STATEMENT OF DENNIS A. DUTTERER,
PRESIDENT AND CHIEF EXECUTIVE OFFICER,
BOARD OF TRADE CLEARING CORPORATION
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION
ROUNDTABLE ON CLEARING ISSUES
AUGUST 1, 2002

I. Introduction.

The Board of Trade Clearing Corporation (the "Clearing Corporation"), formed in 1925, is the world's largest fully independent futures and options clearinghouse and is the only futures clearinghouse that is rated "AAA" by Standard & Poor's. The Clearing Corporation currently serves as the clearing organization for the Chicago Board of Trade, the MidAmerica Commodity Exchange and a number of other marketplaces. The Clearing Corporation has in the past provided trade processing services for the New York Cotton Exchange and the Commodity Clearing Corporation and currently acts as the clearing services provider for BrokerTec Clearing Corporation.

II. Background.

Historically, the markets for futures trading and clearing services have been vertically integrated from both an organizational and a regulatory perspective. In practice, each exchange established its own clearinghouse – either as a division of the exchange or as a nominally separate legal entity – whose sole purpose was the clearing of trades made on that exchange. From a regulatory perspective, futures clearinghouses were not viewed as separate organizations. Instead, they were viewed as an adjunct of the exchange for which they provide clearing services. To the extent that they were regulated by the Commission, it was indirect and, to a large extent, merely a byproduct of the regulation of the exchanges by the Commission and the Commodity Exchange Authority under the Commodity Exchange Act (the "Act").

The legal landscape for the futures clearinghouses began to change in the late 1980s, with the development of cross-margining programs among the futures and securities options clearing organizations. In recognition of the benefits that resulted from these programs, Congress amended the Securities Exchange Act of 1934 (the "Exchange Act") in 1990 to direct the SEC to facilitate the establishment of linked or coordinated facilities for the clearance and settlement of transactions in futures, securities and options.[1] While these developments did not lead to direct competition among futures clearinghouses, they paved the way by forcing the affected clearing organizations to do the hard work of creating and maintaining linkages and interfaces to facilitate the timely and secure transfer of trade data and funds.

The enactment of the Commodity Futures Modernization Act of 2000 (the "CFMA") has dramatically changed the context in which these discussions take place. In addition to authorizing a host of new markets, both regulated and unregulated, the CFMA

created a separate regulatory scheme for derivative clearing organizations ("DCOs") and expressly permitted the DCOs to provide clearing services for transactions that are largely exempt from the Act, such as swaps, principal-to-principal transactions and transactions in exempt commodities effected on an excluded electronic trading facility. Many DCOs, including the Clearing Corporation, have utilized this new found flexibility to clear transactions which are effected on unrelated markets.

Congress also has charged the Commission with the duty to facilitate linkages among clearing organizations. Although much attention has been paid to the requirements attendant to the trading of security futures products, including the need for linkages among clearinghouses that are required in that context,[2] the Commission is separately and independently required to "facilitate the linking or coordination of designated clearing organizations . . . with other regulated clearance facilities," without regard to the nature of the underlying product.[3]

At the same time, Congress placed an affirmative obligation on the DCOs and on the contract markets to "avoid adopting any rule or taking any action" that results in unreasonable restraints of trade or that "impos[e] any material anticompetitive burden on trading in the contract market."[4] Thus, the contract markets and clearing organizations must conduct business with regard for the competitive consequences of their actions.

III. A Response to Marketplace Developments.

The Clearing Corporation appreciates the important steps that the Commission already has taken to facilitate the modernization of the U.S. futures markets. By supporting the adoption of the CFMA and in adopting regulations implementing this legislation, the Commission has fostered the competitiveness of the U.S. futures markets in a manner which benefits the interests of all market participants. In particular, the Clearing Corporation commends the Commission for its balanced approach to the implementation of the special clearing requirements of the CFMA and its willingness to explore further refinements and improvements in the regulatory scheme.

No matter how much the Commission may fine-tune its rules, however, nothing should be allowed to obscure the fact that the organized futures markets are poised at a critical juncture. Predictions of their demise are unfounded, but there can be no escaping the fact that their customers – our shareholders, our members – have alternatives that would have been unthinkable as recently as three or four years ago. The exchanges are beginning to respond to competition from new, less regulated alternatives, many of which are geared toward the same institutional market users who are important providers of liquidity and support for the organized futures markets.

