges has one director on the board. We have one public director. And the other 9 directors are all representatives of clearing members. And we have a nominating committee that's composed of clearing member representatives. They nominate the people for those positions and they nominate their own successors on the nominating committee. And the exchanges

are required under the terms of a stockholders agreement to vote for the election of those persons that are nominated by the nominating committee.

There is a petition procedure if members don't like the people that the nominating committee comes up with. But that's never been exercised.

MR. HARDY: The LCH is a perfectly normal UK limited liability company. Its equity is owned as 3/4 by its clearing members. Each clearing member has one share, making up 75 percent in total. The other 25 percent is owned by the three futures exchanges that we were clearing when we put the structure in place in 1996. And amazingly in 1996, that's all we were doing, clearing three futures exchanges.

The board is made up of three representatives of the exchanges, one from each of the three shareholders. The, and 9, up to 9 representatives are clearing members who are elected by the clearing member shareholders only. We have 2 independent non executive directors who are chosen by the board. And we have an independent chairman. Rather like Bill's comment, the member shareholders go through a nomination committee process. The nominating

committee consists of 3 board members and 3 non board members. Individuals standing within the financial services community, they will put forward nominees. Again, if there's another candidate that shareholders would like to put forward, then they are perfectly able to do that through a procedure. Again, like OCC, that's never been tested in practice.

Is that the sort of extent you were looking for?

WILMOUTH: Jane, the independent non executives are not associated in any way with financial services? They could be the building manager of some building? Or are they associated with the financial services community?

MR. HARDY: Well, the building manager at my building would be the last person doing that, I can assure you. But, no, they are people with standing in the financial services community. Neither are connected with any of our clearing members. Both are, in fact, retired, very senior bankers who bring a rule-based understanding and knowledge of the financial service community, both of whom were welcomed by the Financial Services Authority.

MS. THORPE: Jim McNulty had a comment.

MR. MCNULTY: Yes. We were, when we discussed this, Commissioner, we were thinking that you already have very good surveillance programs and you have oversight reviews with us on a regular basis. And what we were thinking is it would be good if we could weave this DCO oversight program into that same process and in that way continue what we think is an ongoing and very beneficial dialogue. And we also think that it would be helpful if this dialogue was not one that was prescriptive where it came to setting margins, for example, and that type of prescription, but it became beneficial toward building stronger markets on a continuous basis.

MS. THORPE: And indeed, when we were working on the agenda, we were quite aware that one of our challenges would be not to duplicate the existing CFTC financial oversight of the exchange's program with respect to its members. So clearly, you're absolutely right. There is a program that we can build on.

But it also gives us a new opportunity, because we now have core principles both on the exchange side and on the clearinghouse side to do it better than we have been

doing it and to work with the industry as we move forward in this process.

MR. MCNULTY: And we welcome that.

MS. THORPE: Are there any other exchange representatives who, or clearinghouse representatives who have a view on those areas where they think are sort of the outer limits of where the CFTC should be involved, in terms of looking at clearinghouses? I will throw out one example.

Financial resources is one of the requirements under the core principles for clearinghouses. The CFTC has never gone in and set any standards regarding how much default funds or guarantee funds a clearinghouse must have. What is your view on how we should approach that particular issue?

MR. WOLKOFF: I think that probably approaches, perhaps passes the outer limit. I think that one of the issues, I think Jim just brought it up, is to avoid prescriptive regulation. But having said that, I think that there is a case to be made for the Commission to have fairly open-ended discretion in adopting standards clearinghouse by clearinghouse, because there's a wide

variety of risk depending upon the nature of the commodities being cleared, the extent of the open interest, the nature of the customers, albeit retail versus commercial or institutional, the liquidity of the underlying markets and the public purpose of the market and how extensive that public purpose is.

I think it's appropriate without setting specific guidelines for the Commission to look at such areas as it currently reviews right now, the treatment of funds, the segregation of funds, for example, which is probably the single biggest core principle under U.S. regulation of clearinghouses. But also I think issues of best practices at the particular clearinghouse, which could include how a default would be treated, how stress testing occurs, whether stress testing occurs, operational risk at the clearinghouse, the policies underlying margin, whether they have active options contracts permitting for a determination of implied volatility, which I know there are differences of opinion on, but in my view is probably the best determinant of market risk.

I'm not in favor of highly limited CFTC jurisdiction. I think that that jurisdiction, however,

should be carried out in the format of periodic reviews or otherwise reviews for cause with a broad public interest obligation using the core principles as the basis and going on from there and exercising discretion in its expertise. It's an agency created to use its expertise exactly for this.

The only other thing that I would add is I think that the change in the law a year ago, which for the first time separated trading from clearing, we don't know how significant or important that change is because it really hasn't frequently been tested. It's relatively new. And I think that it provides a ready justification for the CFTC to be overseeing, not just integrity of the clearinghouses, but the preservation of market confidence in how the clearinghouses operate by periodic review and public report rather than prescriptive regulation. So I hope that, that helps.

MS. THORPE: Thank you. Anyone else?

MR. MLYNARSKI: Perhaps a few comments on being perhaps the new clearinghouse here at the table. And thank you for inviting me.

I think it's important to note that there are very significant market forces at work here too and the appropriateness of risk management or financial wherewithal at clearinghouses. We established BrokerTech clearing company and slightly over a year ago received our designation. And as we began marketing ourselves to the financial market place, the users of futures markets as clearing firms, first getting them to join and then ultimately obtaining users, we were given a very rigorous test by the market. And it was very important to the market place, including our owners, who separately and independently review us from a credit worthiness and a risk management policy and do their due diligence, because no matter what their initial investment may have been, if their credit people and risk management people felt uncomfortable with us, we were not going to get approved.

So it was a very important part of our establishment of ourselves in the market place that we have a strong financial backing that the market would accept and that clearing members would join us on the basis of the policies that we had in place. And clearly, there are a number who have and have felt comfortable with that. But I

can tell you, as well, that also as we broaden out and try to bring in new members to the exchange and ultimately to the end-user/non member, it is also a very important part of the discussion that the user of the financial market wants to get very comfortable with the financial wherewithal and the risk management practices of that particular clearinghouse, because I know it comes up in every single conversation we have.

So there are very strong market dynamics at work I think that, that keep the clearinghouses sufficiently, you know, serving the industry.

MR. NASTRO: I'm not an exchange, but I'm an end-user. So if I can just make some observations. Essentially what Neal was saying and what Jim was saying, I think it's very important. I don't think the CFTC needs to be having a lot of prescriptions about what's going on here, because every clearinghouse is uniquely different. They have different procedures in place. Maybe that's good, maybe that's bad. And I think that that, though, needs to be examined.

Just general principle, for instance, some clearinghouses have different capital requirements. There

are thinly capitalized entities who are clearing. With the new frontier of electronic trading, we can have an explosion tomorrow that could impact adversely upon the entire market place.

So I think it is right for the Commission to do a little bit more scrutiny of some of these processes to understand the relevance of the capital to risk within the entity itself, vis-a-vis the end-user and the clearing member.

MR. MCNULTY: Yes. Thank you, Commissioner.

I also think that if we can share an intellectual framework for looking at risk, because really when we're talking about the concept of financial resources, we're really talking about how do we measure risk. And risk will have to do with what the probability is of movements and then what the probability is of those movements over time and how does it affect the risk of confiscation due to default.

And I think if we could share an intellectual framework of whether it's value at risk or a probabalistic approach to measuring over time these risks, I think it would be very helpful for all the participants. And I

think it leads us to a better outcome. And so we would be happy to be involved in that kind of a dialogue.

MR. WOLKOFF: Just one last point that I inadvertently neglected from the discussion before.

And that is consistent with what Jim just said, I think that it's of critical importance to augment whatever regulatory oversight program exists with respect to clearing with the ability of end-users, Charlie and certainly people less sophisticated than Charlie, to understand the policies and procedures of a particular clearinghouse.

One of the core principles requires public information. Then within the core principle there seems to be some fairly significant limitation that the public information is only really required to be accessed by market users themselves. And there's some question about shouldn't potential market users, shouldn't competitors, even, have access to the information on the rules and the policies. And I think that because the clearing, the DCO rules have now opened up the ability of clearing organizations to clear all kinds of products that it's impossible to draw lines between where the risk of one

product or one organization ends and the risk of another begins.

And so I think that it is of critical importance that the public information requirement be taken very very seriously, and that that be an area that augments oversight simply because it permits the end-user ultimately, and the other markets through peer pressure to impose standards of operations that are prudential and in line with best practices.

MS. THORPE: Yes?

MR. POLK: Let me just comment on one issue as it relates to clearing corporations. I represent an FCM. At the end of the day it is our capital which is at risk. And to the extent that we discuss probability value at risk, that always converts to dollars and cents.

During issues of times of extreme liquidity problems, the responsibility for solving those problems become the FCMs. We are the ones generally dealing with the customer. We are in the forefront. It is our responsibility to collect those margin calls, to determine to a certain degree what is adequate protection for us.

We are standing normally by ourselves in this regard. And I can attest to several instances during this past year in certain liquidity times in the energy sector. We would welcome CFTC involvement. We do believe that you should be involved in times like this, working with the clearing corporation and with us as FCMs. There is too much money at risk to let individual companies go this alone when it's the magnitude and size of some of the potential problems that we have.

MS. THORPE: Is your microphone on?

MR. MCNULTY: The only addition I would like to make is that as a corporation and clearinghouse, we also keep capital for those kinds of eventualities so that we also have capital in that game. And we think that it's important for us to work very closely with the FCMs in these periods.

MS. THORPE: Thank you.

I was intrigued by a comment that David Hardy made about the process that the FSA used in reviewing the LCH and grandfathering them and the fact that the FSA hired external consultants. I wanted to ask you at the time you made that comment the purpose for which these external

consultants were hired. Because I do think that, you know, what we're moving away from, as everyone understands, is a quantative assessment of risk to a more qualitative assessment of risk in this new environment. And so we, as a Commission, have to move away from our checklist approach of doing rule enforcement reviews and audits to more subjective and analysis of whether you as institutions have analyzed all the risk that you need to take into account in terms of the business that you're doing and your membership essentially.

And part of the problem for us is that we may not necessarily have the expertise to be able to fully understand what it is that you're doing. And so, you know, that's a challenge for us in terms of getting our resources together as we forge ahead in this new world.

David, what is the purpose of the external auditors within the FSA oversight program?

MR. HARDY: Well, Jane, they weren't auditors.

MS. THORPE: I'm sorry. Consultants.

MR. HARDY: They were there to supplement the staff of the FSA in the grandfathering process around some very sort of closely defined and specific expert areas

specifically in systems and business continuity. So as the FSA have not got, I mean, the FSA actually hasn't got abundant resources for staff. It's got a big job and not enough people to do it at the moment.

But in that particular area they didn't, I don't think, thought they had the internal expertise to judge whether or not our systems and our business continuity procedures were at best practice or not. And that's why they brought some people in.

But certainly they have moved quite distinctly towards that qualitative approach. There's never been a box ticking or quantitative approach from them anyway. But it's now even clearer that, you know, we both act as grownups. They accept that we have the internal expertise in operation and risk management areas. They will take an intellectual stance and say, well, do we believe that they are doing enough in those particular areas? Is it reasonable the approach that they're taking?

I think it's very dangerous for any regulatory body to try and get too prescriptive around some of these risk management areas and try and set levels which might just actually turn out to be wrong. And so it all comes

down to the quality of the relationship I think as to whether or not the FSA staff believes that we're always being open, straightforward and actually volunteering bad news as well, which is all very much part of building that relationship that allows us to enjoy that comparatively light touch that I mentioned earlier on.

MS. THORPE: But as part of the reorganization or the creation of the FSA, there was a huge number of staff in the Bank of England who came on board. And these, these experts were, in fact, quite capable of analyzing value at risk models and doing quantitative analysis. And so from that perspective FSA has in-house that kind of expertise that I was talking about. Is that your understanding?

MR. HARDY: In their trade at risk department, they have an awful lot of very smart people and they can certainly tell whether we're trying to pull the wool over their eyes, which, of course, we never would.

But in other specific operational and IT areas, I mean, I don't think they do particularly have the resource. And the smart thing to do is to bring it in as needed.

MS. THORPE: Yes?

MR. POLK: David, in considering risk management, do you look at liquidation risk at all?

MR. HARDY: Yes, very much so. I mean, we have a very broad range of different types of markets now. And the liquidation around a 30 year Euro Swap has to be taken into account extremely seriously in our risk management practices. But that goes across the board from liquidation of our, you know, 300 bags of cocoa right across the board to the swap. So liquidation risk is the key area for us when market risk, when we start to take on board market risk post the thankfully rare failure of a clearing member.

MR. POLK: May I ask one other question?

I believe in the UK you do not have a concept of reportables which allows a knowledge of concentration. How do you handle that? And I guess in one way I look at the CFTC as a recipient of the reportables and what actually in the future will be done in that regard? David?

MR. HARDY: Routine reporting on positions to FSA you mean? All right. So I'm not necessarily, because the term reporting? Do you mean that?

MR. POLK: Yes.

MR. HARDY: Well, there isn't a routine reporting, but there is certainly the opportunity for the FSA to call for that information and in particular circumstances that's freely given. But it's not done on a daily basis across all markets and all products that we're engaged in.

MS. THORPE: Didier, I believe you had a comment?

MR. VITALE: I wanted to make a comment about governance. I think the, one of the key points is that I think in the world, the materialization, we feel of the use of the FCM when we have the control of the clearing process. Because I think that if we have the major crisis, our capital is risk. And as our capital is at risk some key decision will have to be made in that case. And it's quite obvious for us that we must have the control. This is not always the case as you know with some clearinghouses, and we think also that we must have the control over the clearing. Because at the end our capital will be at risk and you, and we would have the assessment procedure. Something is going very bad. So I think we welcome your discussion with the exchanges as the CFTC, but at the end the problem will be to see who will put the

money on the table, it will be us. And I think we don't have to forget that.

MS. THORPE: Yes, Yew-Meng.

MR. FONG: I support what you have just said, Didier. In particular let us not forget something that Charles has spoken about, which is very important. The world is changing very, very quickly, number one. Number two, as Ira and yourself have clearly identified it is the capital and the risk that each FCM, large firms or small firms, will bear.

There is a case for CFTC oversight in certain circumstances I feel. Definitely it should not be prescriptive. Clearly, where there's contagion, where each exchange may only share or each clearinghouse only shares a small piece of the information, but the bulk macro picture resides somewhere. How can we find an easy forum? What would that case be? Let us write the rules now before it happens. What prescriptive rules? Let's have a set of guidelines.

We see these various companies going from AAA to BBB within two weeks. What does that mean to us? What does that mean to the FCM? How do each of the exchanges

and clearinghouses deal with that? It's not that you have to have enough in terms of financial resources in your guarantee funds. How is the CME reacting to that factor versus the CBT versus the Kansas Board of Trade, versus BrokerTec, the new boy on the block?

It may be more pervasive, but clearly each clearinghouse feels there is a conflict of interest if they're disclosing that to a competitor clearinghouse. Clearly, they cannot disclose it to another FCM. Where should the repository of information be? Where shall that information be shared, even across borders into the London Clearinghouse, into the Japanese locations?

