BrokerTec
Clearing Company

COMMODITY FUTURES TRADING COMMISSION ROUNDTABLE ON DERIVATIVES CLEARING ORGANIZATIONS AUGUST 1, 2002

SUBMISSION BY:

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SUMMARY

BrokerTec Clearing Company, LLC (BCC) is pleased to submit its views on several of the complex and important issues to be raised at the Commodity Futures Trading Commission Roundtable on Derivatives Clearing Organizations. As one the newest members of the clearing organization community, one of the first clearing organizations to go through registration ***de novo*** as a Derivatives Clearing Organization (DCO) under the Commodity Futures Modernization Act of 2000 (CFMA) and one of the few DCOs that only clear trades generated on an electronic exchange, BCC is in a unique position to comment on certain Roundtable topics. To that end, we will focus on the Commission's concern about developing a DCO oversight program; how the Commission might address the areas in the clearing process raised in the Core Principles; and finally market structure and competition.

BACKGROUND

BCC is a subsidiary of BrokerTec Global, LLC ("BrokerTec"). The Commission registered BCC as a DCO on June 18, 2001. BCC currently clears futures contracts traded on BrokerTec Futures Exchange, LLC, (BTEX), which received Contract Market Designation from the Commission also on June 18,2001. Both BTEX and BCC have been fully operational since November 30, 2001. BTEX presently trades futures contracts on 5- and 10-year US Treasury Notes and 30-year US Treasury Bonds.

COMMISSION OVERSIGHT of DCOs

While the Roundtable is an excellent way to begin a high level discussion of the Commission's role with respect to clearing organization oversight, we believe that a working group of clearing organization professionals and self-regulatory entities should be convened by the Commission to flesh out both the scope and details of an oversight program. Such working groups have, in the past, been successful in gathering the proper input, developing a big-picture approach and providing the Commission with useful information and guidance.

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We note that the Core Principles for DCOs contained in the CFMA provide a foundation for oversight. They are guidelines for the functioning of clearing organizations rather than a series of hard and fast rules. A DCO is obligated to demonstrate to the Commission in its application for such status and for continued compliance therewith that it is following such Core Principles. We believe that each DCO should review annually its compliance with the statements of Core Principles and then certify to the Commission that it is in compliance therewith. If the DCO cannot make such certification, it will be obligated to disclose that fact and provide an explanation as to why it is not in compliance and what steps are being taken to achieve compliance.

Presently, the Core Principles are silent on the internal governance structure of a clearing organization. When BCC submitted its application for DCO status, it included its by-laws and rules, which covered, among others things, internal governance and membership standards. BCC also submitted a full outline of its risk management procedures and a description of the financial adequacy evaluation process. With regard to corporate governance, we believe that a clearing organization, giving due regard to anti-competitive practices, should be guided in this area by the corporate law of its state of incorporation. We think that it is unnecessary for the Commission to add an additional layer of regulation focusing on internal corporate governance as a condition precedent for designation as a DCO and for continued compliance with such status.

We also believe that market discipline, rather than hard and fast rules, will provide the Commission with rigorous and independent oversight of a clearing organization's risk management procedures and the adequacy of its financial resources. When BCC's clearing members were conducting due diligence reviews prior to seeking approval for membership from their own risk committees, all aspects of BCC's risk management rules, procedures and financial resources were examined in detail. The decision to join BCC was based on achieving a level of comfort with the management of BCC, its financial integrity, its systems and processing capabilities, and its risk to the other clearing organization members. Accordingly, we submit that the Commission should monitor the performance of DCOs rather than adopt any additional requirements at this juncture.

MARKET STRUCTURE AND COMPETITION

BrokerTec believes that the traditional structural arrangements in the futures industry have restricted competition at both the exchange and clearinghouse level. Traditionally, the business and profitability of futures clearing organizations have been dependent upon the futures exchange for which they provide clearing and settlement services. The exclusive nature of most of these arrangements has restrained clearing organizations from competing with each other to provide services to other exchanges and has impeded the development of new exchanges by effectively raising barriers to entry into the business.[1] The result has been a high cost of doing business on the traditional futures exchanges relative to the cost of executing a securities transaction. This same lack of competition has also resulted in lengthy delays in implementing innovations such as cross-margining arrangements between securities and derivatives clearing organizations that are beneficial to market participants.

From its inception, one of the stated goals of the BrokerTec futures initiative was to bring common clearing (or similar clearing efficiencies) to the futures industry. The shareholders of BrokerTec, which include major dealers and traders in the cash and derivatives markets, have long been concerned about the costs, operational inefficiencies and risk management challenges that result from clearing futures

[1] BTEX is the only contract market designated by the Commission since the enactment of the CFMA that is currently operational.

transactions at multiple clearing organizations[2]. The benefits to industry participants resulting from common clearing would be substantial. They would include a reduction in the number and absolute amount of margin payments, coordinated control of systemic risk, operational efficiencies and better collateral management. Common clearing continues to be the ultimate goal with respect to the processing and clearing of trades executed on BTEX and we urge the Commission to study the steps taken by the Securities and Exchange Commission to require common clearing of equity options.

Consistent with our goal of common clearing, we also believe that fungibility of 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. Fungibility would allow futures market participants to realize some of the benefits of common clearing while avoiding the structural changes necessary for implementation. Fungibility would also ensure futures traders of the ability to take advantage of best price execution.