The clearinghouses, in turn, are confronted by and must respond to competition. As new exchanges and less regulated markets are formed, the existing clearinghouses have and will continue to compete for their business. This process is salutary to the extent it results in greater efficiencies and lower costs. This process poses risks, however, to the extent that a clearinghouse may seek to win or retain business from an

exchange or market, not by reducing rates and improving services to members, but by lowering risk standards and participant requirements for their clearing members.

The Clearing Corporation, therefore, believes that it is important for the Commission, the clearinghouses, the markets and market participants to take steps to foster an outcome that serves the interests of the markets and market participants by fostering and strengthening the clearing process. The Commission could do so by adopting further "interpretations" of the core principles for derivatives clearing organizations in areas such as clearinghouse and clearing member capital requirements, margin-setting standards, operating systems and procedures. Any such interpretations would lack the force of law or of Commission regulations, however. In addition, the implementation and enforcement of the policies embodied in any such interpretations may require a substantial commitment of resources from the Commission.

The Clearing Corporation accordingly believes that the better course would be for the Commission to use its powers to foster an environment where clearinghouse customers, members, and owners can, together with the exchanges and other marketplaces, more freely determine the appropriate structure and use of a clearinghouse. This may or may not lead to so-called "common clearing."

The Clearing Corporation recognizes, however, that the Commission may be reluctant to pick winners and losers, to put itself in a position where it is effectively the arbiter of the appropriate ownership and structure of a clearing organization or the manner of a member's or customer's use of that clearing organization. The Clearing Corporation, therefore, alternatively recommends that the Commission use its powers to develop a framework to permit the separation of execution and clearance activity.

Specifically, the Clearing Corporation urges the Commission to convene a high-level working group consisting of regulated exchanges, other marketplaces, clearinghouses, clearing members and other market participants. The working group would be charged with the objective of developing a clearing model – one in which firms could clear their trades at the clearinghouse of their choice, whether it be a clearinghouse owned by an exchange, an independent clearinghouse or a yet-to-be developed clearinghouse. The Clearing Corporation envisions that this new model would be entirely permissive – a firm could select which clearinghouse it wanted to use to clear some or all of its trades. In other words, a clearing firm could elect to clear all of its trades at a single clearinghouse or could split them up, by product line or otherwise, and clear at more than one clearinghouse. A key element of such an arrangement would be the absence of any kind of mandated clearing – the choice would be that of a clearing firm to choose the marketplace and the clearinghouse that was best.

Clearing organizations, of course, would have to meet certain minimum criteria. Although the following list is by no means exhaustive, we think that the requisite standards would have to include such important safeguards as clearinghouse financial backing, whether capital, guarantee funds or similar support, membership standards, risk controls (including margin policies, banking arrangements and financial reporting

requirements) and operational capacity. Once those standards are in place, there should be no basis for objection to participation in such an arrangement.

The implementation of this proposal will require the clearinghouses to interface with each other by participating in and maintaining reciprocal accounts in each other's systems. Through debits and credits to these reciprocal accounts, as well as direct communications between interfaced organizations, the payment and receipt of margin and settlement payments will be possible. This, in turn, will permit clearing members to consolidate their clearing activities at one entity regardless of where the underlying transactions may have occurred. While the creation of these interfaces would no doubt require an expenditure of time and effort, it would not be an insurmountable problem. The futures clearinghouses currently have the infrastructure in place necessary to share information about common members and coordinate payments among them in a variety of cross-margining programs. Further, and as discussed more fully in the Appendix to this submission, this type of interface has operated well for many years in the securities markets. Accordingly, it is possible for the futures clearinghouses to adopt a similar type of arrangement without excessive difficulty.

Finally, the clearinghouses and the Commission would need to ensure that a clearinghouse does not indirectly preclude a clearing member from clearing its transactions at a competing clearinghouse. For example, one issue which arose in connection with interfaces among the securities depositories was whether a depository could impose interface fees either on other depositories or on its participants. The SEC resolved this issue by requiring free interfaces among securities depositories and by preventing them from imposing interface usage fees on their participants. The Clearing Corporation is optimistic that the clearinghouses, exchanges and our common members will be able to address these concerns reasonably and in good faith.[5]

IV. Conclusion.

The regulatory separation of the clearing organizations from their related exchanges and the increased flexibility granted to clearing organizations present an opportunity to enhance the integrity of the futures markets by promoting competition in the market for futures clearing services without sacrificing the financial integrity of the clearing system.