Let's think about that. I believe that is where part of your new movement is to be able to create a forum, create that knowledge that, yes, you know, you have the public non executive director come to talk to you and how to bring that information across quickly because then decisions can be made quickly. And I think really it adds much more weight, because Charlie is saying how can DCMs with very not big capitalizations impact other clearinghouses if they impact the United States DCOs.

MS. THORPE: That's a very interesting point that you raise, Yew-Meng, that you are perhaps advocating that the CFTC should be the repository of information that the exchanges themselves cannot share because of competitive reasons or that clearinghouses cannot share because of competitive reasons, and that we would deem relevant for systemic risk purposes across all markets and across all clearing organizations.

Does anyone else around the table have a view on that?

MR. WOLKOFF: I think just informationally I think I'm certainly a big believer for regulatory purposes in information sharing, in information sharing agreements. I think domestically for probably close to the last 15 years the U.S. exchanges or clearing associations have had an agreement in place to share on an automated basis pay and collect information.

So with respect to at the FCM level at the various clearinghouses in the United States we all agree, notwithstanding competitive issues, to share the information on a FCM basis. Now, we don't share the information on a specific customer basis. And, and perhaps

there's an issue there. But in responding to that, because it is something that Ira eluded to before, I think it's a very difficult place for the exchange to be in making client specific decisions other than on a, a really case-by-case generally disaster specific standard. Because typically what it is that we do is to measure market risk, make determinations on operational risk, which I would include liquidation risk, but as to the client level that has historically been--and I think appropriately so--at the FCM, at the FCM level.

The exchanges certainly--I'll speak on the energy side--have been able to share information across FCMs through large trader reporting. So that we would have that fuller picture of who is doing what, where, and be able to establish limits and the like. But as to whether a particular customer is a good risk or not a good risk and should have special margin or not margin, that's an issue that has historically been left to the FCM. And I, I--not as really an exchange, but I would think that the FCMs would feel relatively uncomfortable in having the CFTC step in and second guess their own customer-specific margin decisions.

WILMOUTH: I may be a little bit off here, but it seems to me purely from a regulatory standpoint if the elements that we've identified and talked about here are reported in the trade execution process and it's all standardized, then I would think you could measure exposure across the markets on a far more consistent basis than you can now. But that would require, as I think Mr. Fong said, all that information being gathered perhaps by the CFTC. And then you would have a better basis, I think, for measuring consistently the risk across the markets if it was all in one place, which it isn't now. I think that that's what Neal was thinking.

MR. EARLE: If I can try a slightly different tact. Energy Clear probably represents the most aberrant of the forms of clearinghouse at this table. But as I look around at my colleagues, we do not represent a homogenous community of members, nor a homogeneous community of products. Given that, it's very hard to see how the Commission could prescribe how we would measure and mitigate risk with a single standard that would apply equally well at every organization.

But, yet, I can understand the Commission's wanting to be able to set some kind of a prudential public policy, because confidence in the markets is important. And, you know, the Commission being able to have that could well render confidence where it doesn't exist in some markets.

But it would seem to me that the ultimate test of a clearinghouse is when it has an insolvency and how it handles that insolvency. Now, my memory may be wrong, but I seem to remember that the Bank for International Settlements was looking for a standard for inter bank clearinghouses and how they could promulgate a standard that inter bank clearinghouses were expected to reach so that they would be considered appropriately working as inter bank clearinghouses.

And if memory serves me right, they focused on how those clearinghouses handled an insolvency. And the BIS promulgated an expectation as to how the clearinghouses would be able to act in an insolvency. And all the inter bank clearinghouses were asked to do was to demonstrate how they would reach that expectation.

So there was promulgation of a standard on measuring risk, membership, mitigating risk, financial safeguards. Rather, it was simply asking each clearinghouse to be able to demonstrate that in the event insolvency occurred, it could reach a certain level of performance in handling that insolvency. Perhaps what the BIS has already done could be considered by the Commission as an appropriate path for looking at DCO oversight since it does not get involved in the micro details of how we operate on a day-to-day basis, and addresses the key role that we're all here for, which is to handle insolvent members while keeping confidence in the markets.

MR. DAMGARD: Jane, it seems to me that after Barrings, didn't we end up with a system whereby there was going to be greater communication at all clearinghouses--that way in terms of establishing an agreement that clearinghouses had to sign globally. And it dealt with both recovery and prevention, because it was two clearinghouses, I think, one in Osaka and one in Singapore, unaware of what the position was. And so I think maybe some has already been, something has been done in this

area, but it seems to me that it's certainly something valid for the CFTC to look at.

MS. THORPE: Those agreements basically are triggered when there is an event. And I think what Yew-Ming's point was in advance of a triggering event, is there some central repository of risk information that might not present competitive concerns to the industry and could the CFTC be a useful central repository for that kind of information. It's certainly something that I think the Commissioners here, that staff will be looking into.

And speaking about events, one of the things that we have on the agenda is the issue of system security. System security I believe is core principal (I) for DCOs. And it talks about the operational capacity of a clearing organization in the event something happens.

The CFTC, as you know, put out a report in March of this year following the events of September 11th. And in that report the Commission identified the events, the things that the Commission itself had undertaken, the developments in the industry itself. The Chairman I believe sent out a letter in October of last year asking each of the exchanges and clearinghouses to file their

contingency reports. And there's been discussion internally here about doing a follow-up letter one year after September 11th to find out what new procedures have been implemented.

But the Commission's report also talked about getting the industry together to develop standards of best practice and how we can be better prepared next time. And my understanding is that there is a lot of developments internally and vertically within each institution and clearinghouses and exchanges, but there's very little horizontal coordination between the institutions, between the exchanges and clearinghouses and between the clearinghouses and the members and the banks.

Would each of you like to comment, would some of you like to comment on where you are as far as that issue is concerned?

MR. MCNULTY: I would first, my first comment would be I would like to really congratulate John Damgard and the FIA in the way that they performed during the September 11th debacle, because I think they really did a great job of keeping all of the exchanges in touch with each other. And I think that it was a nice cornerstone for

communication on a daily basis, several times a day, we were on all on telephones together. And it helped us solve problems that otherwise might have been very difficult to solve.

So I think, I think that John and the FIA should be commended for that. And we think that that may form the beginnings of a way to move forward in the event of other crises. And I think it would be useful for us to begin that dialogue of how we could have that kind of level of communication again in the event of a crisis.

I think if you go to the next step, which is, what are we doing besides putting in place all of the back up facilities so that we can run completely separately from our own physical plant today? We are working with all of our major FCMs to make sure that we have back-up plans for them at both their off site centers and our off site centers so that if and when necessary, we literally could flip the switch and be running in a completely separate mode on separate telecoms lines, on separate electricity, etcetera, to make sure that it works again.

MS. THORPE: David, do you have any thoughts you'd like to share with us about the Board of Trade's activities in this area?

MR. VITALE: We don't do our own clearing. It's done by BOTCC. So I'm a little reluctant to engage in the discussion of what should go on within clearing organizations.

In the broader context of the prior discussions about regulatory oversight and how it should be applied, I think the point of looking at how other regulatory agencies have done it has some value, as was pointed out earlier. I think, you know, one of the issues that you see is that rules-based regulation when it's applied in certain industry has a tendency to drive itself actually to more supervisory regulation. And so starting out too heavily rules-based creates problems because then it's difficult.

And I come from the banking industry where I, I think there's lots of evidence of that in capital adequacy establishment. Somebody pointed out that you can get the wrong capital adequacy rule. And, and I think you could ask your colleagues down the street whether they started on the wrong foot. And they probably would admit that they

did. And they have been trying to unwind it and point out that that regulatory regime has tried to move towards a more market-based regime in terms of its oversight, even suggesting that rating agencies might have something to do with looking at capital adequacy and so forth and so on.

So in the broader context of things, you know, I would support a more supervisory approach to all of these issues. Use markets where you can aggressively, and be very, very careful on rules because rules don't last very long in this environment. But then again, we don't run a clearinghouse.

MS. THORPE: Could you comment on the BOTCC's activities in the area of the events following September 11th?

MR. DUTTERER: Yes. Following September 11th I think we, as all organizations, began a first look at what we do internally, what changes should we make, if any, how do we improve what we're doing, how do we ensure that there is an appropriate responsiveness or continuity of what we did.

I think as we talk among all of our clearing organizations and the exchanges as well, and I think we're

all doing that maybe more individually than we have in an organized effort, we are now beginning to see where there are areas of cooperation and what we might do together.

So I think the first thing we did after the 11th was see what we felt we needed internally for our own organization. Having set that as sort of a base, we have begun to go out and talk to other organizations or make other changes or see if there is a possibility to work together in certain areas.

I think for us at the clearinghouse, the first and most important thing to us was to reconfirm our communication capabilities. As Jim mentioned, the ability to switch from here to there, that would be invisible to the FCM, or to switch from the FCM's new site to our new site, that sort of thing. From where we are, I think one of the most, greatest concerns to us is the telecommunications. It is something that we, as a clearinghouse, we don't have control over. It's not as though you can deal with a local back-up site or a local organization in Chicago or in another city because the telecommunications is, indeed, nationwide and all policies are largely nationwide.

And I think that gives rise to an area where the CFTC, or similar organizations, could be helpful to us. Because I think as we find our own needs, as we talk to other clearinghouses and see what their needs are, we do run into issues where we simply can't solve them internally, like telecommunications, for example. So I think we may be at the point where it would be useful for maybe a more formal structure among ourselves and the CFTC to indicate where we have run into areas that need your assistance.

MR. POLK: We were involved in 1993, we were in the World Trade Center. And in 9-11 we were in the World Financial Center. Based on our experiences, I would fully support your involvement in disaster recovery oversight.

There are basically four parties as I review disaster recovery. You have the exchange, you have the clearing corporation, you have the FCM, and the ultimate customer. In order for disaster recovery to work properly, all four parties have to be involved and understand one another's plan. And to do that, you actually have to test that plan. You cannot just put it in writing. You actually have to live it. You have to go through it, and

you have to, perhaps, mandate it. Because that's the only way it's going to work.

I can tell you that before 9-11, we reviewed our plans and when we called various exchanges, clearing corporations, we did not have adequate responses. And as a result then, although we had a backup site, etcetera, etcetera, it was not properly linked the way it should have been to the clearing corporations and the exchanges.

So I do believe that it should be mandated. There should be tests. And the supervisory responsibility to do that should fall to the CFTC as overall coordinator.

MR. VARLET: As you know we have experienced a very difficult situation in the aftermath of September 11th. And I know I would say that we, we had a lot of problems with some area organization at this time.

What I would advocate is not maybe a prescriptive approach, but a best practice approach, where in fact we can define between market professionals key roles, and I think that could be organized under the authority of the CFTC to make sure that everybody meets and the best practices are distributed among all the members. And I think it's affecting all participants you spoke about and

it's very clear that September 11th has been for all of us a warning. I think that the financial committee has been exceptional because we--being unprepared for the magnitude of the event, we have been, I think, extremely good to address the problem. But it's like a warning I think now we have to get prepared and make sure that we won't improvise, like we have done during the September 11th, after the September 11th date.

I think that one of the priorities in this field would be to organize a working group to define the best practice--such regulation which I think I wouldn't like regulation because, again, you have to update and it's very difficult to do. And best practice can be reviewed also by the market participant on a regular basis. That would be my, my comment.

MR. NAVIN: I just had two comments. One is in addition to the four constituencies that Ira identified, there's a fifth very important one. And that is the settlement banks. And some of the biggest problems which occurred in the wake of 9-11 had to do with their lack of adequate back-up. And that's an area where I think potentially an agency like the CFTC can maybe speak with

bank regulatory agencies and try to make sure that everybody knows what everybody else is doing.

And I also know, though I'm not personally involved in it, that the SIA on the security side, has a committee that's very actively looking into the process of maintaining communications in a disaster And I don't know, the FIA may also be doing that. But if not, I think it would be a worthwhile undertaking.

MR. WOLKOFF: I agree. I think the banks would be very important.

I don't know that given the magnitude of what happened 9-11 that you ever completely can hope to get away from improvisation, but I, I also want to say that I thought the FIA stepped up the plate in a very big way, in a substantial way. And, you know, John deserves a lot of thanks.

I do think that, that you're highly reliant on somebody stepping up to the plate. I mean, certainly the CFTC did, the FIA operated as a coordinator of all of us. But I, also I agree with a lot of the points, although I don't, wouldn't like to come out of this with a prescriptive, you do this; you do that, you have the state.

I think there are a number of changes that occur just as after the '93 bombing of the World Trade Center a number of the FCMs I think that hadn't established back-ups or secondary locations did so at that point. 9-11 has driven more of that. And as an exchange we've actually been, contrary to CME, we've been very uninvolved in overseeing what the member firms are doing. I guess to some extent taking it for granted that they're reacting to their woes in much the same way we're reacting to our woes.

I think from a utility perspective, I think the biggest change that we've done, vis-a-vis the relationship with the member firms, and I think you can do anything you want with your own operation and in the end no matter how careful your planning or how good your testing, it really has to be integrated. It is the member firms and it is the banks in the end that you really are, are depending on. Of course, the customer is at the end of that chain.

But certainly the ability now, given the internet, to move away from formal networks and to be able to exchange information without having dedicated frame reeling networks as we experienced, and just learning the importance of back-up and location of back-up and things

like that. But I think we would be very much in favor of a CFTC role in reviewing the response at the various layers since 9-11 to make sure that we do have at least a couple of sessions of communication and that we can have a comfort level just, again, as building confidence in what we've done. And I think that would be--and, of course, correcting what we haven't done, if indeed it comes up that there were some very good ideas that some of us haven't thought about, I think that's a very, very helpful role that the Commission could play at this point. And we would certainly welcome that.

CHAIRMAN NEWSOME: I think Neal's comment certainly about coordination across industry groups is extremely important. And to me that may be one of the brightest things that came out of September 11 was the need for coordination outside just your, your own organization.

I wanted to go back to the working group to see if that's something that you think we should approach. I think we've got working group possibility. You know, we're limited on the number of advisory committees we can have at the Commission. I think certainly if we took the advisory

committee approach, the technology advisory committee would be the appropriate advisory committee at the Commission.

But, John, with FIA's tremendous involvement right after 9-11, I'd be interested in your thoughts about the advisory committee or a working group, and in any others?

MR. DAMGARD: Thank you.

I'm a little embarrassed to sit here and get all this praise. It's not going to, Jim, it's not going to effect my presentation in the second part of it.

[Laughter.]

MR. DAMGARD: But credit where credit was due, Mr. Chairman. You divided up the responsibilities among various Commissioners' office, and my job was to keep the CFTC informed. And rather than pick up the phone and tell Tom Erickson each and everything that went on in the conversation, I put Tom on those calls. And so everything that we knew, you knew. And that exhibited a tremendous amount of more trust than we've had with the Commission in some of the past administrations. So that was, I think, a big part of at least getting us through that part. And anybody that needed it, had the dial-in number.

