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I would like to begin my remarks by congratulating the U.S. futures exchanges on the phenomenal year they are having. At the end of June the CME was up 36%, the CBOT was up 21%, and the NYMEX was up 27% in terms of trading volume. I think that is a testament to the strength of the management teams at the exchanges, the great products they are offering, and the simple fact that our customers need these products more than ever.

It might seem strange to call for 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. As the saying goes, if there's a hole in the roof, fix it while the sun is still shining.

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, and lifted the prohibition on single stock futures, 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 already has 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 point of view 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 have the 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 don't 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:

- <u>How should clearing be structured in the new world of for-profit exchanges?</u>

- <u>Do futures exchanges face competitive threats?</u>

- <u>Should the CFTC mandate fungibility?</u>

Before answering these questions, let us 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

"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. This role for competition has not been fully realized yet, 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:

How should clearing be structured in the new world of for-profit exchanges?

It is no secret that the FIA has made several attempts to separate clearing from execution and create a common clearinghouse in the U.S.—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 costs, reduced cash flows, and an improved risk profile. Many of our members operate in both the securities and futures industries, we use both systems, and the securities 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 Corporation was originally part of the CBOE. When 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 nine executives from clearing member firms, 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 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 the clearing corporation. The Board of Trade Clearing Corporation changed their board structure in 1999 to reflect the interests of members—the new governance structure reflects a "one share one vote" measure for six of the nine governors.

Common clearing has not 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 markets to hedge their positions. I think we can put that argument to rest. What we should focus on is the exchange vs. 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 successes 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 benchmark 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.

This 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 members' interest. Whatever profit the exchange might make is a secondary concern, because the members' primary business is trading, and from their point of view the transaction 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 is 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 those exchanges are going to want the highest possible return on their investments. Ultimately that means that customers will pay higher fees—fees that aren't subject to the intense and unconstrained competition that most businesses face.

<u>Should the CFTC mandate fungibility?</u>

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 to promoting real competition. We know that derivative markets can work just fine with fungibility, because it works in the securities world. And we know that common clearing with fungibility promotes competition because we have seen lots of competition in securities options, with exchanges listing the same options and taking market share from one another. And we have also seen a significant new securities options competitor—the ISE—that has come out of nowhere and now has a market share of about 25%, most of it in options that were previously dominated by other exchanges. In the options industry, we have examples of competition that is good for customers.

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. 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 that this model works because we can see it working.

Alternatively, the Commission could look at ways to promote product fungibility and competition among clearinghouses. For example, several decades ago the CME pioneered a system to make products fungible across two different exchanges. It's called mutual offset, and they do it with the 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 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 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 1987, 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 rather have cleared in Chicago than at the Comex. It took many years before the 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 stronger, better managed organizations.

So I don't think that the exchanges 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 the new era of for-profit exchanges.

Thank you.