While the implementation of this proposal may be challenging, the benefits to market participants would be significant. Among other things, this proposal would reduce the number of financial settlements for a clearing firm by providing for the greater netting of financial transactions. And under such an arrangement, clearinghouses would compete with one another based on a variety of factors, including creditworthiness, operational flexibility and ancillary services provided. Further, this arrangement would permit clearing members to streamline their operations by permitting them to consolidate all of their clearing activities in one place. This proposal also would provide a valuable safety valve in market emergencies in that it would permit the ready migration of business from a clearinghouse that is threatened by clearing member defaults into the "strong hands" of a clearing organization that is not confronted by those challenges.

The Clearing Corporation recognizes that this may be a complex undertaking. The Clearing Corporation also believes that fostering responsible competition for clearing services is the best way to enhance the competitiveness of the U.S. futures markets and to ensure the financial integrity of the clearing process. We believe further discussion of this concept in a more formal structured environment is appropriate. The Commission's convening a working group to begin these discussions is an important and necessary first step.

###

---

[1] Exchange Act Section 17A(a)(2)(ii), 15 U.S.C. § 78q-1(a)(2)(ii).

[2] *See* Section 2(a)(1)(D)(i)(II) of the Act, 7 U.S.C. § 2(a)(1)(D)(i)(II) (linkages required for physical settlement of security futures products); Section 2(a)(1)(D)(i)(IV), 7 U.S.C. § 2(a)(1)(D)(i)(IV) (linked and coordinated clearing required to permit offset of contracts bought and sold on different markets). The effective date of the latter requirement is delayed by the CFMA. *See* Section 2(a)(1)(D)(vi) of the Act, 7 U.S.C. § 2(a)(1)(D)(vi).

[3] Section 5b(f)(1), 7 U.S.C. § 7b(f)(1).

[4] Sections 5(d)(18) (contract markets) and 5b(c)(2) (DCOs) of the Act, 7 U.S.C. §§ 7(d)(18), 7b(c)(2).

[5] In the event of an impasse, the Commission, among its other powers, is authorized by Section 8a(7) of the Act to alter or supplement the rules of a registered entity, including a contract market or a designated clearing organization, if the registered entity fails to do so after a request therefor from the Commission. 7 U.S.C. § 12a(7).

A CHRONOLOGY OF SEC AND SELF-REGULATORY ORGANIZATION ACTIONS RELATING TO THE ESTABLISHMENT OF CLEARING AGENCY INTERFACES AND THE DESIGNATION OF A SINGLE CLEARING ORGANIZATION FOR THE CLEARING OF STANDARDIZED SECURITIES OPTIONS

Securities Clearing Agency Interfaces

1. Prior to 1975, the rules of each national securities exchange required brokers trading on that exchange to utilize the exchange's clearing organization subsidiary to clear and settle those transactions. This linkage of the exchanges and their subsidiary clearing organizations effectively precluded any competition among clearing agencies. *See Bradford National Clearing Corporation v. SEC*, 590 F.2d 1085 (September 19, 1978).

2. Market participants began exploring the possibility of centralizing securities clearing facilities in the U.S., including the possibility of merging several existing clearing agencies, shortly before the enactment of the Securities Acts Amendments of 1975 (the "1975 Amendments") to the Securities Exchange Act of 1934 (the "Exchange Act"). As a result of these discussions, the clearing agencies of the New York Stock Exchange and some of the "regional" stock exchanges initiated a pilot operation called the Regional Interface Organization ("RIO"). Under this program, the clearing agency affiliated with an executing exchange would compare (match) the trade but then route the compared trade to another participating clearing agency for clearance and settlement. The operation of this interface was fairly limited in scope, and some participants impeded the use of RIO by imposing interface fees on transactions. *Id.*

3. The 1975 amendments added a new Section 17A to the Exchange Act in which Congress set forth in its findings that the linking of all clearance and settlement facilities, the use of new data processing and communications techniques and the development of uniform standards and procedures for clearance and settlement would reduce unnecessary costs and increase the protection of investors and persons acting on their behalf.