I think that--I kind of agree with Neal. I don't know that you can ever anticipate each and every thing that needs to be done the next time. We've done this after Barings. We did this after the '87 crash. And, of course, September 11th was another example. And I do think that technologically we have better opportunities to connect more and more people. And certainly I think we did a better job after September 11th than we did after October of '87.

But in both instances, I might say I was very proud to be a part of this industry because everybody worked together. And there were, there was no rancor. People got up in the middle of the night. We yanked Neal out of bed several times and raked him over the coals about missing this deadline or that deadline. And for the most part tempers never really flared and probably we were pretty fortunate to do as well as we did after that.

But certainly each of the institutions has thought about it a lot and the exchanges have worked on, I guess, back-up locations that they feel are important. And I think the firms have all taken disaster recovery very, very seriously. And each of the firms, not just in

futures, but really across the board are looking long and hard at it. And presumably all that adds up to better preparation the next time.

And whether or not there's some way to link together all those efforts or not, I really don't know. I will say that we are working with the SIA in a number of areas and disaster recovery is one.

MS. THORPE: Yes, David?

MR. HARDY: In the aftermath of the events, the Bank of England and the FSA and the Treasury combined in order to begin a full scale review of readiness, if you like, in the UK and getting together clearinghouses, exchanges, representatives of trade associations, in particular, in order to try and get a feel for best practice, in order to try and get a feel for preparedness, and to do some really sensible, practical things like for the first time put together a map of where people's primary and secondary locations and datacenters, for example, were. And guess what, there tended to be two pockets. So everybody now understands that sort of typology and can begin to plan accordingly to spread that out, to make

things rather more sensible. Other practical things, I'm sure, had already happened.

But myself and others in the markets are now, instead of relying on the standard providers of low budget phone networks, we're hooked into a government network to ensure that we get priority access in the event that--for all times. So it's good for me and my bookmaker. But in the event of-- we have sort of access in the event that it's really necessary and other forms of communication are knocked out.

On the afternoon of the 11th of September we learned a lesson as well and my head of operations decided that, because there were rumors of other aircraft still up in the air, it would be a good idea if we tried to invoke our tertiary location, which is a shared site, only to discover that we weren't allowed to invoke it because we hadn't actually suffered some form of event. So we now have a new provider of tertiary.

Testing was absolutely vital. Certainly our form of test came in the event of our power of the data center being knocked out twice in one month in a switch over to our secondary site, which thankfully I don't think any

member of the LCH actually noticed happened. So that was an unintentional test, but it certainly allowed us to learn many, many lessons. So I can only say that the more testing you can do the better.

We have also in London, as Jim knows, I'm fairly heavily involved in the FIA’s opposite number in the UK the FOA. And watching the FIA's involvement post 11 September, we have just completely copied the arrangements for a phone-in service so that members of the FOA all have those details and that phone-in arrangement would be immediately kicked in which only emulates the work that was done here.

MS. THORPE: We were talking about the role of government in this discussion. And, indeed, there actually is a specific role for an agency like the CFTC. The CFTC, along with the SEC and other financial services regulators, are part of a body that is known as FIIBC. And I cannot recall what all of those letters stand for.

But it is a group of financial agency--financial regulatory agencies that are responsible for critical infrastructure issues when a disaster, like September 11th, occurs. And one of the things that each agency has been charged with is getting each of the industries that we are

responsible for priority access to telecommunications systems in the event that the normal lines of communications become jammed or unavailable because of a September 11th type event.

And so we are in the process of sending out, setting up some mechanism for coordinating with the exchanges and with the firms regarding who should get access and within those institutions who to delegate for that purpose.

It does seem as if there is a role for the CFTC in getting all of the various parties at the table to talk about best practices in terms of all of the issues that we have discussed, but also in terms of, you know, getting, getting out these kinds of coordination mechanisms, like the GETS card that I was talking about earlier.

And I know that Commissioner Erickson, within the context of the technology advisory committee, has been talking about standardization on some of these issues. Commissioner Erickson, would you like to comment on some of these issues?

COMMISSIONER ERICKSON: Thanks, Jane. The Technology Advisory Committee has undertaken a couple of

projects. One, in particular, that might bear on this discussion as people are looking at system security and other issues is the work of the Standardization Subcommittee, which issued a report that was accepted by the Full Committee this past spring.

That effort was chaired by Yvonne Downs of NFA and Scott Johnston of the CME. The standardization report sets out some recommendations for best practices in the area of content standardization, as far as what information should be included in the order flow of customer orders from the time that they're actually entered into a system to the time they are confirmed back to the customer. What information is necessary for back office functions by the firms.

There's an exhaustive list of information that was put forward by the subcommittee as information that might be included in order flow information that would be helpful across the board, and ultimately to the regulator.

The second part of the report discusses standardization of protocols and the issue of systems and applications being able to communicate between and among each other. Whether that means everyone adopting one

protocol or some mechanism where protocols would be able to communicate with each other has not been determined by the work of that subcommittee. But they did note that the FIX technology seemed to meet the needs of the futures industry.

If you haven't taken a look at it, the report is on the Commission's website. You can get a hard copy from my office as well, but it's listed under the Technology Advisory Committee on the CFTC's website. That maybe something for you all to consider as you look at disaster recovery and business continuity and what role the CFTC might be able to play.

MS. THORPE: Any other thoughts on the issue of system security and business continuity?

MR. MCNULTY: If I may just mention, I'm going back one step on the names of these groups that do cooperate in terms of understanding the riskiness of various clients and Puphinder Gill, who is here today, could fill people in on the details, but I thought it might be interesting for the group to know the names. There's the Joint Audit Committee, which includes 26 exchanges and the NFA. There's also the Intermarket Financial

Surveillance Group. And then finally there's a third group that was put together to share information and this is the Intermarket Surveillance Group, and that's 26 domestic and foreign self-regulatory organizations that work together to share information.

So we would be happy to provide information to those who need it on those groups.

MS. THORPE: Thank you.

I think one topic that we haven't yet touched upon is the fact that we now have DCOs that can clear exclusively for over-the-counter markets and over-the-counter transactions. And NYMEX is also an example of a regulated exchange and clearinghouse that clears for both OTC and regulated transactions in the same segregated account at the clearinghouse. I'd like to, perhaps, seek input from people like Dennis Earle and from Neal, as well, on what if any additional risks you believe there are presented by the OTC component of clearing and what additional considerations the CFTC should take in its oversight program? Dennis, can we start with you, please?

MR. EARLE: Sure.

Well, unlike David's five minute notice, I got eight hours notice. So I have a little advantage. I had time to think about it.

But when you look at an over-the-counter market like the energy industry, while trading may occasionally occur through firms, where one firm trades through another, clearing is essentially a bilateral function. What that implies for the clearing system is that, at least in the case of energy firms, there's no history and experience of clearing for other participants. That means that if we were to impose the concept of customer clearing where one energy firm cleared through the other, we might actually be creating new risks because these firms don't have the experience, they don't have the systems, and actually they don't even have the appetite for handling that kinds of risks.

Traditionally clearinghouses in the United States, and I think in the UK, have basically reserved their membership for the most credit worthy participants in the system. But that system worked only because FCMs and broker dealers had a long tradition of being able to clear through each other. But when you're with an OTC market

where we don't have that ability for participants to clear through each other, that is going to have long term systemic implications for the definition of who is a member and may require us to rethink the normal classifications of what a clearinghouse would permit as the members.

Additionally, if I can go back to my notes, there are significant implications for what you might have to do if a member falls below normal membership criteria. I mean, the normal routine in a clearinghouse if somebody no longer meets the membership criteria, you get them an exit pass, they go find a clearing member, and they come back in through the clearing member. Well, what do you do when there's no clearing member to come back in through?

If you look at the energy industry today, which yesterday had another significant firm that was downgraded to junk status by S&P, that could present rather interesting complications. If an OTC clearinghouse, not just for energy, but for any true OTC market which forage swaps and several others might well qualify, where if you take a participant who fell below membership criteria and exclude them from clearing, you might, in effect, be excluding them from the market as a whole because of their

inability to clear transactions through any other vehicle. That has significant implications.

How you handle a liquidation in the event of a failure of an intermediary could be significantly different. In a normal exchange market where the exchange has an affiliation with a clearing system, any member that fails in the clearing system, traditionally their transactions could be either customer transactions, could be transferred to another clearing member or could be liquidated in the market. But what do you do when that is an OTC market when there is no organized exchange that has a high concentration of activity in these instruments to allow the clearing system to go to that exchange for liquidation of the contracts?

I think what these imply is that as we at Energy Clear learn more about how to clear OTC markets, and if, indeed, other markets do decide to develop clearing mechanisms for their own purposes in their OTC environments, that we are really looking at a model that may not be identical to how we clear organized exchanges from definition of who is a member to how we handle liquidation, to the fact that there may be no customer

clearing in these markets. We may be looking at something that is a hybrid of existing models.

So I would suggest that certainly in the development of what we're doing in perhaps analogous organizations, close cooperation with the regulatory authorities, at least during the period of definition while we figure out how these issues can be dimensioned and dealt with, will be essential to the success of that kind of venture. They are very different mechanisms than anything we have dealt with to date in this classical industry.

MS. THORPE: Thank you very much for that.

Neal, would you like to comment on some of Dennis' comments?

MR. WOLKOFF: Well, indirectly perhaps.

What we've done, I mean just so for those of you not familiar with it--first of all, I represent the New York Mercantile Exchange. And what we've done is asked the CFTC to give us the permission, now that there's been a separation legally between the trading function and the clearing function, to be permitted to clear transactions that have not been executed on our exchange, but have been executed elsewhere, therefore by definition executed over-

the-counter. And to treat those transactions by using the EFP or EFS mechanism, most of them cash settled, as part of the regulated segregated pool of funds and positions at the clearing firms.

And what that presumes, just as what futures contracts and futures markets presume, is that the clearing firm has the customer relationship and is adept, most adept at making the determination of credit worthiness of the customer. I think as to Dennis' point that there are distinctions between over-the-counter and exchange traded, that's clearly true. However, now that it's permitted, it's important to note that there are quite active and liquid markets over-the-counter. And I would say electronic markets, voice brokered markets, as well, one to many multilateral transaction facilities. And I think that the real key to it is not whether or not it's cleared in the regulated or an unregulated fashion, I would like to speak to that for a moment, but how the risk management is handled at the exchange level and at the FCM level, what's the experience, what the procedures are, and the like.

And to most extents, with the exception of the liquidation issue, the customer relationships, the ability

to measure the risk are similar if not identical to what happens on a futures exchange. And given the fact that margins can be appropriately determined, that settlements are real because they're determined by exchange staff based on real transactions, there's no issue like in the Klein and Company default where margin was collected but not to settle risk. Margin was collected for the sake of collecting margin, and it really had no relationship to the risk involved.

I think the exchanges--on clearing associations we happen to be a merged entity, have the expertise to determine the risk and then to determine the settlement and to mark it on a daily basis. And that's probably the best mechanism for preserving integrity.

Now, I know that at the end of the day one of the issues that we did have in doing this at all, really, was that there was some concern about the potential impact that OTC transactions might have on regulated transactions. And I think that a legitimate enough concern, but one of the benefits of doing this, especially doing it as an energy exchange, taking in over-the-counter energy, is that you're getting more of the book potentially than before.

So whereas now a firm might have a customer that somebody mentioned downgraded within several weeks, and you have all of the customers long positions, but all of the short positions are over-the-counter, this gives you an opportunity to take in the short positions as well. And so you have a balanced portfolio at the clearinghouse. That's a risk mitigant.

I also think, and this goes to a larger policy issue, and is a very longstanding issue, perhaps, argument in the FCM and clearing community that probably the single biggest concern about combining OTC with the traditional regulated commodities is, well, it's the fact that under the rules of clearing, non defaulting customers potentially can be at risk for the default, for the bankruptcy of the clearing firm. And so it puts the customer in a position of essentially really needing to know information it has no access to, mainly the credit exposure of the clearing firm to its other customers. And that's a very, very difficult I think rule in this business to carry forward.

But nonetheless I think the fact now that over-the-counter transactions can be cleared at all, think of it in reality, a company that is clearing over-the-counter

positions and clearing exchange positions, let's say at the same clearinghouse, if there's a bankruptcy in the over-the-counter market and the FCM goes bankrupt as a result of the customer bankruptcy, I think it's not realistic to think that won't have a spill over or carry over effect into the regulated market place.

So the issue is really an issue of risk and systemic risk now brought about because of the legal permissioning of the division between trading and clearing. And the secret to it is not really regulatory. The secret to it is risk management. And I think, as we said before, it all comes around in a circle. The role of the CFTC in this shouldn't be prohibitive or prescriptive. It should be an oversight role and a management role to make sure that this practice and procedures of over-the-counter clearing is fitting within the fiduciary obligations that we have to the clearing members and the customers and the market place. Thanks.

MR. VARLET: As you know in this example of OTC--let's be clear that first of all I'm in favor of OTC clearing. And I think it's a good idea and I think a good

service we can provide to the market place because we have set risk and it's a key advantage.

This being said, I think we, okay, we go back to the way we handle the process. And first of all we had the kind of, if I can take this example, of a fait accompli for the exchange's clearing members. Suddenly we have discovered that suddenly the exchange was clearing OTC products, which to be frank, is a big problem for us. And we go back to the issue of governance. We go back to maybe the second section of this. But I see the issues are clearly linked. And as far as we are concerned, we consider that even if we support the idea, we are exposed to risk that has not been discussed with us before.

And second I think the problem will be solved if we had the control as FCM of the clearinghouse. Because in that case, we could make sure that as the guarantor of the, the financial guarantor of the system, we could make sure that the system in place is proper.

And I think, for example, I consider that in this case of OTC product, the segregation between OTC activities and the futures activity would be certainly a good idea to be standardized. To see if an FCM who doesn't want to

participate in the OTC program could be out of the risk of the OTC clearing. They are a system at risk, but they are not the only system at risk. And I think in that case we can perfectly merge in the two different pools of risk in the clearinghouse. And I think we would welcome as a FCM the opportunity to discuss this issue.

COMMISSIONER ERICKSON: If I could ask just a general question? As the CFTC looks at some kind of oversight of DCO activities, with clearing organizations' abilities to clear cash, derivative and over-the-counter transactions, what should be the focus of the CFTC's inquiry as far as adequacy of financial capital? Is it strictly limited to our insight with respect to segregation of funds in accounts that are tied directly to futures activities? Or should it be broader to take into account some of the risk exposures of over-the-counter clearing and cash?

MR. EARLE: I'll take a crack at that really quickly. I think that since my clearinghouse represents strictly OTC participants, no FCMs, no broker-dealers, it seems appropriate from our discussions that we certainly

would value the Commission's oversight of our ability to handle an insolvency in the OTC markets.

I don't know, given the heterogenous nature of this table, if there is any regulation or viewpoint that could be established that there is one way to measure the risk of a member or one way to measure the risk of a participant or an instrument. I mean, look what we have. We have independent clearinghouses owned and operated by FCMs. We have clearinghouses that are divisions of exchange. We have a clearinghouse sitting here that's owned by people that aren't even FCMs or broker-dealers. We have instrument types that are all over the board and expanding rapidly.

It's hard to believe that any regulation that was published today would be accurate tomorrow.

