

**CURRENT STATUS OF REGULATION
OF SWAPS IN THE US: THE DODD-
FRANK WALL STREET REFORM AND
CONSUMER PROTECTION ACT**

CFTC's International Symposium and Training Program
October 17, 2011
Chicago, Illinois

CURRENT STATUS

- o Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law by President Obama on July 21, 2010
- o Title VII of Dodd-Frank Act focuses on the "Regulation of Over-the-Counter Swaps Markets"
- o Certain provisions relating to futures became effective on July 16, 2011 and the implementation of swaps related regulation have been delayed.

RULEMAKING STATUS

- o Commission substantively finished proposed rulemaking in Spring 2011.
- o Have completed 12 final Dodd-Frank rules and have a robust schedule this fall to consider more final rules.
 - Completed final rules include important issues such as: mandatory clearing, swap data repositories, agriculture swaps, retail forex trading, anti-manipulation standard, whistle blower protection and large trader reporting.

CFTC DODD-FRANK RULEMAKINGS

- o I. Registration
- o II. Definitions – Participants
- o III. Business Conduct Standards with Counterparties
- o IV. Business Conduct Standards –Internal
- o V. Capital and Margin for Non-Banks
- o VI. Segregation and Bankruptcy
- o VII. Clearing Organization Core Principle Rulemakings
- o VIII. Process for Review of Swaps for Mandatory Clearing **FINAL**

CFTC DODD-FRANK RULEMAKINGS

- o IX. Governance and Possible Limits on Ownership and Control
- o X. Systemically Important Clearing Organization Rules Authorized under Title VIII of Dodd-Frank
- o XI. End User Exception
- o XII. Regulated Exchange Core Principle Rulemaking
- o XIII. SEF Registration Requirements and Core Principle Rulemaking
- o XIV. Registration Requirements for FBOTs

CFTC DODD-FRANK RULEMAKINGS

- o XV. Rule Certification and Approval Procedures **FINAL**
- o XVI. Swap Data Repositories Registration Standards and Core Principle Rulemaking **FINAL**
- o XVII. Data Recordkeeping and Reporting Requirements
- o XVIII. Real Time Reporting
- o XIX. Agricultural Swaps **FINAL**
- o XX. Forex (Retail Off Exchange) **FINAL**
- o XXI. Definitions – Products
- o XXII. Portfolio Margining Procedures

CFTC DODD-FRANK RULEMAKINGS

- o XXIII. Anti-manipulation **FINAL**
- o XXIV. Disruptive Trading Practices
- o XXV. Whistleblowers **FINAL**
- o XXVI. Position Limits
- o XXVII. Investment Adviser Reporting
- o XXVIII. Volcker Rule
- o XXIX. Reliance on Credit Ratings **FINAL**
- o XXX. Fair Credit Reporting Act and Disclosure of Nonpublic, Personal Information **FINAL**
- o XXXI. Conforming Amendments
- o XXXII. Large Swaps Trader Reporting **FINAL**

JURISDICTION

- o Definition of a swap
 - Title VII of the Dodd-Frank Act gives a broad list of products that are covered.
 - CFTC-SEC joint rulemaking submitted a proposal in May 2011 for public comment
 - o Provides interpretive guidance that define certain insurance, consumer/commercial mortgage, and forward products as outside the definition of a swap.
 - o FX forwards and swaps are included in the definition of a swap, but Treasury has issued a proposed rule to exempt them.

JURISDICTION

- o Swaps vs. Security-based Swaps
 - The SEC has jurisdiction over security-based swaps, while the CFTC has jurisdiction over swaps
 - o Security-based swaps defined to include: swaps based on a single security or loan, narrow-based security indices, or on the occurrence of an event relating to a single issuer or issuers of securities in a narrow-based security index
 - o Swaps defined to include: commodity swaps, broad-based index credit default swaps, interest rate swaps, currency swaps, and swaps on broad-based security indices

3 CORE ELEMENTS OF REFORM

- **Dealer and participant regulation** Mandated registration and regulation of swap dealers and major swap participants
- **Clearing** Reduced risk by moving eligible derivatives onto central clearinghouses
- **Transparency** Increased pre-trade transparency by moving eligible cleared derivatives onto regulated exchanges or swap execution facilities (SEFs), and increased post-trade transparency for all swaps

WHAT IS A SWAP DEALER?