4. Section 17A(a)(2) of the Exchange Act directed the Securities and Exchange Commission ("SEC") to use its authority under that Act to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities" in accordance with those findings.

5. Shortly after the enactment of the 1975 Amendments, the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers, Inc. agreed to merge their respective clearing agencies to form the National Securities Clearing Corporation ("NSCC").

6. In several releases, the SEC developed the basic characteristics of a national clearance and settlement system (the "National System"). *See* Securities Exchange Act Release No. 12954 (November 3, 1976); Securities Exchange Act Release No. 13163 (January 13,

8938716 42001271

1977) ("NSCC Registration Order"). The SEC envisioned that one of the basic objectives of the National System would be to enable participants to access, at reasonable cost, one entity for the comparison, clearance and settlement of all securities transactions, regardless of the location of the other parties to the transactions or the market in which the transactions occurred (commonly referred to as "one-account settlement"). *See* Securities Exchange Act Release No. 12954 (November 3, 1976). With such a system in place, the SEC expected that brokers and dealers would choose the marketplace of execution on the basis of price and service, and would then process their transactions through the clearing organization of their choice. *See* NSCC Registration Order.

7. According to the SEC, one-account settlement would present the following advantages: (i) the ability of participants' back-office personnel to be familiar with one set of procedures and to use one set of forms in processing securities transactions, (ii) the ability of participants to make one daily money settlement (as opposed to multiple and possibly offsetting money settlements), and (iii) reduce the facilities and personnel required to process transactions. *Id.*

8. This merger was to be accomplished in two phases. During the first phase, NSCC would operate each of the three merged entities as separate divisions, and the rules tying the exchanges to each such division would remain intact. In phase two, the clearing operations of the separate divisions would be merged into a single system, and the rules tying a particular trading market to specific clearing organization would become obsolete.

9. In 1977, the SEC granted NSCC's application for clearing agency registration subject to certain conditions which were designed to promote competition among clearing agencies. Under the SEC's order, NSCC would not be permitted to begin phase two of its operations until it established full interfaces with the regional clearing agencies without the imposition of fees or charges for moving data through these interfaces. In addition, the SEC required NSCC to provide at its cost facilities to which other clearing agencies could forward trade data for comparison. Taken together, these two conditions ensured that a broker could execute a trade in one market and settle the transaction at the clearing agency of its choice.

10. In order to comply with the full interface condition, NSCC expanded access to the RIO program by adding a rule for "special representatives" in 1977. *See* Securities Exchange Act Release No. 13456 (April 21, 1977). Under this arrangement, a transaction in which a non-participant in NSCC agreed to sell securities to a NSCC participant would occur as follows: The special representative (an NSCC member) would submit a non-participant's transaction to NSCC for comparison. Assuming the opposite party (the buyer) did the same, the trade would then be compared. NSCC would then credit the special representative with a securities delivery obligation and a right to receive of a sum of money, and the buyer would be credited with the opposite rights and obligations. Next, the special representative and the non-participant's clearing agency (for example, the now-defunct Midwest Clearing Corporation ("MCC")) would submit a compared trade to NSCC showing MCC as the seller and the special representative as the buyer of the same security at the same price. NSCC would then credit the special representative with the right to receive securities and a money payment obligation, and would credit MCC with the opposite rights and obligations. The special representative's rights and obligations would net down to zero, and MCC would assume the special representative's securities

delivery obligation and its right to receive a payment from NSCC. MCC would fulfill its delivery obligation by using the securities it obtained from the NSCC non-participant and would will pay the non-participant the funds it received from NSCC at the end of the day.

11. In 1978, the exchanges and the NASD took another step towards the implementation of a national clearance and settlement system by rescinding their rules which tied the clearance and settlement of transactions to clearing agencies affiliated with a particular marketplace. *See* Securities Exchange Act Release No. 14636 (April 7, 1978).

12. The SEC also anticipated that the depository portion of the National System; if efficient, would allow participants to redeliver securities to another participant on the same day they are received ("same-day turnaround").