On the other hand, the litmus test of every one of our organizations has to be our ability to handle an insolvency, which is germane to the Commission because any insolvency we have could easily have a domino throughout the system. And I think other regulators have looked at their activities as focusing on the ability of the clearing system to be able to handle the insolvencies, which in our

business are inevitable. I mean, members fail. It happens no matter how much we protect against them.

So if that was a Commission goal, I know that that is something that we would very actively support and encourage.

MR. POLK: I think it opens the door to rethink about the concept of customer segregated funds in a net capital computation. Because once you start down this road of OTC, and now talking about a risk based capital approach, and I would strongly suggest that that's something that has to be considered.

Let me just, as an aside, give you one example. As we have the energy liquidity problem, Man is being very conservative and consecutively increasing the original margin requirement to protect itself. We take in more and more money, thereby reducing our potential risk and what happens. And when net capital goes up, and when net capital requirement goes up, it's completely contrary to risk prevention from our side of protecting the systemic problems that could occur in the bankruptcy situation of a major, major customer.

So I think risk based capital is something that you should consider.

MS. THORPE: We have 10 minutes left, actually 7 minutes left. And so I will throw out this last issue that's on the agenda for this session which is the delinking, which we talked about quite a lot actually, but around the issue, the delinking of the clearing and the execution function and whether that is promoting competition among clearing organizations and whether that actually minimizes or increases risk in a system.

Or shall we save that for the next session?

[Laughter.]

MS. THORPE: All right. Well, then the chairman, whose orders I always follow, has suggested that we break at this point in time and reconvene at 10 minutes after 3:00. Thank you all very much for your insights.

[Recess.]

SESSION TWO

CHAIRMAN NEWSOME: Okay. We're going to go ahead an get started, because we do have a time frame.

Okay. If I could have your attention? First of all, I want to say thank you for the very helpful discussion from the first session. Certainly it's the beginning of a dialogue that we hope to have as we move forward on developing general oversight rules for DCOs.

I fully expect this second session to be more lively possibly than the first. But I think the topics are just as important. I know for one at the Commission I am anxious to hear the deliberations. And I appreciate, again, everyone's willingness to come here to discuss these issues.

At this time I'm going to turn it over to Dr. Susan Phillips, who we introduced earlier, who absolutely needs no introduction to this group. All of you know she's a former chair of the CFTC and a former governor of the Federal Reserve Board. We very much appreciate her willingness to moderate this panel. And with that, I'm going to turn it over to you.

DR. PHILLIPS: Thank you very much, Chairman Newsome.

First of all, let me say it's a great pleasure for me to be back here. It's a little bit of deja vu for me to be chairing a session within the halls of the CFTC. But I also, as I was listening to the first part of the session, realize that a lot of the issues that we were faced with during even my tenure back here, are still here, some of the issues are still alive and well. And it's, it's a honor for me to have been asked to come back to chair this session.

I also want to congratulate Chairman Newsome and Commissioners Holum and Erickson for holding this session. You know, I do think that when a regulatory agency is given a major new charge, that can be fairly daunting and that it's very refreshing to see that the Commission has, is holding such an open general discussion before they start putting pen to paper. And I do think that, and I know that they will take to heart all of the statements that have been submitted and all of the statements that not only you will be giving as we move forward, but as Jane mentioned, they would keep the record open for a short period of time

so that if you think of something later that you wish that you had said, you can submit additional written comments.

I think it's particularly useful to hold a session like this in Washington not only for the Commissioners to hear, but also for the staff of the CFTC to hear, because they will be the ones who are writing the first draft of whatever regulations come out. So it's very useful for them to hear all sides of the issues. And it will be particularly useful for them if we put those issues before them in as orderly a fashion as possible.

So with that in mind, I'm going to suggest that we have a few ground rules for this session. There are some very provocative issues that were listed as topics for this session. And I know that the people around this table, some of them hold very strong views and not all of them on the same side of the issue.

So even though I now come from George Washington University, GW, where they every day film Crossfire, I want to mention that I don't think Crossfire is the appropriate mechanism for a discussion like this. So what I would like to do is to propose that in particular since the FCM community has raised some issues, I'd like to start with

the FCM community and have their statement of their views on the issues that are listed in your program. And if they would go for maybe 30, 45 minutes, then I will turn to the exchange community and ask the exchange community to do the same. That will give us enough time then so that we can have additional questions and comments at the end.

And rest assured that anyone who wants to make a statement, we will get your statements in. So there's not a need to feel too rushed in this process. But we have, I think, some lively discussion topics this afternoon. And I certainly look forward to hearing everyone's viewpoint.

So with that introduction, if I can call on John Damgard to start us off and give us an overview of FCM positions.

MR. DAMGARD: I'll be delighted to, Susan. And you didn't mention the clearinghouse community, and we love having them with us. We just don't want to yield them a whole lot of our time.

First of all, thanks, Jim, for organizing this, and Jane Thorpe, thank you as well for the work that you've done. These are terribly important issues. And thank you, Susan, for being willing to moderate this very important

session. I would just like to add that I've been around long enough. I think Susan might have been a mere teenager, but I was there when she was sworn in as chairman of the CFTC, and if I'm not mistaken, she's probably the only chairman ever sworn in at the White House. And as I sat there in the Roosevelt Room, Ronald Reagan came out and said, "I'm so proud to be here and I'm so proud to be naming Susan Phillips as the Chairman of the CFTC and the Senate in their wisdom has just confirmed that nomination unanimously because the CFTC is my absolutely favorite agency."

And I remind people of that a lot. I'm not so sure that Mary Shapiro didn't write it, but I remind people that this was Ronald Reagan's favorite agency. And he doesn't think as clearly today as he used to, but he'd be awfully proud of the talent that's here now and I'm sure it would continue to be his very favorite agency.

I hope Tom's not offended by that.

I would like to begin my remarks by congratulating the U.S. futures exchanges on the phenomenal year that they are having. At the end of June the CME was up 36 percent, the CBOT was up 21 percent, and NYMEX was up

27 percent in terms of trading volume. I think this is a testament to the strength of the management teams at the exchanges, the great products they're offering, and the simple fact that our customers need these products more than ever.

It might seem strange to call for a structural change at a time like this, but I believe our industry faces some serious challenges that need to be addressed, and the sooner the better. The passage of the CFMA, in my view, marked the start of a new era in our industry not just because we achieved legal certainty for swaps, cleared up the foreign exchange jurisdictional problem, lifted the prohibition on single stock futures--in the name of competition I might add--although those certainly were major achievements. But also because Congress made a fundamental change in the way that the CFTC is supposed to operate.

What we have now, and I believe that our industry is on the cutting edge of regulatory innovation, is an agency dedicated to a flexible system of market oversight based on core principles. I am confident that this approach to regulation will lead to much greater innovation

and efficiency in our industry. In fact, I think it has already begun to have that effect if you look at how exchanges are thriving under the new regime.

But our work is not done. If we are looking at this from the standpoint of what's good for the industry as a whole, it's not good enough for the exchanges to do well. We also need to be sure that customers do well.

We do not have a competitive environment right now. Instead, we have exchanges that are each monopolies in their own products. And customers do not thrive under monopolies. I believe that clearing could be one of the principal factors in determining the degree of competition in our industry. And the challenge facing us today is to find the structure that best promotes competition.

We need to ask ourselves some basic questions. Number one, how should clearing be structured in the new world of for profit exchanges? Do futures exchanges face competitive threats? And three, should the CFTC mandate fungibility?

Let's take a look at what the CFMA instructs the CFTC to do in the area of clearing. First, Congress recognized the idea that clearing can be provided

separately from execution. And the CFMA authorized the CFTC to create a new regulatory category, derivatives clearing organizations. Second, Congress included into the CFMA two crucial directives that relate directly to our discussion of clearing issues. The law instructs the CFTC to prevent, and I quote, any unreasonable restraint of trade or imposing any material anti-competitive burden on the contract market.

The Act also instructs the Commission to facilitate the linking or coordination of derivatives clearing organizations with other regulated clearance facilities for the coordinated settlement of cleared transactions.

We should also keep in mind that Congress, in writing the CFMA, expected the forces of competition to take the place of the old prescriptive approach to regulation as a source of discipline on the exchanges. The role for competition has not yet been fully realized. And it is going to become more and more important in the coming world of for profit exchanges.

With those directives in mind, let us turn to the first question. And that's how should clearing be

structured? It's no secret that the FIA has made several attempts to separate clearing from execution and create a common clearinghouse in the United States, along the lines of what we see in the securities world. This model has indisputable benefits for FCMs and their customers, economies of scale, reduced cost, reduced cash flows, and an improved risk profile.

Many of our members operate in both the securities and futures industry. We use both systems and the security system works better. It's cheaper, simpler, and more efficient. And a centralized system works better in a crisis.

Let me briefly summarize the situation in the equity options world, which I think is particularly relevant to the futures industry. The Options Clearing Corp was originally part of the CBOE. When the AMEX prepared to enter the stock options business with its own clearinghouse in 1974, the member firms and the SEC urged the AMEX and the CBOE to strongly consider having a common clearing organization. To their credit, the OCC was spun off from the CBOE and jointly owned. Other exchanges joined in succeeding years.

OCC is owned by the exchanges and controlled by the clearing members who are users of the facility. The board is composed of 9 executives from clearing member firms, as Bill pointed out, one representative from each exchange, and one public director.

The London Clearinghouse is clearly a fine example of the virtues of common clearing in the futures world today. It operates on a not for profit basis and undertakes not to build up reserves. A majority of the shares are owned by the clearing members. Voting rights are based on ownership interest. Firms that have the most capital at risk should have the most say in the governance of a clearing corporation.

The Board of Trade Clearing Corp changed their board structure in 1999 to reflect the interests of its members. The new governance structure reflects a one share, one vote measure for 6 of the 9 governors.

Common clearing has not yet happened in the futures world, despite its obvious advantages and despite years of meetings and discussions and studies and panels because at the end of the day the futures exchanges have never been willing to do it. By keeping their clearing

operations closed and proprietary and their products non fungible, they make it more difficult for another exchange to compete. That's a perfectly understandable motive, but it doesn't coincide with the text of the CFMA and it should not influence the CFTC.

We now have demutualized for profit exchanges. The FIA has not opposed demutualization. We understand the benefits of having a more flexible and faster moving governance structure and access to capital markets. And we certainly are not opposed to profits. But we all have to remember that a liquid futures contract cleared at a captive clearinghouse is one of the strongest de facto monopolies on earth. And we need to think about how for profit companies might use that market power.

Do futures exchanges face competitive threats? The exchanges have long felt threatened by the over-the-counter market when in reality the OTC market brings more business to the exchange because OTC traders use the futures market to hedge their position. I think we can put that argument to rest. Just look at the example of the growth of the swaps market on the growth of the Eurodollar contract that's emerged.

What we should focus on is the exchange versus exchange competition which is turning out to be a lot less than we expected. I can name only one case where an exchange lost a liquid dominant contract because of competition. And that's the LIFFE Bund contract. Other than that, we have lots of talk, but no success by new entrants. The bottom line is that one example of successful competition in one product in a worldwide industry with hundreds of products doesn't exactly make a great case for competition. In fact, EUREX and the CBOT have actually signed a non-compete agreement to protect their bench mark products. So I think it's fair to say that a dominant futures contract cleared through a captive clearinghouse has significant market power, a lot more than most businesses have.

The issue of competition among exchanges is going to become more important as our exchanges move to a for profit ownership structure. As long as they are run as membership organizations, the exchanges are not likely to take full advantage of their market power to raise their fees to the highest possible level. Why not? Because it's not in the member's interest. Whatever profit the exchange

might make is a secondary concern, because the member's primary business is trading. And from their point of view, the transactions fees charged by the exchange look like a tax. Speaking as a membership organization I can tell you with great confidence that members apply a lot of pressure to keep fees low.

Well, things will be different with for profit exchanges once they go public. The CFTC needs to think about how it's going to handle a group of for profit exchanges with market power that are able to convert clearing and trading fees into profits and dividends. The owners of these exchanges are going to want the highest possible return on their investment. Ultimately, that means the customers will pay much higher fees, fees that aren't subject to the intense and unconstrained competition that most businesses face, certainly the FCM community.

Should the CFTC mandate fungibility? The Commission can't do much about the natural advantages of concentrating liquidity in a single market, nor should it. But changing the clearing system so that rival products can be fungible would go a long way towards promoting real competition. We know that derivative markets can work fine

with fungibility because it works in the securities world. And we know that common clearing with fungibility promotes competition because we've seen lots of competition in securities options with exchanges listing the same options and taking market share from one another.

And we've seen a significant new securities option competitor, the ISE, that has come from no where and now has a market share of about 25 percent, most of it in options that were previously dominated by other exchanges. In the options industry we have examples of competition that is very, very good for customers.

Now, that's not all that much--now, there's not all that much economic difference between a securities option and a commodity option or future. But in the securities world, fungibility through common clearing has led to a totally different structure that assures competition in the area of execution.

Given this example and the mandate of the CFMA to prevent unreasonable restraint of trade, how can we justify maintaining the present clearing structure in which products are never fungible? This isn't the time or place to offer detailed proposals or solutions, but broadly

speaking there are at least a few different ways to improve the structure of clearing in the futures industry. One is to move to common clearing. That model would let the trading arms of the exchanges compete as for profit companies, but would centralize the clearinghouse as a single, not for profit membership organization with members motivated to keep fees low. As I've said, we know this model works, because we've seen it work.

Alternatively, the Commission could look at ways to promote product fungibility in competition among clearinghouses. For example, several decades ago the CME pioneered a system to make products fungible across two different exchanges and in two different time zones. It's called mutual offset And they do it with SIMEX. What would the competitive world look like if the CFTC said that clearinghouses could not unreasonably refuse to engage in mutual offset with other CFTC approved clearinghouses? At the very least we would get more competition in clearing and probably in trading. And in a centralized clearinghouse--and if a centralized clearinghouse is really more efficient, as the FIA believes, then competition would drive us toward one clearinghouse, hopefully run as a

membership organization. We don't have to guess about the best structure for clearing. We could let the competition determine it.

Finally, let me conclude by addressing an issue that needs to be front and center in any discussion of clearing, security efficiency and financial stability. We need to realize that a system of monopolistic exchanges with captive clearinghouses is not inherently safer than other alternatives and may be less safe under some conditions. First of all, both common clearing and mutual offset have been proven in the real world. They work fine. Second, the natural monopoly created by a futures market with a captive clearinghouse can sometimes force market participants to do business with clearinghouses that would lose out in a competitive market.

Remember that in May of '87 the Comex clearinghouse almost melted down. It failed to clear trades effectively for three days during a peak in volume. And the Chicago exchanges tried to capture that market by listing look-alike contracts for gold futures. But by the time they were up and running, the Comex was back in business. And Chicago failed to overcome that natural

monopoly, despite the fact that anyone in their right minds would have preferred to clear in Chicago than at Comex. It took many years before Comex finally merged with a stronger exchange.

In a truly competitive market for clearing, the Comex Clearinghouse would have lost out and its business would have moved to a stronger, better managed organization. So I don't think that the exchange can justify captive clearinghouses on a safety and soundness basis. This is really about competition and market power. And the Commission will have to deal with that issue as we move forward into a new era for profit exchanges. Thank you, Sue.

