COMMODITY FUTURES TRADING COMMISSION
ROUNDTABLE ON CLEARING ISSUES

STATEMENT OF DIDIER VARLET
CARR FUTURES INC.

AUGUST 1, 2002

Good Afternoon. My name is Didier Varlet. I am the Chairman and Chief Executive Officer of Carr Futures Inc., a registered futures commission merchant and broker-dealer. Carr Futures, an indirect subsidiary of Crédit Agricole Indosuez, is a global institutional brokerage firm with clearing memberships on major futures and equity markets worldwide. We have more than $2 billion in customer segregated funds on deposit and hold an additional $1 billion in customer funds under Part 30 of the Commission's rules.

The issues that my colleagues and I in the FCM community will be discussing with you this afternoon will not be new to you. In particular, the need for independent clearing organizations, better representation of intermediaries on exchange boards of directors and increased competition among US futures exchanges have been constant themes during the regulatory reform efforts that have been the focus of the Commission, Congress and the futures industry generally over the past several years.

These issues have not lost their urgency with the passage of time. To the contrary, they have become even more important in the current market environment.

- First, the markets are continuing an inexorable shift from floor trading to electronic trading platforms. The United States futures markets stand virtually alone among major markets in continuing to support both an exchange floor and an electronic trading platform.

- Second, the goal of assuring the financial integrity of derivatives transactions by transferring counterparty risk to a strong clearing organization is receiving renewed emphasis following the failure of Enron. Enron has served as a stark reminder of the importance of appropriate risk management procedures with respect to all derivatives transactions and of the pivotal role that a clearing organization may play in this regard.

- Third, although the US futures markets can be proud of their historic role as leaders and innovators, the European markets have taken the initiative on matters such as coordinated clearing, block trading and conversion to electronic trading platforms. As a result, they are challenging the US markets for leadership of the derivatives industry.

The Commodity Futures Modernization Act of 2000 was an important step in providing the US futures markets the tools they need to reassert their leadership position. By replacing a series of prescriptive statutory provisions with a set of broad core principles to guide their business decisions and by authorizing the exchanges to adopt new rules without prior Commission approval, the CFMA gives the exchanges and designated clearing organizations the necessary flexibility to implement promptly innovative new programs and procedures in response to the evolving marketplace.

As an example of the "responsible innovation" that the CFMA was designed to promote, exchanges and clearing organizations have used this authority successfully to form alliances with the over the counter markets enhancing the efficiency of all markets for the benefit of market participants. The relationships that the Intercontinental Exchange has recently forged with the London Clearing House and the Board of Trade Clearing Corporation, providing ICE members with added credit enhancements and cross margin opportunities, are examples of the type of innovation that we might not have seen prior to the enactment of the CFMA.

The same tools that Congress gave the exchanges to respond to the competitive threats of the over the counter markets and foreign exchanges were also intended to promote "fair competition" among the US exchanges themselves. Unfortunately, Congress gave them little incentive to do so. To the contrary, the CFMA essentially grants the existing exchanges a *de facto* monopoly with respect to the contracts they trade.

Let me explain. Liquidity is essential to any successful market. But, it is nearly impossible for new markets to build liquidity in an existing contract, unless the contracts executed on one exchange may be offset against contracts executed on the other. For new markets to have a fighting chance to compete, therefore, futures contracts must be fungible across markets. The CFMA does not require fungibility of contracts. (To be fair, no one asked Congress to impose such a requirement.) However, as a result, US exchanges have a *de facto* monopoly with respect to the contracts they currently trade.

Moreover, certain exchanges hope to extend the advantage to new contracts as well. For example, at least three exchanges have been designated for trading security futures products. They will trade contracts on many of the same individual stocks, the contracts will have the same terms and conditions, and all of the contracts will be cleared through The Options Clearing Corporation. There is no rational reason why these contracts should not be fungible, allowing exchanges to compete on a basis of quality of execution and costs as well as liquidity. However, at least one exchange has indicated that its contracts will not be fungible with identical contracts traded on other exchanges. With best execution being both an objective and a legal requirement, traders and intermediaries should have the choice of closing out a transaction on an exchange other than the one where it was opened.