13. To facilitate same-day turnaround in a system with multiple depositories, book-entry delivery capability through depository interfaces is required. The securities depositories interfaced with each other by participating in and maintaining reciprocal accounts in each other's systems. Through debits and credits to these reciprocal accounts, as well as direct communications between interfaced depositories, book-entry deliveries between sole participants in different depositories were made possible.

14. These depository interface deliveries principally involve two types of securities movements, "dual-participant" and "third-party" movements. Dual-participant deliveries occur when a participant in two depositories makes a book-entry transfer from its account at one depository to its account at the other – in effect, an inventory transfer that frequently was motivated by a need to meet settlement obligations at the receiving depository. Third-party movements occur when a participant in only one depository made a book-entry transfer to a participant in a different depository.

15. The SEC noted that the availability of these interfaces contributes to competition among clearing agencies. For example, a dual participant that adjusts its inventory by effecting a delivery from its account at one depository to its account at another may be taking advantage of special or superior ancillary services, such as timely dividend and interest payments or the use of a corporate reorganization database, at the receiving depository. The SEC noted that these interfaces also contributed to competition among broker-dealers, by enabling depository transactions to occur efficiently among participants in different clearing agencies.

<u>Single Clearing Organization (Standardized Securities Options)</u>

1. The application of the Chicago Board Options Exchange ("CBOE") for registration as a national securities exchange was granted on February 1, 1973. Under CBOE's proposal, all options traded on CBOE were to be cleared by its subsidiary, the Chicago Board Options Exchange Clearing Corporation. *See* Securities Exchange Act Release No. 9985 (February 1, 1973).

2. The SEC adopted Exchange Act Rule 9b-1, 17 C.F.R. § 240.9b-1, with an effective date of January 17, 1974. Rule 9b-1 made it unlawful for a national securities exchange to trade options except in accordance with a plan declared effective by the SEC. Among other things, Rule 9b-1 required these plans to contain specific provisions relating to the

clearance and settlement of standardized securities options. *See* Securities Exchange Act Release No. 10552 (December 13, 1973). The SEC simultaneously approved CBOE's option trading plan. *Id.*

3. The SEC announced in late 1973 that it will study the issues related to options trading. In the release announcing the study, the SEC asks for comment as to whether the proposals for competing options clearing organizations should be permitted to proceed. *See* Securities Exchange Act Release No. 10490 (November 14, 1973).

4. The American Stock Exchange ("Amex") filed a plan for options trading under SEC Rule 9b-1 in January 1974. Under this proposal, options transactions would be issued and cleared by the Options Clearing Corporation, at that time a wholly owned subsidiary of Amex. *See* Securities Exchange Act Release No. 10602 (January 15, 1974).

5. In August 1974, the PBW Stock Exchange ("PBW," the predecessor of the Philadelphia Stock Exchange) files a plan for options trading under Rule 9b-1. Under this plan, options transactions would be cleared and settled by PBW's subsidiary, the Stock Clearing Corporation of Philadelphia. *See* Securities Exchange Act Release No. 10950 (August 7, 1974).

6. In August 1974, the SEC sends a letter to the Amex and CBOE regarding certain issues relating to the trading of options. In this letter, the SEC notes that substantial progress has been made concerning the development of a program for common clearing. The letter states that the SEC expects prompt submission of rules governing the operation of a common clearing corporation and the filing of a registration statement for the options to be issued by such clearing corporation. Finally, the letter states that the SEC will approve the Amex's options plan when, among other things, Amex has submitted specific rules governing the operation of a common clearing corporation. *See* Securities Exchange Act Release No. 10981 (August 22, 1974).

7. In December, 1974, the SEC declares Amex's option plan effective. The Amex plan provides that Amex options, as well as options traded on the CBOE and any other exchange, will be issued and cleared by The Options Clearing Corporation ("OCC"), a common clearing organization which will be owned by the options exchanges. The SEC states that the establishment of OCC as a common clearing entity is necessary and appropriate for the trading of exchange-traded options and for the protection of investors in trading such options. *See* Securities Exchange Act Release No. 11146 (December 19, 1974).

8. In May1975, the SEC approves the PBW Stock Exchange's options trading plan. Under this plan, OCC will clear options traded on PBW. *See* Securities Exchange Act Release No. 11423 (May 15, 1975).