DR. PHILLIPS: Thank you very much, Mr. Damgard.

Are there other FCMs that would like to make additional comments? Mr. Nastro, you want to go first?

MR. NASTRO: Thank you, Susan.

My name is Charles Nastro. I'm the managing director of Lehman Brothers and co-head of global futures at that firm. I have been employed in the futures industry for over 25 years. And during that time I've been privileged to serve on the boards of several exchanges.

I've served as Chairman of the Coffee Sugar Exchange. I've served as the first Chairman of Commodities Futures Trading--Clearing Corp of New York, CFCCNY for short. We also have the first president here, Dennis Earle. And I also serve now as Chairman of the Board of Directors of National Futures Association.

The CFCCNY experience is something I would like to just talk about briefly. But to those who may not remember, CFCCNY was one of the industry's first attempts to develop a common clearing entity in the New York Futures market place. With ownership residing with the then five New York futures exchanges, governance was to reside in a board of directors whose composition would be comprised of a majority of clearing members. It sounds a lot like the OCC model, and that has had such great success in the securities market.

It was really far from a perfect solution, but it was a major step toward our industry's efforts to consolidate. It was going to create greater efficiency, improve risk management. And it would certainly have lowered the cost across the board, especially due to the

significant number of clearing members who were clearing members of all of those markets or most of those markets.

Unfortunately, like our Chicago common clearing initiative, it was defeated for much the same reasons that John has mentioned in his remarks. But the core concept that I strived for, and everyone was striving for there, was that we were attempting this venture, and the concept is there today, namely to take control, take management control of the clearing process because of the fact that every day there is risk of default, we are the ones who take on that exposure. We are the ones who really create the market. There is liquidity, but without the clearing member guarantee, there would be no market.

And, but unfortunately, not withstanding exchange pronouncements about representation of constituents in governing bodies, some exchanges have little or no clearing member representation in the decision-making process around clearing issues that confront us every day. Serving on a clearing advisory committee and giving advice on how an exchange should manage our assets does not do it for me and it doesn't do it for my colleagues in my treasury department. They think it's incredulous, by the way.

We, as clearing members, need to be able to manage our risk directly and as efficiently as possible. Exchange control of the clearing process has been more an obstacle course than a fast track. And I'll give you a few examples, but there are many more. Let's take one example that's currently facing all of us today, and that is single stock futures. It's illogical that single stock futures are notfungible. IBM stock walks and talks as IBM stock. And, yet, that is not--the exchanges have effectively mandated that this should not be a fungible product. That, to me, is illogical and it should be unacceptable to clearing members. It's a clear example of poor risk management.

We have a similar situation in the treasury bond complex, in the note complex. We have a situation where the Board of Trade has a contract, but BTEX has this same contract. We should have--there's no cross margining function there. So, for me, sitting back as a dealer and a member, it's absolutely ludicrous for me to put up money over the Board of Trade and also have to put up money over at BTEX. But because I think of a lot of the concepts that John recited, the two have not met. And they should meet.

And that is the reason why the Commission has to take a look at these kinds of issues because that's really where the restraint of trade is. It really lies in now having those kinds of arrangements.

Now, it may be that at the end of this meeting the Board of Trade and BTEX will come to an agreement. And I'd be the first one to be delighted by that. But if that doesn't occur, then I think the Commission has a role to play. But it's my premise that direct governance by clearing members who put up the funds to make these exchange and market places work and function and assure that those core principles enunciated for the DCOs and the CFMA will work and work well, we will have financial integrity without political burdens. No clearinghouse should exist without significant clearing member representation. Independent clearing entities with proper and fair representation afforded to all clearing members will better enable us to assess appropriate risk, since it will directly impact the very people in firms that are involved in the decision-making process.

There certainly would be more cooperation between clearing entities where there are similar products and

significant commonality of membership because that is in the best interest of those firms and their end-users. One of the issues you need to look at is we need to get to the end-user. It's the end-user's monies that we bring to the table, not only our own firm trading, but the end-user's. So you try to explain to a large end-user why he has a contract on the Board of Trade and on BTEX and he has to come up with two margins when as far as he's concerned he's flat, he really has no risk and no exposure whatsoever.

So I just think because the clearing members are the ones who are struggling with these issues, we need to have representation and we need to have a majority of that representation, because it's my pocketbook. I mean, we can talk about people saying that the clearinghouses have monies available and reserve funds. Well, those reserve funds are the direct result of my clearing fees. And the retained earnings of clearinghouses are really the clearing member's products.

Financial standards, John's talked about this, but they must also be commensurate with the inter-day and overnight risk of the market, and I mentioned this in the first session, especially given the explosion of electronic

trading 24 hours a day. In today's electronic world, there are little or no meaningful exchange and/or clearinghouse risk management filters for these electronic trading platforms for obvious and various marketing reasons. Exchanges want to have trading. So these platforms don't have risk management filters. We are delegated with that responsibility. And that's fine for large firms who will be willing to pay the money to have the technology necessary to run those systems will be there. That was my point this morning that, or this afternoon about thinly capitalized entities who have the capacity through a system to create the insolvency situation that Dennis spoke about.

Clearing entities need to examine this phenomenon separately and away from exchange perception and determine what it means to the overall risk for the market we guarantee. So when we talked in the first session about the role of the Commission, prescriptive guidelines, best practices, you have to dig in. You have to get to the underlying to understand the minutia, because the minutia is what's going to hurt us and impact upon us adversely in an insolvency.

Large firms have significant risk management. The smaller firms, and I'm not disparaging the small firms, may not have the capacity, the financial wherewithal to develop those kinds of systems.

I'm convinced, because of that, there will be more efficient risk management when it's in the hands of the clearing members. And I'm not saying that clearinghouses have done a poor job. They've done an excellent job. I'm the first to congratulate the CME and all the problems we've had over time and they've stood tall. There's no question about that. But we have to do more. And progress is slow. I mean, I can tell you--and I'll give you an example. If you look at the annual report of the CME four or five years ago, three years ago maybe, you would see in that document the fact that the CME had $19 billion backing it up. $6 billion of that was Lehman Brothers because we were not a firm that had a subsidiary. We were a parent. And for years and years and years I questioned that, because I didn't want to be at risk, but Lehman did not wish to go through a subsidiary route. So I represented $6 billion for a long time. And rightly you finally changed that to a limited kind of process.

But that's what I meant when I said it's been, it's been an obstacle course. It took many, many years. I've been in the business for 25 years, and I'm telling you that it's been a long time that I've been raising that particular point. It took us a long time.

So I think we need to do more. And I think the problem is, is that we need to separate the execution, the clearing, because a lot of decisions, notwithstanding all the good faith we have today, are based on a perceived protectionism of the execution franchise, whatever exchange that might be. Let me give you some examples of that.

Firms, Lehman was one of them, were initiating Eurodollar block trades on SGX and then transferring the positions via mutual offset. Great mechanism because the contracts are the same. Well, after a period of time the CME realized what was going on and they stepped back and closed that down. Why? Because it was a perceived perception, perception that this might have been taking away business from the exchange floor. Yet, from a risk management standpoint, from all of the concepts of clearing that we all know, it was a good process.

Just another example recently, and this one unnerves my treasury department. The clearinghouse, and again Chicago, Merc and other exchanges, and the Commission were in the forefront here to create money market funds and allow those deposits. Excellent, excellent concept. And we're trying to convince other exchanges around the world that that's a good concept. But recently an edict came out from one exchange that we needed to allot a portion of our money market, our margin deposits to specific money market funds. Now, those money market funds may be fine, reputable institutions, but you're asking me to go to my treasury that does a credit analysis every single day on my counter party exposure, looks at everything we put out to the market place, and say, by the way, forget about those rules, you have to take these funds and put them with A, B and C. We may not want to do A, B and C that day. We may only want to do D and F. So it's just another issue of what we are confronted with.

I think they're indications of how certain clearinghouses are constituted today because they do not primarily focus on what's best for the clearing member who funds the guarantees for the clearinghouse and the end-

users. And I'm not saying that everything should be with us. I think, you know, we spent a lot of time and worked with David Hardy with the LCH. It's a wonderful, wonderful product. At the end of the day it's exchanges and clearing members working together to watch over the risk, but everyone's views are heard and the ability of clearing members to make decisions because they have majority governance is paramount.

So I personally think that proper governance with significant clearing member participation will assure that the core principles promulgated under the CFMA will be achieved and will avoid the temptation to use the clearinghouse as a restraint of trade in a competitive market place that the CFMA was intended to engender.

I, like John, would like to take this opportunity to thank everyone, especially the Commission, for putting this together. This is a great effort. I know it will go forward and we will hopefully develop a process to speak more frequently and come up with some ideas. We all need to, have to understand the process. Not only the CFTC, the staff, I need to understand better the exchange issues and

they have to understand our needs as well. So, again, I thank you.

DR. PHILLIPS: Thank you very much, Mr. Nastro.

Are there other representatives of the FCM community that would like to speak at this point? Mr.?

MR. FELKER: My name is Bob Felker.

DR. PHILLIPS: Okay. I can't see your name tag.

MR. FELKER: This year I'm Chairman of the Futures Industry Association.

I would like to just very briefly again thank the Commission for this forum and also say that the board of directors of the FIA completely agrees with everything John and Charlie have said. I think it's really important to recognize that we come up with a position on public policy. We represent the legitimate business interests of our firms, but also the public because we represent the public worldwide on exchanges where we manage risk. So it's very important to keep in mind what we're talking about here we believe very firmly is in the public interest and a very important public policy issue. So with that, I'll pass.

DR. PHILLIPS: Thank you very much.

Any other FCM representatives? Mr. Varlet?

MR. VARLET: Yes. Good afternoon.

First of all I want to thank the Commission for giving us the opportunity to present our positions. My name is Didier Varlet. I'm Chairman and Chief Executive of Carr Futures. Carr Futures is a FCM and a broker-dealer. And we are a subsidiary, we are part of the group Credit Agricole, which is one of the top banks in the world. And, but Carr Futures is U.S. based worldwide. The head office of Carr Futures is in Chicago, which I think is worth to mention for a French, a French ownership.

I won't follow in order not to be too long my whole statement, and based on what has been said, I would like to maybe concentrate on a few remarks and to try to illustrate what we feel at the board. I think we have mentioned the key trends. We have this issue of the shift from the block trading to the electronic platforms and the fact that we think that the U.S. is behind in this area and this issue in terms of looking at the environment has to be mentioned. We think also that we, more and more we need strong central clearing. I think ENRON has been a wake-up call for a lot of people. And it's quite obvious that including for OTC where I think there is a lot of

opportunities that we can develop for business, we have to support the development of new clearing possibilities toward a safer market place.

And also I think innovation is extremely important. I think the U.S. exchanges have been, our industry has been extremely important for innovation. And I think we have to continue to foster innovation and I think it's key.

Obviously demutualization is of concern today because we, I think we are all supporters of free markets and so we feel that demutualization is a positive evolution. But we want also to make sure that demutualization is done in such a way that we don't create destruction in competition in the market place. And I think that when we have spoken about the de facto monopoly of the exchanges, it's not to try to be political in any way. I think it's something that we can see that some major contracts are very difficult to move when you have a vertical process. And we can see this evolution of the market place without, I think, a transition. Because we went overnight from the old system where there was heavy regulation to a system that we welcome, all of us, with

less regulation. It's creating some, we think some risk for the competition.

And the first one is the lack of efficiency due to the fragmentation of clearing, a thing that my colleagues have already explained a lot. But I think some of the key points, the first one is that we cannot really benefit from the advantage of standardization of futures. I think the standardization of futures is one of the fungibilities, one of the key advantages. And I feel that is the one of the key points to see that the market users cannot really--and the examples that Charlie Nastro gave I think are very good, and I won't repeat that--are an extremely important point for us.

I think also the example for the governance is also key. I think that when you provide the support in terms of capital, you must have the right to define the basic rules and the safety net and the way the clearinghouse is handled. I think, I won't develop too much this point because they have already been very explained by my colleagues.

Obviously we have another key concern. And maybe it's a concern for the future. Today I think that I had

some discussion with Jim about the accuracy of demonstration about fee comparison, but I continue to think that the fees in the U.S. are fairly higher to the excess, the cost of excess to the future exchanges is higher than in Europe. And it's, it's--we think they are--I won't go into all the detail for that, but I think it's an important point. And we think that the de facto monopoly that we are facing today is the vertical organization creates the risk in terms of fee increase. And I would like only, and Jim, I will quote the IPO, I'm quoting, but I will take an extract from the IPO document of this year. And in the risk when you risk the risk, it's page 32 of the IPO document it says, "We have tried to mitigate the downside of unpredictable volume swings through various means, such as increasing current fees." See, it's written.

And at the same time I think if I take the same IPO documents we can see that the expenses of the same exchange increase by 24 percent for the first quarter of 2002 and we have an increase of 16 percent in 2001 and 15 percent in 2000. I know that maybe I'm acting like an analyst, I'm sorry about that, only to mention why we are concerned. They are not saying that it happened. We had a

few fee increases. We, we, we made, I think, some remarks about the fee increase. But I think that this number is a concern for us. And, and this is a reason why we, all of us, we are raising these questions.

Also, when we look at the cost, the risk of the maintenance of European outcry and the electronic system in parallel. It's a burden for us and clearly we have, all of us, to maintain the floor systems, and it costs a lot of money because for the same product we have two infrastructures. Again, I quote the IPO document of the CME, "We maintain the simultaneous operation of open outcry trading and electronic trade execution facilities which may over time adversely affect our business."

I quote further, "In addition it may be expensive to continue operating two trading systems for the same product. Substantial expenses may be incurred and delays may be caused by efforts to create trading links between the separate trading platform in order to facilitate trading on both systems. Any loss of efficiency or increase in time of marketing new or improved product could be the pre-emptor to our business in a highly competitive market. In addition, we may be required to expend

resources on the maintenance of open outcry facilities that could be more efficiently used in developing our capacity and reducing our cost in the increasingly competitive market of electronic trading facilities."

That are some quotes, okay, that's my quote, that's a statement from--these are areas where we are concerned.

We have also an issue which is a little bit different and in terms of supervision and self-regulatory obligation. And we think that most of these obligations must be transferred to an independent SRO because obviously demutualization is raising issues about the conflict of interest. And we, our favorite SRO in that case would be the NFA. I think it's also something important to mention.

I think that as a conclusion I would like to say that exchange, clearinghouses, the CFTC and the FCM, and we don't have to forget the customers, we have all created a very successful industry. And I think I'm proud to be part of this industry. I've been 15 years. I started the business from scratch and I am proud of it. At the same time we believe that we must establish a strong cooperation with the regulator, but with the exchanges. And I think we

will. After this meeting we'll have more cooperation with the exchanges. But at the same time I think we have now to adjust to the demutualization of the exchanges and we have to provide open competition for clearing and giving the opportunity to the market place to evolve as a more efficient structure. Those are my comments. Thank you for your attention. And thank you for giving me the opportunity to give my opinion.

DR. PHILLIPS: Thank you very much. And let me say your full statement will be considered as part of the record. And I appreciate the constructive way in which people are trying to add to comments.