However, short of common clearing and fungibility, there are two other arrangements that would also be beneficial to futures markets participants and would increase competition in the futures industry – cross-margining and directed clearing. These arrangements could, to varying degrees, address two of the primary concerns of those who desire to trade similar products on competing exchanges, i.e., the management of credit risk and the inefficiencies of posting margin at multiple clearing organizations. We believe that the Commission has an important role to play in encouraging the adoption of these arrangements in order to remove any unnecessary barriers to competition among exchanges and clearing organizations. We note that Core Principle N for DCOs provides: "Unless appropriate to achieve the purposes of this Act, the derivatives clearing organization shall avoid (i) adopting any rule or taking any action that results in any unreasonable restraint of trade; or (ii) imposing any material anticompetitive burden on trading on the contract market". In fleshing out Core Principle N, the Commission (with the assistance of the Working Group we have proposed) should consider providing DCOs with guidance on developing pro-competitive arrangements and the need for DCOs to make decisions concerning such arrangements independent of the exchanges for which they clear. The Commission should also consider whether the failure to implement or allow such arrangements, in certain cases, could be inconsistent with such Core Principle.

Cross-Margining

Under a cross-margining arrangement, two clearing organizations that clear products which have a demonstrated degree of price correlation enter into an agreement to provide inter-exchange spread credits for offsetting positions held by a clearing member at the two clearing houses. The benefits to individual market participants, as well as the systemic benefits of cross-margining arrangements are well acknowledged by industry participants and financial market regulators.[3] We believe that the

[2] The term is commonly understood to mean the clearing of futures contracts, regardless of the exchange on which they are executed, at a single clearinghouse operated as utility for the industry. Common clearing involves the netting of identical contracts traded on different exchanges, the application of intra-commodity spread credits to different contracts, and a single set of rules, including delivery procedures. Common clearing currently exists for equity options traded in the U.S., all of which are cleared by the Options Clearing Corporation.

[3] A number of DCOs, including the Board of Trade Clearing Corporation ("BOTCC"), the clearing division of the Chicago Mercantile Exchange ("CME"), New York Clearing Corporation and BCC have entered into cross-margining arrangements with the Government Securities Clearing Corporation which provide for the cross-margining of securities, futures and repurchase positions held by their common or affiliated members. In addition, BOTCC and the CME have entered into a cross-margining agreement.

decision of two clearing organizations to enter into a cross-margining arrangement should be based primarily on three factors: 1) the interests of their respective clearing members; 2) the degree of price correlation between the products cleared by each; and 3) their respective analysis of the risk management procedures and financial integrity of the other. Assuming satisfaction of these criteria in each case, the Commission should direct all derivatives clearing organizations to establish cross-margining arrangements. The decision by two DCOs to enter into a cross-margining arrangement should not be controlled by either of the exchanges whose contracts they respectively clear. Such a decision should be within the sole province of the DCOs.

Though industry-wide cross-margining arrangements will undoubtedly result in more efficient markets, we note that cross-margining arrangements, as currently constructed, fall short of providing markets participants with the full economic benefit expected with very highly correlated positions. In addition, current arrangements do not provide any economic benefit to customers of FCMs, as the only eligible cross-margining participants are futures clearing members and/or their affiliates. Therefore, though implementation of such arrangements is desirable and a step in the right direction, it should not be considered the final solution to the problems inherent in the current market structure. More fundamental change is required.

Directed Clearing

A directed clearing arrangement de-links execution from clearing. It allows a clearing member to determine the clearing organization that will clear its transactions (or the positions of one or more of its customers) executed on a specific exchange. This arrangement has the potential to benefit the clearing member by allowing it to concentrate its open interest resulting from transactions on more than one exchange at a single clearing organization, where presumably those positions could obtain the benefits of netting and/or inter-commodity spread credits, thereby reducing margin requirements.

We believe that the Commission should study the potential benefits of directed clearing arrangements and any potential operational or risk management issues that may arise for clearing members or clearing organizations, respectively, as a result of having transactions executed on one exchange and cleared at multiple clearing organizations. We believe that the Commission will find that the potential benefits outweigh such concerns. If that is the case, the Commission should analyze whether prohibiting a clearing member from exercising the freedom to decide where to clear violates Core Principle N. (Similarly, the Commission should determine whether boycott threats of contract markets against DCOs or clearing members related to the possible implementation of direct clearing arrangements violates Core Principle 18 of Section 5(d) of the Act applicable to Designated Contract Markets.)[4]

CONCLUSION

In the interests of the continuing growth and competitiveness of U.S. futures markets, structural changes to current clearing arrangements are necessary. Current clearing arrangements unnecessarily restrict competition among clearing organizations and impede the growth and development of new exchanges. We believe that common clearing has the most potential to provide the greatest benefits to market participants. Fungibility would provide many of the same

[4] Core Principle 18 provides: "Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid – (A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anticompetitive burden on trading on the contract market."

benefits. However, we recommend that, within the next 120 days, the Commission (1) use its supervisory authority to require cross-margining across DCOs and (2) complete a study of the potential costs and benefits to market participants and the integrity of the futures clearing system of allowing clearing members the freedom to choose where the positions they carry will be cleared. These will be important steps in fulfilling the promise of the CFMA of increased competition in the U.S. futures markets.