We cannot fault the exchanges for wanting to maintain the volume they have. After all, most US exchanges are in the process of converting from non-profit membership organizations to for-profit entities, including publicly-held corporations. Profits are an essential goal of any for-profit entity and are a critical prerequisite to a successful initial public offering. The decision to maintain two trading platforms—the floor and an electronic trading platform—imposes substantial costs on the exchange itself as well as the intermediaries trading through the exchange. Consequently, the exchanges have every incentive to maintain or increase revenue by holding onto their trading volume and, in some cases, increasing fees charged to intermediaries and their customers. For example, one exchange imposed a surcharge on block trades; another raised fees for transactions executed on its electronic trading platform shortly after announcing plans to demutualize. Several exchanges are also reconsidering the fee structure for market data. Further, at least one exchange has also increased the costs for affiliates of members to trade on the exchange. The exchange rules governing when affiliates of members are entitled to member rates have been changed to require affiliates to hold additional memberships in order to obtain member rates.

Another means by which an exchange can maintain control over volume and revenue, of course, is to require all exchange contracts to be cleared through a single clearing organization which is controlled by, or part of, the exchange. This requirement understandably benefits the exchange and its clearing organization. We respectfully suggest, however, that it does not benefit market participants generally or the intermediaries that execute and clear their trades. The use of exchange-dominated clearing organizations can indirectly deny market participants and their intermediaries the ability to make the most efficient use of their capital, while managing most effectively the risks associated with their trading.

Moreover, at certain exchanges, the clearing organization is an important source of revenue. We are not suggesting that a clearing organization should not make money. We simply suggest that the revenue the clearing organization earns should be compensation for assuring the financial integrity of the contracts for which it assumes responsibility and not investment income resulting from unnecessarily high margin requirements. The clearing organization should not serve as a source of profits for an exchange whose contracts it clears.

We further submit that meaningful competition among exchanges demands independent clearing organizations. If market participants and their intermediaries have the freedom to choose where they will clear the contracts they enter into, we believe that competition among exchanges themselves will follow, resulting in more efficient and less expensive markets. To be independent, clearing organizations, of course, must be governed by the clearing members whose capital is at risk, rather than the boards of the exchanges whose contracts they clear. Currently, this is not the case. Clearing members have little or no voice in the governance of many clearing organizations, which often results in policies that deny clearing members the ability to use their capital efficiently. For example, certain clearing organizations continue to require gross margining of positions, which is unnecessary at the clearing level for risk management purposes.

The solution is relatively easy to describe. How we achieve it is more difficult. The CFMA established no transition period during which the Commission would continue to have direct regulatory authority over the exchanges, while the exchanges convert from non-profit membership organizations to for-profit entities. The internal politics of the exchanges make it difficult to alter the structure of exchange governance to reflect more accurately the interests of all market participants and the public. As a result, policies that would benefit market participants appear to languish.

For example, certain exchanges have refused to adopt rules authorizing block trading of large orders or have prohibited block trades in certain contracts. Block trades clearly benefit institutional market participants by assuring them that they will be able to effect the execution of large orders in a timely manner and at an efficient price. The failure to permit block trades of large orders disadvantages many market participants.

Separately, we believe exchanges should be encouraged to transfer the bulk of the self-regulatory obligations of the exchanges to an independent SRO, such as the National Futures Association. The potential for conflicts of interest at an exchange is not reduced when an exchange demutualizes. To the contrary, as the Commission's Division of Trading and Markets noted in its memorandum to the Commission regarding the CME's demutualization plan:

> For-profit exchanges must consider shareholder interests, perhaps at the expense of the interests of market users. Decisions and actions should be designed to maximize profits and stockholder value. Furthermore, shareholder interests may be protected by shareholder derivative litigation or shareholder class actions, at the expense of market participants. If an attempt to fulfill self-regulatory obligations negatively affects the profitability of a for-profit exchange, a conflict of interest might arise. Conversely, a conflict of interest might be thought to arise in the disciplinary proceedings of a participant of a for-profit exchange if the participant was the owner, or a significant shareholder, of a competing exchange.

Moreover, since many exchange member firms are also active in the over the counter derivatives markets, the exchanges will be exercising self-regulatory authority over entities with which they may be competing for business.

Exchanges, of course, should be able to exercise self-regulatory authority with respect to market specific conduct. However, an independent SRO should have authority over sales practices, financial responsibility, supervision and other cross-market matters. The transfer of these regulatory functions to NFA would not only be in the public interest, it would also result in more efficient oversight of intermediaries, reducing costs for exchanges and intermediaries alike.

The enactment of CFMA was an important step in providing the exchanges and clearing organizations with the tools they need to respond to the demands of the marketplace and the competitive challenges of foreign exchanges and the over the counter markets. We fear that if they do not use these same tools to permit competition among US futures markets and, in particular, to permit market participants and intermediaries to clear trades through clearing organizations responsive to their needs, the US exchanges run the risk of losing their leadership. We look forward to working with the exchanges to assure a market structure that benefits all market participants.