In view of the constraint of time I think it would be good if we not, you know, not repeat things. But in particular, if you have additional items to get on the record, because the important thing is that we have a clear, clear record of all of the various viewpoints.

Mr. Krulik, are you ready?

MR. KRULIK: Yes, I am. Thank you.

As the place card says, my name is Ira Krulik. I'm a Director at Credit Suisse First Boston and the global head of derivatives for it. I am also an Executive Board

Member of the FIA Futures Services Division. And for the past 18 months and an ongoing situation I sit on the Steering Committee, the Joint FIA/SIA Steering Committee for single stock futures.

My points are going to be pretty focused just on the topic of fungibility, a topic that I have had the honor of debating for the past 18 months and ongoing. It is difficult to have a conversation about common clearing without discussing the concept of product fungibility. Many believe the two are naturally linked, as to have one without the other contradicts the desired end result.

First fungibility helps support the standardization of contracts. This has been and continues to be a cornerstone and founding principle of the futures industry. Fungibility helps creates and enhance a single liquidity pool. The deeper the liquidity pool the more efficient a market will be for the end customer. And that's clearly part of the success that the OCC, when I discussed this whole issue of fungibility, that they put out as one of the first and foremost.

Fungibility helps promote best execution. This is achieved by allowing customers and intermediaries the

opportunity to seek the best price when establishing or liquidating a trade. What I would like to do also is just add for the record an excerpt from the comment letter the joint committee, the single stock futures issued on June 17th of this year. And in the last paragraph it says the associations believe that the application of best execution obligation to non fungible contacts is unrealistic, inconsistent with the interest of investors, inconsistent with the traditional super transactional focus of best execution obligation, and is not justified by an analogy to any existing application of the best execution obligation. So clearly is a mismatch.

Fungibility helps spur competition, exchanges and intermediaries would now compete on price and technology, clearly benefiting the customer involved. And, again, if I could read an excerpt from a BrokerTec document that was submitted here today. Consistent with our goal of common clearing, we also believe that fungibility and identical contracts traded on competing exchanges is important to enhance the competitive nature of the U.S. futures industry and reduce the cost of trading futures. The lack of fungibility currently forces traders to make decisions on

where to execute futures transactions based on considerations other than price and cost. But, however, in a document that the CME has here, any attempt to force exchanges to adopt common design standards in the interest of fungibility detracts from competition based upon product innovation. And I believe the issue is that when there are two or more products on different exchanges of identical design, as in, as Charlie said, single stock futures, and they have a common clearing structure, the OCC, why then would an exchange not favor for their clients fungibility. Competition is discussed by the exchanges that as far as single stock futures are concerned, the exchanges have been talking about competition as part of their market place structure.

Fungibility will help reduce overall operational processing costs. I've also been in the industry for 23 years, 20 of which has been on the operations side. I stated earlier fungibility and common clearing need to be thought of as one concept. With that processing costs are reduced with fungibility as intermediaries would be afforded the opportunity to streamline back office processing and pass much of those savings on to their

customers. These savings would be in the area of reduced technology maintenance costs and reduced staffing needs to perform the many reconciliation processes they need to perform with the various different clearinghouses. Compliance issues would also be streamlined as there would only be one set of rules to comply with.

Fungibility, again, coupled with common clearing lowers the cost of collateral to member firms and their customers. This is achieved by more cross margining and a single margin requirement to all participants. It reduces costs of having to move collateral around and the maintenance of numerous settlement bank accounts. Fungibility also reduces the amount of margin required by the customers. And I think this is probably the single concept that I have been trying to advocate as a member of the Single Stock Futures Steering Committee for the past 18 months, that it is the end customer that is really bearing the cost of a non fungible product in a common clearing environment with single stock futures.

In a non fungible world customers with economically offsetting positions bear additional costs by being required to post additional capital to maintain

offsetting positions until final settlement. And that's because those who have been involved in the process with the joint margin rules just coming out as of yesterday, it has been pretty much written into the rule, unless it's changed since yesterday, I don't know, that customers would need to post 3 percent of the current market value of their economically offset single stock futures position.

Think of the implication that intermediaries have when they say, we don't need to put that up to the clearinghouse to the OCC, because the OCC is margining the clearing members zero, but the regulation is requiring a 3 percent margin rule to the customer. I think that's an issue. And, B, clients must bear the additional execution costs if they desire to liquidate the non offsetting positions prior to final settlement.

The last comment that I have is as the rules were written in the CFMA for single stock futures, fungibility is required two years after implementation of the product or at one--at such point that single stock futures open position reaches or exceeds 10 percent of the corresponding single stock option. What does that mean? That means all the intermediaries will have to bear dual development costs

to now tweak the systems two years after launch. So we then, again, have to pay for it for a second time. That's it, short and sweet. Thank you for the opportunity.

DR. PHILLIPS: Any other FCM? Mr. Dawley?

MR. DAWLEY: Thank you.

I'll just make a quick comment. I find it interesting that there aren't discussions going on like this related to the shares world or the government security world mainly because I think DTCC and GSCC work. I should mention the equity option space too. We did bring up OCC today, but that was really to talk about how well they do things.

My main comment is I just think that common clearing is the best thing for the futures industry and for its clients. And I think the best way to get there is via competition. And unfortunately, we can't get there via competition because of some of the structures that are in existence whereby exchanges own the clearing process and are kind of holding that captive. And it happens to be on some very successful products too, which really makes a difference. That's really all I have to say.

DR. PHILLIPS: Thank you very much.

MR. DAWLEY: Thank you.

DR. PHILLIPS: Mr. Polk, did you want to make a comment? Could you turn your microphone on?

MR. POLK: Just very quickly a few things.

John talked about, a little bit about volume. Volume does not ensure or result particularly in profitability. Profitability is made up of what I would call three components, commissions, interest, and control over your cost side. The structure that we have today is extremely inefficient. We have disparate systems to deal with all of the various clearing corporations. We need more people, more overhead, more IT people, and as a result our return on capital employed and profitability is lower than it should be.

Secondly, from a risk management standpoint, the FCM is responsible for risk, but we are not really compensated for risk, which is an important point as well.

Lastly, the ability for us to compete on a global basis becomes more and more problematic because our capital has to be more employed here in the United States to a certain degree inefficiently. So we need to streamline

that process here so we can deploy and ensure overall growth.

DR. PHILLIPS: Thank you very much.

Are there any other FCM comments?

Mr. Gaine? Yes.

MR. GAINE: Madame Chairman, I have a brief parliamentary inquiry. I don't consider myself an FCM representative, but I have about 45 seconds of comments if now would be the appropriate time?

DR. PHILLIPS: Surely. Go ahead.

MR. GAINE: All right. Thank you. And one thing, it will be 45 seconds because I walk 50 yards across the street to get here, and I see many of my friends who have gone to a lot more inconvenience and trouble than that to get here.

I'll just say when Bob Wilmouth and I were kids, a lot of things have changed since then. You can now make a right turn on red. You can eat meat on Friday, and we put a man on the moon. Now, the idea of, you know, clearing number two yellow corn in New York, that was not done then, and it's a new idea. Whether it's feasible or not, I don't know. But I think basically I, being I think,

along with yourself, Chairman Phillips, the true public interest representatives here, feel that the comments of Didier and John Damgard and Charlie and Bob and others, at least deserve a serious look by the Commission I think whether it's a working group or another advisory committee.

I don't know that we have answers to all the questions. I mean, John says fix a roof when the sun's shining. I think our exchange friends could say, if it ain't broke, don't fix it. They have a tremendous record. I was here in 1980 when there was the silver blip. And the clearing mechanism was terrific. Financial integrity shouldn't be sacrificed, but the competition that every one of the prior speakers has raised has really got to be looked at as an end-user point of view in inefficiencies in the market, inefficiencies at margining. And I would just commend the Commission to take a hard, hard look at the questions that have been raised and yield back the balance of my time.

DR. PHILLIPS: Thank you very much, Mr. Gaine.

Any other FCM comments?

[No response.]

DR. PHILLIPS: Okay. If I can, if we can turn to some of the exchange issues and if I can ask Mr. McNulty to lead off the discussion with the exchanges and the clearinghouses, I would be most appreciative. Mr. McNulty?

MR. MCNULTY: Thank you very much.

I'm very pleased that we're actually having this opportunity and I like hearing the direct feedback from the FCMs and I think this forms the basis for good future dialogue and probably some actions in various areas.

As a preamble let me underscore our continued deep commitment to serve the needs of the futures trading community, including our important clearing member firms and their customers. We clearly recognize that the interests of the exchange must be aligned with the interests of our customers in order to assure our mutual prosperity. But I should also say that we have some differences of opinion from some of the ones or maybe differences of interpretation from some of the ones that we just heard. And I think it might be useful to go through why we have some of those differences.

What I'd like to look at are competition, common clearing, costs, and control, because I think really this

has a lot to do with control and its control of the Bid-Ask spread. When I think of competition we think that diversity of business models is a key stone to competition. To me a mandated industry restructuring, for example, enforced fungibility or common clearing, would be inherently contrary to free competition.

Keen competition for derivatives business, we do at the CME have keen competition. Let me give you some examples. The CME flagship Eurodollar contract competes with $50 trillion in interest rate swap markets, FRAs and other Eurodollar futures on LIFFE and also in the CBOT. In stock indices, we compete with ETFs, security options, OTC derivatives, for example, interest rate swaps, index funds and other stock index futures.

Currencies, in currencies we compete with the inter bank forward market and the inter bank spot market and the inter bank swap market. And from electronic platforms, I think it was interesting to look at the testimony in June here by Jan Waye of Cargill where he said we've got ICE coming in. In terms of energy, BrokerTec trying to copy financial instruments. Merchants Exchange trying to do something on energy. Island trying to compete

with One Chicago and NQLX. So there's plenty of new competition that is coming to the market place.

One of the things that we see is the fact that exchange traded futures in total have approximately $23 trillion in outstanding size. However, if you look at the competing products in the security side and the OTC world, you see that it's in the vicinity of $96 trillion. So 23 trillion versus 96 trillion, the exchanges are not running the universe, they're just a small part of the total universe.

But the important thing about the exchanges, the futures exchanges is they are a place where the public can see prices in a transparent way and where the public has a chance of capturing a Bid-Ask spread where one public member could end up meeting another public member on an electronic trading system like Globex, for example, or even on our floors.

When we think of competition we think of three pillars, innovation, liquidity, and financial integrity. Let me start with the diversity of futures contract designs. Fungibility certainly is really seen in the context of the securities world. But that makes sense. If

you think about a stock, a stock exists entirely independently of an exchange. IBM doesn't need the New York Stock Exchange to have equity. It doesn't need the AMEX. It doesn't need the PCOAST.

However, when you come to futures contracts, futures contracts do demand innovation because they do not exist separately from the exchange. And so we think that it's important that there is a distinction between futures contracts and securities. One of the reasons it's important for us is that we think that if we can be more innovative than others, that we have a chance to create shareholder value for our shareholders and also to do a public service of creating better risk management instruments. So we think that innovation is important.

One of the things that futures exchanges attempt to do is to add unique value. The products are rarely generic. Innovation is key to the exchange value proposition and also to our growth. So enforced fungibility would stifle new product innovation and, in fact, at worst it begs the question of why innovate because as soon as you innovate and create the product, it now becomes somebody else's product as well.

Liquidity and price transparency. Futures only have utility if they offer enhanced liquidity relative to cash or derivative market solutions. And liquidity is as elusive as it is vital as we all know in this room. Successful futures contracts concentrate activity in open, transparent market places and help achieve that critical mass of liquidity. I think that's extremely important for the public, for our FCMs, for our banks and investment banks that we have this critical mass of liquidity.

Financial integrity, designated contract markets are bound by core principle 11 of the Commodity Futures Modernization Act of 2000 to provide for the financial integrity of its markets. And that means the financial integrity of our markets from end to end, including the clearing process. We think that a vertically integrated structure, such as we have at the CME, allows us to properly discharge that duty. We can control from end to end the financial integrity of our market place.

We also think when we talk to our clients that they find it important that we do that as well, from the point of view of straight-through processing. More and more we're finding people saying we do STP not only at the

front end when we do our trade on Globex, but we also are doing it at the back end. And I can, I can guarantee that that's the case, because when we had--when we did 1.5 million contracts on Globex a week ago and the clearing piece started to slow down towards the end of the day, we had many calls. We need that clearing piece to be just as fast as the front end because we use it for straight-through processing. This is very important for us and for our clients as a risk management tool.

Finally, I think it's important to say that the CME in 104 and a half years has never experienced a default. So we've worked very closely with our FCMs and clearing community and our members to assure that it's a strong exchange from a default perspective.

Some of the benefits of common clearing I think are interesting to look at. One is capital efficiencies. To that end, CME pioneered cross margining with the OCC, with the New York Clearing Corporation, with BOTCC, with LCH, with NYMEX, with the GSCC. We think that this pioneering helped save our community $350 million a day in margins.

CME also introduced common banking with BOTCC. Only three firms participated and the program, therefore, was terminated in the spring of 2002. But that's something that we didn't choose to do. We hoped that more firms would use it.

Operational efficiencies and standardization, SPAN Risk Management System was developed by CME and licensed to 30 exchanges and clearinghouses worldwide again in an attempt to come to a common framework for thinking about risk and risk management. Leading industry efforts to develop--we've been leading industry efforts to develop a fixed protocol which is the protocol that most of our large bank and investment bank clients use, and also standardizing out trade and trade register reports, trade record or TREX formats and give up and APS systems with BOTCC.

Also in common clearing we think that reliability and operating costs are important, but a vertically integrated exchange promotes reliability with coordinated execution, clearing and settlement.

Let me now move to the concept of costs. Are fees for vertically integrated exchange higher is one

question you might ask. The vertically integrated model reduces cost by diffusing overhead resources, facilities, and software licenses as we see it. In fact, on a post netted basis, the different domestic settlement organizations in Europe vertically integrated within exchanges, are cost efficient as the DTCC, a centralized agency is thus not necessarily cheaper than competing organizations. And this came from a paper called the Security Settlement Industry in the EU by Lineau Levin, CEPS Research Report in December of 2001.

The other thing I think is important to do when we look at costs is make sure that we're comparing apples to apples. In the June testimony Mr Damgard unfavorably compared the CME E-Mini-S&P $1.14 customer fee with the 30 Euro fee for the Eurex Euro STOXX contract. But if you do that, you're comparing two completely different business models. We have a pricing structure which encourages liquidity providers to provide liquidity. And if you take our weighted average fee, it's 37 cents for all participants. Further, the E-Mini is 1.7 times larger than the notional value of the STOXX contract. So on an apples

to apples comparison, the weighted average of our E-Mini fee is 22 cents versus the 30 cents for the STOXX contract.

The CME, the fee structure favors liquidity providers and it helps reduce the overall trading costs, including slippage, for those retail users who are paying $1.14. Another note here is that Eurex is also a vertically integrated exchange like the CME.