- Any entity that:
 - Holds itself out as a dealer in swaps;
 - Is a market-maker in swaps;
 - Regularly purchases and sells swaps as an ordinary course of business; or
 - Engages in any activity that would cause a person to be known in the trade as a dealer or market-maker in swaps.
- CFTC-SEC proposal says characteristics of a SD include:
 - SDs tend to accommodate demand from other parties
 - SDs are generally available to facilitate other parties' interest in swaps
 - SDs tend to enter into swaps on their own standard terms or on terms they arrange in response to other parties' interest
 - SDs tend to be able to arrange customized terms for swaps on request

EXEMPTIONS AND EXCLUSIONS FROM SWAP DEALER DEFINITION

- De minimis exception: an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers.
- CFTC-SEC proposal requires that a person meet the following conditions to qualify:
 - Aggregate effective annual notional amount is < \$100M
 - Must not enter into swaps as a dealer with >15 counterparties in a year
 - Must not enter into >20 swaps as a dealer in a year

WHAT IS A MAJOR SWAP PARTICIPANT?

- o Any entity that:
 - Is not a swap dealer; and
 - Maintains a substantial position in swaps for any major swap category excluding positions held for hedging or mitigating commercial risk; or
 - Has substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets; or
 - Who is a highly leveraged non-bank financial entity that maintains a substantial position in swaps.

- o CFTC-SEC proposal creates formulas for "substantial position", "substantial counterparty exposure" and "highly leveraged"

REGULATION OF DEALERS AND MAJOR SWAP PARTICIPANTS

- o Capital and margin requirements
- o Requirement to maintain daily trading records/audit trail
- o Reporting and recordkeeping obligations
- o Business conduct standards
- o Documentation standards, and
- o Requirement to designate an in-house chief compliance officer

BUSINESS CONDUCT STANDARDS FOR SDS AND MSPS DEALING WITH COUNTERPARTIES

- o CEA Section 4s and the CFTC proposed rule contain business conduct standards for SDS and MSPs dealing with counterparties including:
 - o Verification: Duty to verify a counterparty's eligibility to transact in swap markets
 - o Disclosure of
 - Material risks for high risk bilateral swaps
 - Material incentives and conflicts of interest
 - o Daily Mark: Duty to provide the daily mid-market value of uncleared swaps to the counterparty
 - o Clearing: Duty to notify of the right to clear
 - o Fair Dealing and Good Faith: Duty to ensure that all communications with counterparty are fair and balanced

**INTERNAL BUSINESS CONDUCT STANDARDS
FOR SDS AND MSPS**

- o Section 731 of Dodd-Frank further amends CEA Section 4s with respect to business conduct standards and other requirements for swap dealers and major swap participants, including:
 - o Business conduct standards relating to:
 - Such matters as the Commission determines to be appropriate
 - Diligent supervision
 - Adherence to all applicable position limits
 - o Reporting and recordkeeping
 - o Daily trading records
 - o Documentation standards (confirmation, processing, netting, documentation, and valuations of swaps)
 - o Recordkeeping for security-based swap agreements

CLEARING REQUIREMENT

- o All eligible swaps must be cleared on a registered clearing organization
- o End-user exemption: End-user counterparty may opt out of clearing requirement if it:
 - Is not a financial entity
 - Uses swaps to hedge or mitigate its commercial risk, and
 - Notifies the appropriate regulator of how it meets its financial obligations when entering into non-cleared swaps
- o Proposed hedge/mitigation definition encompasses:
 - Swaps that are bona fide hedges under CEA rules, qualify for hedging treatment under FASB 815 (formerly 133) or economically appropriate to the reduction of risk in a commercial enterprise

CLEARING ELIGIBILITY

- o Initiated by the clearing organization
 - Clearing organization submits swaps it plans to clear to its regulator
 - o DCOs are presumed eligible to accept for clearing any swap that is within a class that the DCO already clears.
 - Regulator must review and consider public comments to determine if the swap must be cleared
 - Regulator must make its determination within 90 days of submission to the regulator
- o Initiated by the Regulator
 - On an on-going basis, the regulator must review swaps to determine whether the clearing requirement should apply

FACTORS TO CONSIDER WHEN MAKING MANDATORY CLEARING DETERMINATION

- o Existence of significant outstanding notional exposures, liquidity and pricing data
- o Availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure
- o Effect that clearing will have on the mitigation of systemic risk (consider size of market and resources of the clearing house)
- o Effect on competition (considering clearing fees, etc.)
- o Existence of legal certainty in case of insolvency of the clearing organization/one or more clearing members

REPORTING REQUIREMENT

- o All swaps transactions, whether cleared or uncleared, must be reported to a registered swap data repository (SDR).
- o If no SDR exists to accept the swap transaction, the details of the transaction must be reported to the regulator.
- o There is no geographic mandate on where an SDR must be located.