If I can go to the next page, page 10, in fact, Goldman Sachs in a Global Derivatives and Trading Research Report written by JoAnn Hill recently recognizes the CME in terms of costs as a value leader. To quote her, she said, "Commissions, including exchange fees and brokerage charges represent only a small part of overall transactions costs for futures. Typically well under 5 percent of the total trading costs, comparing E-Minis, ETFs and STOXX, futures contracts are the cheapest to trade and STOXX the most expensive. This is primarily due to higher commissions for STOXX and ETFs, a wider Bid-Ask spread and higher market impact."

In fact, what you see is that the S&P 500, SPDER, ETFs and an individual stock portfolio to make up an S&P 500 basket is anywhere from 30 to 50 percent more expensive

than trading the S&P on the CME floor or trading the S&P as an E-Mini contract on our Globex system.

So what is this about? I was in London recently and sat in on a conference where people talked about horizontalists and verticalists. It was a swiftian debate. And the armed camps were speaking with great heat about the issue of being vertical or being horizontal. And it seems to me that when people get aligned in that way, there must be money in the middle. And I think it's important to keep an eye on that.

I think what it's really about is the bid-offer spread. The majority of exchange shareholders are locals whose interest is in maintaining the grip of open outcry, preventing other forms of trading, such as internationalization or crossing--sorry--internalization or crossing because of the rules requiring exposure to the floor. That was from Kevin Davis' CFTC testimony in June.

So now I think we're getting closer to the heart of the issue. And if we think about what Mr. Davis is saying is that we want to be able to internalize these orders. Why? Because the richness, the BNL is in the Bid-Ask spread on these orders. However, it's not necessarily

a great idea for the public that that happens. In fact, Arthur Levitt in May of 2000 in a testimony said, "Internalization substantially reduces the opportunity for investor orders to interact, which may hamper price competition, interfere with public price discovery, and detract from the depth and stability of the markets. Price matching dealers take advantage of the public price discovery process, but need not contribute to the process of price discovery, otherwise known as free-riding. This creates disincentives for vigorous price competition which could lead to wider Bid-Ask spreads, less depth, and higher transaction costs. And all orders could receive poorer executions."

We see that there are some agendas. We know this because we listen to our clients. And a number of them that are in this room today over the past two years have made many recommendations to us which we have followed. Including opening access to the whole electronic trading platform to the CME, including launching block trading. We now, over the past two years, have created block trading rules on 22 of our products, including at night time in Singapore so that, which we didn't have in our cross

margining agreement with Singapore, but we do have a block trading facility for Eurodollars at night and during the day.

So we can see, for example, that 12.9 percent of BrokerTec volume was blocked from 12/1 to 6/2. On some of the days the proportion of block trades was as high as 82.79 percent. Where was the transparency? It was upstairs. Where was the Bid-Ask spread? It was upstairs.

CME block volume during the same time frame was .1 percent. CME is promoting openness and transparency, price discovery, transparency, competition enhanced by a centralized liquidity pool. The CME block trade prices easily compared to transactive prices in open outcry or Globex to ensure competitiveness.

In conclusion, we think that there is a motivation behind fungibility and common clearing. The proponents of fungibility and common clearing seek to internalize their dealings, take the markets upstairs, and exploit the profit from the Bid-Ask spreads. We also think there will be two casualties from that. The first will be in the transparency implicit in the exchange transaction

process. And the second casualty will be that of innovation.

Does anyone remember the last great innovation produced by a utility?

On that note I want to thank you very much. And I do also want to say that we are very willing to work with the FCM counterparts. We do listen to you and have made many changes over the past two years. We will continue to make changes to get to the best possible outcome. We don't think the suggested outcome today is that outcome.

DR. PHILLIPS: Thank you very much.

Do any of the other exchanges wish to add something?

MR. VITALE: Susan, I won't go through all of--which we support at the Board of Trade. But I guess I would like to make a couple of comments.

Despite the claims of my former colleague and friend, Mr. Felker, about the public policy perspective being brought by the FCM community, I think the reality is that the rhetoric that has been thrown around on this subject prior to today, as well as today, is actually one

that really suggests less of an interest in public policy, more self-interest.

When I listen to terms like monopoly and restraint of trade and market power and protectionism, you know, I think of the Justice Department not the CFTC. And I begin to wonder whether or not we're in the wrong forum here because that's essentially the accusation. There are laws on the books, if those are the real problems, and they should be pursued. I don't think they should be pursued by the CFTC.

On the other hand, the purported public policy benefits, as I hear them, are cost reduction, efficiency, risk reduction, all of which in the American capitalist market place is usually undertaken by a competitive environment and not usually dictated by a regulatory process. In fact, the history, I would suggest, is that when the regulatory process tries to dictate those solutions, it, in fact, fails. So as I listen to the argument, I think the reality is we have a--we have self-interest here on both sides of the table in the exchanges obviously as well. And that the market place is a very

good place to resolve those. And there are different models out there. There are different models competing.

And at the Board of Trade, you know, our mission like I think Jim's and the other exchanges, is to provide, you know, a fair and transparent and open market place conducted with integrity in its execution and efficiency. You know, our presumption is if we execute against that mission, the market place will beat a path to our door. And we've got some evidence that when you do some of that, and at least in the last couple of years, it actually happens. So we think that's actually a pretty good thing and that's kind of what we're doing.

We're also presumptuous that if we don't do that, we'll, in fact, invite competition. And I would suggest that at least a few people out there presumed that the Board of Trade wasn't doing that because we do have two designated contract markets that in fact today list our most popular products in an attempt to compete with us. In fact one of them even uses the same clearing services we do, outsourced to Board of Trade Clearing Corp.

If that's not competition, then I guess I don't know what competition is. And, you know, you wonder a

little bit about why it is that we need government intervention to "level the playing field." I'm not sure I fully understand the arguments associated with that when, in fact, we have competitors out there. If we're not doing it right at our place and it can be done cheaper and better some place else, maybe it goes there. So from our standpoint, I think we'd say be very careful about directing the direction of any business activity and let's follow "The American Way" and let the market place decide what's best. And, yes, it might be a little sloppy. It might take a little longer to get there, Charlie, but the market place usually comes up with a better answer. Thank you very much.

DR. PHILLIPS: Are there any other exchange comments at this point?

Yes, Mr. Mlynarski.

MR. MLYNARSKI: Thank you very much. Thanks for inviting us to participate as well.

Like my friend, Jim, said about comparing apples and apples and costs, I do think it's important to state that since the beginning of this year our block trading percentage on BrokerTec is less than 8 percent. And the

day he stated, I assume we probably did so little volume that the one block trade accounted for the 82 percent of the business. So, the manager on our BrokerTec exchange are delighted of the fact that this percentage is falling.

And I'll further point out that we can only compete on the basis of transparency in the market place. And that as our markets have improved, our business has grown, albeit at a relatively slow pace, slower than we would like. But, but we're working on that, because we do have formidable competitors in the market.

I also want to point out to Charlie that he would be the second most delighted person in the room if we were to walk out of this meeting with our contracts fungible with those of the Board of Trade. So--

[Laughter.]

MR. MLYNARSKI: Let me just make a brief statement, and then I'll talk a little bit about our experience in the cash market. As you know, BrokerTec participates in that as well. From its inception one of the publicly stated goals of BrokerTec Futures initiative was to bring common clearing or clearing efficiencies to the futures industry. We didn't think of this idea of

BrokerTec on our own. We listened to the industry. We listened to the users. And clearly there was some dissatisfaction.

The shareholders of BrokerTec, which include many of the firms around this table and many, many others, are active traders in the cash and derivatives markets and have long been concerned about the cost and operational inefficiencies and risk management challenges that result from clearing futures transactions at multiple clearing organizations.

I would also like to point out that, by the way, if you don't know that BrokerTec is the only contract market that has been designated by the Commission since the enactment of the CMFA that is currently operational, if we want to talk about some of the barriers to entry. We see the benefits to the industry participants resulting from--the results would be substantial for the industry that include a reduction in the number and absolute amount of margin payments, coordinated control, systemic risk, very significant operational efficiencies and better collateral management.

Common clearing continues to be the ultimate goal with respect to processing and clearing of trades executed on BrokerTec. And we do urge the Commission to study the benefits, to study the steps taken by the Securities and Exchange Commission to require common clearing of equity options.

Ira surprised me by quoting out of our statement, our comment on fungibility. I won't repeat that. But I think that there are perhaps some interim steps along the way that we need to take a look at. Short of common clearing and fungibility the other two arrangements I think that would be beneficial to futures markets participants and would increase competition in the industry are cross-margining and directed clearing. I recognize that there have been efforts in the cross-margining arena. I do think that significant progress has to be made, though, however in the overall usefulness of those arrangements that these arrangements, because of the efficiencies and the information transfer available on the market, need to approach the true economic benefit that is available between highly correlated instruments. So I think that we

need to continue to push ourselves in that direction as an industry.

These arrangements--excuse me--cross-margining the directed clearing, I think would to varying degrees address two of the primary concerns of those who trade similar products and competing exchanges by the management of credit risk and the inefficiencies of posting margin at multiple clearing organizations. We do believe that the Commission has an important role in encouraging the adoption of such arrangements in order to remove any unnecessary barriers to competition among exchanges and clearing organizations.

Let me talk a little bit briefly about our experience in the cash market. As you know, we also started as an over-the-counter broker in government securities a couple of years ago from a market share of zero where we started our futures business from. We had the benefit of working in a market place that did have common clearing through the GSCC. And because of the efficiencies that we were able to bring to the market place, the product that we were able to bring to the market place and competing with our many viable competitors in

that market place, we think that we have delivered ultimately, we, and our competitors, as well, have delivered better technology, a better delivery platform to the market. The market has generally benefited from significantly lower costs of execution, dramatic improvements in straight-through processing, and also it's created an expansion of the market place and, if you will, a race to new clients.

For those of you who don't know, BrokerTec is deployed in the cash market to over 70 users of the cash market around the world, clearly more than our 14 shareholders. Our major competitor in the cash bond market, can reach speed--I don't know exactly what the numbers are, I hear hundreds up to perhaps even thousands. And if we need to compete with as formidable competitor as they are not only both in terms of serving clients, but in terms of delivering technology, we have to move in that direction too. It's created an interesting phenomenon. I can't prove it and I think it's perhaps more anecdotal. So forgive me on that. But there are trading rooms and traders around the world, a lot of them are located in Chicago, obviously where a great deal of activity takes

place. And many of the traders that were active, there clearly are lots of people who are still very active in the futures markets given the volume that's been going on. And congratulations to the exchanges for delivering that.

But many of these rooms full of traders used to trade futures and now they trade cash markets. And you'll find that, you know, a very significant percentage have shifted over. And I think that there has to be a reason why. And I think perhaps it's they're dissatisfied with providers of one market or perhaps they're better served in another market. Perhaps the transactions costs and the deployment into the market place and the competition in the market place has actually allowed them to participate in a cash market where they otherwise weren't.

So I think there are benefits through competition that are raised from the end-user. And those end-users are a variety of people. Maybe they're individual traders to significant financial institutions.

DR. PHILLIPS: Thank you very much.

Any additional exchange comments?

Yes, sir?

MR. COLLINS: Hi! I just want to make a few brief remarks. I'm Beau Collins with the New York Mercantile Exchange. I'm new to this way of thinking about utilities and exchanges. The vast majority of my experience comes from being, actually being a trader. So I'm enjoying the vast debate about the customers and what they think. I can tell you I think what they think pretty specifically. But I want to make some observations about the comments that I've heard so far and be as brief as possible.

One really interesting aspect of what has been said so far is that we, we seem to be condoning or talking about one form of monopoly versus another. That part of what has been proposed, I suppose by the FCM community, is that in fact a formal monopoly that kind of supports a cartel perhaps would be a better way of organizing the industry. That is not clear to me mostly because of the evidence that I see in the market place.

One is, a very key piece of evidence is that we, in fact, have competition in my market place particularly we have a number of interested parties that have popped up, both in serving the market place as a contract market, per

se, and also in the field of clearing. I think it is very, very early in the game when you start talking about the competitive abilities of start-ups that are now 18 months old or 2 years old and they're branching into a competitive space that has been owned by effectively government endorsed franchises for 130 years. I think the jury is still very much out on how these competitors will perform.

I think as another point of evidence you can see very clearly that there's been aggressive moves by the exchange in responding to the competition. And were it not real, I don't think you would see that. Perhaps you don't see it on across a broad base of rules, but certainly in our market place we've had enormous innovation and enormous amount of rule changes in the span of one year, mostly bending to competitive forces.

So, again, that's another kind of proof in the pudding. Another point of kind of proof is that our fee structure, at least in the space of energy is really all I can speak to. The competing platforms all end costs are more expensive than the exchange. That's just a fact. It's very difficult for me to understand, particularly from the point of an end-user, any kind of complaints around fee

structure when you can clear the New York Mercantile Exchange for an all end cost that's cheaper on a clear credit intermediated piece of business than a bilateral counter party piece of business, that's more expensive. So that's another point of reference that, that kind of, to me, is evidence that what we have created through the CFMA is fostering competition.

And the last piece of evidence I want to, I guess, propose is the fact in the space of clearing specifically, we have no less than five competing forces in the space of energy. All of them are in various stages of development. Some are just now getting their real operating agenda together. Others are further along. As strange as it may seem, we embrace this at the exchange. We see this as a great, great catalyst to innovation. And as you've seen in our recent product initiatives around OTC clearing, and etcetera, we are reaching out to an industry that is going through very difficult times from a credit perspective, and rolling out products that are innovative. And we are collaborating very closely with our FCM community.

One of the great things about the system now is that an FCM is free to participate in a broad range of products at our exchange. They're not forced to. They have the option. A lot of FCMs are making that option. Some are choosing to clear all of our new products. Others are limiting to specific products that they're comfortable with.

So what we see in the way of competition is faster development of products, innovative development of products, and choice, not only for the customer, but for our FCM community as well. That's it.

DR. PHILLIPS: Thank you very much.

Any other exchange comments?

If not, I'd like to ask Mr. Dutterer if he has comments from a specific clearing corporation?

MR. DUTTERER: Thank you very much.

My comments, I'll direct them to really three areas that I think have all been touched on to date. And without going into detail or restating what has been said in those areas I'll share some thoughts. One area has been common clearing, one has been what I refer to as clearing choice, and the third has been fungibility.

First as to common clearing, I think that as Charlie and John mentioned, that is something that has been looked at over the last 15 years. It has had difficulty to put in place. I think it is also something that it would be difficult for me or us to embrace to be put into place on a government level. I don't think that the Commission wishes to get into the business of picking winners and losers. I think there are some discussions and arguments that could be made for that and against that, particularly in the utility area. What I'm more comfortable embracing, as we did in our paper, and what I want to talk about for a minute which is clearing choice.

I think in the clearing choice area, as we envision it, it would simply be for the market user, the FCM, if you will, to choose a clearinghouse at which it wishes to clear the product. At first one might think of this as something new and different. But if we move from the historical perspective of where clearinghouses in the futures industry, and indeed in the securities industry, as far back as 30 years or 40 years ago were part of the trading mechanism, securities industries as securities have been mentioned, have moved to single clearinghouses or

linked clearinghouses for a while in the securities area before the choice was to go to DTCC and NSCC.

But in the futures side, the last 10 or 15 years have been full of examples of where clearinghouses have linked, have worked together. Jim had mentioned some in the cross-margining area. SIMEX was an example that was mentioned, common banking. We had provided processing, as David mentioned, for BrokerTec. We provided processing 10 years ago for the Cotton Exchange. We have had in place for 10 or 15 years, which I think as mentioned earlier, an information sharing system. So the concept of a clearing choice and what might go along with that, that is, clearinghouses working together and interacting with each other, is really not a new thing, that is the interaction and the operations and technology is not new, because we have been doing that for 10 or 15 years.

And I think now is the time to further the discussion of a clearing choice rather than a mandated, if you will, governmental solution but working together to do that. And I think that the changes in the Federal law and the Commodity Futures Modernization Act which specifically recognized the Commission should facilitate the coming

together, the linking of clearinghouses, and it was done without regard to product. Now, it's true that a lot of the discussions were about single stock futures, but it was done without regard to product.

I think now is the time to have that discussion of clearing choice, and certainly could, could touch on common clearing, it could touch on fungibility. And I think now is the time and I think it's appropriate for the Commission to under that statute to facilitate that by establishing a working group or formal procedure for all of the parties to come together and do that.

Let me touch for one minute on fungibility. I don't readily embrace the concept of fungibility that, that some people have advanced here. I think it's appropriate to discuss. It should be included in clearing choice and maybe if clearing choice were to be permitted, were to be enacted, that might be the outcome of it.

But I am reminded that with regard to fungibility was some mention of OCC. But there the contract is issued by the clearinghouse. On the equity side the share of stock is issued by, I think Jim's example was IBM. So I suggest that that's a little bit different there. Here the

contract is designed by the market place. And indeed, it may be that there are some trading mechanisms at the market place that even if it appears to be a similar contract, the trading concepts and mechanism may make it different or react different. So I think that is something that is probably appropriate for the working group to look at. But I think those are the things that one needs to look at a bit more closely before saying that they have to both go together, that is, a clearing choice or a common clearing and fungibility. I think they could operate differently.

And, indeed, you could have clearing choice or common clearing without fungibility and I think accomplish and achieve some of the things that John mentioned, a cost savings, interacting with one clearinghouse, margins, and things like that.

So I, I would suggest that the Commission give consideration to taking some action to facilitate the linking. And I think the first step is a forum to discuss many of the things that have come out here today. Thank you.

DR. PHILLIPS: Thank you very much, Dennis.

Are there any people who have not yet made statements that would like to make a statement?

Mr. Stevens?

MR. STEVENS: Just briefly.

You know, we've been run up the flag pole as the poster child for common clearing solution for the FIA and the FCMs. I don't know whether to be flattered or embarrassed, but we are what we are and we're very proud of what we are. But I want to make a couple of observations without hopefully repeating what others have said very well.

You know, we don't have a dog in this fight. We're not advocates here. We are what we are. And I would point out that it's--and others have noted the evolution of OCC and how it came about. And I would point out that that was from a blank piece of paper and we evolved based on the will of the membership and the urging of the regulator. That's a far cry from that, you know, evolving to what's right from a blank piece of paper and imposing what's right--put that word in quotes--imposing what's right on a structure that has worked quite well for many, many, many years.

You know, I think our structure is the right one, but if I were running an exchange, I think I may have a very different view since clearing is a very important part of the complex of an exchange.

I want to clarify a couple things or at least make some points. I don't--on this internalization business, our exchanges are wrestling with it and are troubled by it as well, but I don't think internalization in any way is linked to common clearing. I mean, our exchanges are going through the same angst as the futures exchanges in terms of the members wanting to do more and more off the board. We will only clear what's a matched trade from an exchange. So whatever exchanges, however they deal with internalization and, you know, whatever they permit to take place in transactions on their exchange we will clear it, but nothing beyond that.

And I don't know, I don't think there's a linkage. I would--well, I have a bunch of other things to say, but time is late. I would remind, since David brought it up, we're reluctant--well, the Justice Department did go after the options markets and did extract a pretty significant settlement. There may not be any analogy,

whatsoever, and I'm not suggesting there was any, but when David referred to the Justice Department, it triggered a recollection that was very painful for our exchanges a couple of years ago. Thank you.

MR. VITALE: And I was on the board of one of those.

MR. STEVENS: Yes. Thank you.

DR. PHILLIPS: Thank you very much.

Again, are there any other people who would like to make statements who have not made one?

Mr. Hardy?

MR. HARDY: Briefly if I could, Dr. Phillips. If Jack Gaine had the shortest distance to travel, I probably had the greatest. I would like to make just a couple of very brief observations.

LCH is a mutual from a risk backing perspective. Our members contribute to a default fund which provides the wherewithal for us to be in business as a clearinghouse. But it is no less commercially minded than pretty much any other business around this table. It does set out to make a profit. It sets out to do that in order to keep innovating and to keep its infrastructure up to date.

But then does it, not considering any business requirements for reserves, distribute surreptitious profit, pre-tax by way of rebates, or this is all about business issues, there's no debate, or post-tax by way of dividend? And does it particularly matter?

Actually in our context our equity structures always made a rebate structure more logical for the purpose of our customers. The key to the future is to determine whether in the context of a clearinghouse, and this is different to an exchange, I believe, whether distributions should in the future be only to stake holders in the clearing process, so exchanges and firms in the industry of a clearinghouse, or should it be, could it be to third party investors who may have absolutely no interest at all in the proper functioning and integrity of the clearing operation.

In Europe, and I suspect I was a participant in this panel that Jim described earlier as having swiftian conversations, we had LCH advance a theory--and I've banged on about this at some length at least in Europe--that we see that there are three quite separate layers in the market infrastructure, a trading layer, a clearing layer,

and a settlement layer. I believe that they all have quite different business models and I have a sense that they all have different needs in terms of their structure, their ability to generate the finance to be in business.

The investor owned model is seeking to operate, to generate the returns that I think suits trading platforms. They're increasingly offering a commoditized service. They have to be incredibly competitive to stay in business. And actually I fully understand the desire on their part to retain a clearing business to aid their competitiveness. And competition is there. It is possible to low cost engines. It's very difficult for them, but it is also equally difficult to move liquidity away from established platforms.

The example has been used of the LIFFE Bund contract. There are all kinds of circumstances around that, but that was perhaps the only example. But I think that said as clearing members our shareholders benefit from having a clearing platform which enables multi lateralized netting of positions from the widest possible range of trading arena, whether they are exchange commoditized

products or bilaterally negotiated contracts. And some of which may, of course, compete with one another.

I believe that is exactly what the FCM community and the wider financial services community is looking for. I don't believe that exchange owned, strategically directed clearinghouses can facilitate that with ease.

Now, in Europe we have three major central counter party clearinghouses, LCH, Clearnet and Eurex. There are a number of smaller domestic players. The other two major clearinghouses are owned by exchanges which are actually not just demutualized but have already gone through their IPOs. There are questions being raised, as there are here, around the competition issues which arise, lack of transparency about pricing, and lack of contestibility, in particular contestibility in the sense of whether or not, particularly in the clearing arena where these exchanges own their clearinghouses, whether or not the lack of contestibility is only competitive or not.

I mean, there is no basis or example which I could pitch the business of Deutsche, Boerse, or Eurex, simply no way it could happen.

If, though, clearing is handled by an independent body, whether it's profit-making or not, an independent body that I would define as a replaceable one that is doing its business by way of contract, I think that's the best check on the potential, underlined, anti-competitive nature of the organizations and the monopolies that they operate.

And LCH does operate a monopoly in the exchange traded contracts that it clears. That's the only way that you can bring efficiency into exchange traded clearing by the introduction of a monopoly structure. But we only have that monopoly while we have the contract to clear. We have no monopoly instead in the OTC markets that we've introduced clearing services to.

And, Jim, I have to say you won't be surprised that I have never thought of myself as a utility provider in the sort of slightly pejorative way that you used the term. And you ask when did the utility, if that's what we are, last innovate? Well, I'll point towards the introduction with the support of all of our members of LCH's interest rate swap fixed income equity clearing services over the last three years. Actually, I think that proves a point.

But we'll only keep the business if we continue to improve our level of service and our tariffs remain competitive. If we lose the support of our clearing members, they will attempt to make changes and we are entirely replaceable. The solution in Europe I think will be a business based solution. The exchanges which own their own clearinghouses are not going to give them up. It would be illogical, I think, almost to ask them to do so. It needs a business solution whereby the clearing organizations come to some terms which enable their consolidation that will mean a blending of their business interests, blending of the financial models, blending of ownership structures. But I believe that in the European context, that is what we are continuing to push for to try and promote a single clearing platform within Europe across a wide range of different asset classes, but it has to be a business solution which respects the ownership arrangements of those exchange and clearinghouses. But we will need to try and pull those together with the, you know, more typical structures that have been seen in futures clearinghouses over the years. And we're attempting to do that in Europe.

DR. PHILLIPS: Thank you very much.

The hour is getting late. Does anybody want to make final comment? Mr. Damgard?

MR. DAMGARD: Obviously I've struck a chord. And I want the exchanges to know that my members absolutely depend on strong, healthy exchanges. It's the core of the business. But I do think we have totally different definitions of what competition is. My members compete for the very same customers, offering the very same services, for the very same products. And if a customer doesn't like the way Goldman Sachs treats him, that customer can go across the street and get another FCM to do the business, whether it's over-the-counter, or whether it's taking that business to the exchange.

And exchanges don't have that kind of competition. It's not unlike comparing, you know, taking a train to Chicago or taking a plane. If you take a train, you get on one train and you go on one track, and that's all there is. And if you go on an airplane, there are five or six different airlines that are competing for your business. And, yes, you can also take a bus. And maybe that's competition as well, but clearly the definition of

competition that we're talking about is the exact same product.

And it seems to me what the Act does, it calls on the government to assist in competition. And in other words, to prevent anti-competitive acts is the same thing as promoting competition. And if there are ways, we don't want to hurt exchanges. But we believe, looking at our fee structure, we have over the 15 years that I've been at the FIA, seen commission rates for customers go from $70 to $7, and that's competition. And in the same period, we've seen exchange rates increase, and that's because there hasn't been competition.

And I honestly believe that block trades are a great idea. But for the exchanges to sort of pick and choose which ones they're going to piece out to the customer, there's a demand for block trades in the S&Ps, but the Merc doesn't want to do block trades in S&Ps because it takes the business away from the pit. So as a consequence, the liquidity providers, whatever that means, it seems to me everybody trading on the Merc is a liquidity provider, not just the local. I mean, I think you insult your customer, Charlie, if you went to Fidelity and said,

you're not a liquidity provider because you don't do enough business on the Merc.

My view is that we have an opportunity here to utilize what the CFTC is able to do in clearing to enhance the competitive environment. And every clearinghouse out there is good. And every exchange is good. And there ought not to be any reason why you guys don't compete at the clearing level.

Maybe Dennis has got the right idea. Maybe a customer should go to the Merc, you know, end up making a trade and then be able to choose to take his clearing business and his clearing fee to the clearinghouse of his choice. And if he did that, frankly, I would bet you a dime to a dollar that the fee would go down. A captive clearinghouse is a monopoly. My biggest customer member 15 years ago was doing 95 percent of his trading in futures. And I spoke to him yesterday. And he said, yeah, we're doing 75 percent cash now and occasionally we're still in the futures market. And it's cost across the board. And the reason that the costs are higher in futures is because the competition, as we define it, is not there.

And I believe that the industry has enormous growth prospects because the volume is going up. And in this case we see a concrete example, and I think Hank referred to it as well, of business that used to be ours that's going to the cash market because of competition. And I think it's time for all of us to pull in the same direction and look at the competitive aspects of our market versus securities. I mean, ECNs have taken a lot of cockiness out of the New York Stock Exchange. And it may not have benefited the New York Stock Exchange, but it sure benefits the customer.

And in the options business, I don't know how they got there, but I know multiple listing in a direction that says an exchange can't discount somebody else from coming to the same clearinghouse, that's a restraint of trade. If a new, if a new entry into the business of execution says I think I've got a better product or a better way to trade it, and nobody owns the 10 year note or the 5 year bill, if there are such things. Those are government products. And the Board of Trade does a great job in trading those products. But if BrokerTec has the exact same product and BrokerTec can take advantage and

build on that liquidity pool by going to a clearinghouse and sharing that liquidity pool, that's good. That's not bad.

And look at the failures over the years of products that exchanges have tried to bring to the market place and the money that they've spent in attempting to bring those products out, because they wanted to control those products. Think if, in fact, there was an opportunity to on a global basis pool that liquidity, half of those might have been successes instead of one guy trying to control something to make it a success.

And I just think those are, those are concepts that we need to be thinking about going forward, because the business is changing dramatically. And clearly the way the new Act is written, it's intended to lower the regulatory burden on the exchanges. And we supported that. But the quid pro quo was to support competition. And, yeah, we can wait five years or ten years to see if it happens. But my belief is that this industry is going to miss a great big opportunity unless we all concentrate on ways in which to enhance competition. And frankly, David, nobody wants to go to the Justice Department. But,

I mean, you know, I think Paul's right. There are curious people who get paid to look at anti-competitive situations who work not only at the Justice Department, but at the Federal Trade Commission. And this is the appropriate place. I mean, you say it's not the appropriate place, but I think it is the appropriate place. And the law says it's the appropriate place. So I would encourage the Commission to take this very, very seriously and look long and hard. Because the issue is not just money. The issue is competition. That's what the heart of the issue is. And I'm sorry if I've offended some of the exchanges, but I believe that you guys all do a fabulous job. There isn't one, there isn't one clearinghouse out there that isn't doing a great job. And for those guys not to be able to go out and compete for business isn't right. They should be able to compete for that business. I mean, I like the idea that you're clearing OTC products. There may be different ways to do it, maybe you need to use a different pool of capital if you find that that risk is greater. But competition is good, not bad. And we've certainly seen that in our business. Thank you, Susan.

DR. PHILLIPS: Thank you. We've gotten a lot of material out on the record this afternoon. And I want to remind everyone that if there's something else you'd like to say, please submit it in writing to Jane Thorpe. And we've had a wonderful, I think, exchange this afternoon. And the Commission now is left with going through all of these viewpoints and figuring out what's the best thing to do.

I'm going to turn the gavel back to Chairman Newsome and thank him for the opportunity to participate in this, this afternoon. Jim?

CHAIRMAN NEWSOME: Thank you very much, Susan.

I wanted to, to just thank everyone for the very thoughtful comments and discussion. There is no question that these are some extremely serious issues that face this industry. And I can assure you that this Commission will give very thoughtful deliberation to the items raised today.

I do want to remind each of you that this is just the beginning of this dialogue. I think as the Commission starts to focus that we will continually focus more and more as we learn more about the issues. And as we do

focus, we're going to want more input from you about the appropriateness of us moving forward and the appropriateness of the CFTC's involvement in this area.

Again, I want to thank Dean Phillips and Jane for leading the discussions on both sessions. As Dean Phillips said, I certainly encourage you to supply any further comments that you may want to from today's discussion because the record is open.

Are there any final thoughts?

If not, then this meeting is adjourned. Thank you.

[The meeting was concluded at 5:09 p.m.]

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