SDR REQUIREMENTS

- o SDRs are subject to registration and must adopt procedures for auditing, monitoring, and confirming the data.
- o CFTC proposed rules specify data fields that must be reported.
- o An SDR must provide open and equal access to all swaps in a given asset class.
- o Access to Data:
 - SDRs must provide the CFTC with direct electronic access to the swap data.
 - Other regulators can receive access to data:
 - o Directly from SDR if that regulator indemnifies the SDR
 - o Directly from SDR if it is dually registered by the other regulator
 - o From CFTC provided the regulator agrees to keep the information confidential.

PUBLIC REPORTING

- o Real-time public reporting for all swaps
 - "Real-time" means "as soon as technologically practicable after the time at which the swap transaction has been executed."
 - CFTC proposed rule says counterparties may satisfy this requirement by executing on a SEF or DCM.
 - o If swap not executed on a SEF/DCM, then must be reported to an SDR or 8th party that can act as real-time disseminator
 - CFTC proposed rule lists data fields to be reported including, price, volume, contract type, tenor, etc.
 - CFTC proposed rule has real-time disseminator delaying reporting by 15 minutes for block trades
- o DFA requires that reported information does not identify the participants to the swap transaction

TRADE EXECUTION

- o Swaps subject to the mandatory clearing requirement must be executed on a regulated exchange or a SEF, unless no exchange or SEF makes the swap "available to trade"
 - Swaps involving non-eligible contract participant counterparties, limited to trading on regulated exchanges
 - o An eligible contract participant is a designation for a regulated entity, such as a financial institution, insurance company, or a corporation or commodity pool with a significant amount of assets. This classification permits these persons to engage in transactions (such as trading on a derivatives transaction execution facility) not generally available to retail customers.
- o No Single Dealer Platforms
 - "a trading system or platform in which multiple participants have the ability to execute or trade [swaps/security-based swaps] by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce"
 - Platforms must provide impartial, open access

TRADE EXECUTION

- o CFTC proposal implements the execution requirement by allowing transaction to be traded on Order Books or Request for Quote (RFQ) systems.
 - Order books include trading platforms where all market participants can enter bids and offers, observe bids and offers entered by others on the platform and transact on those bids and offers.
 - RFQs include trading platforms where market participants transmit a RFQ to at least 5 market participants in the platform. Any resting bids or offers on the platform must be taken into account and communicated to requester.

TRADE EXECUTION

- o CFTC proposal codifies regulation and provides guidance governing SEF obligations on:
 - Trading and products requirements,
 - Compliance obligations,
 - Surveillance obligations, and
 - Financial information and resources requirements.
- o The SEF proposal intends to meet the Dodd-Frank goals of:
 - Increasing pre-trade transparency
 - Increasing price competition
 - Increasing market participation/open access

INTERNATIONAL IMPLICATIONS

- o **Scope of Dodd-Frank:**
 - CEA Sec. 2(i) states that the provisions in the Act relating to swaps "*shall not apply to activities outside of the United States unless: Such activities have a "direct and significant connection with activities in, or effect on, commerce of the United States . . ."*
 - Applies to all activities subject to Frank Dodd.
 - No exemptions for SDs, MSPs, and SDRs.
 - However, comparability exemptions exist for DCOs, SEFs, and FBOTs.
- o **Coordination**—CFTC will coordinate with foreign regulators in instances where Sec. 2(i) results in entities being registered both here and abroad

COMPARABILITY EXEMPTION

- o **Applicable entities:**
 - FBOTs that provide "direct access" to a US person;
 - DCOs; and
 - SEFs.
- o **Criteria**—CFTC must find that entity is subject to "comparable comprehensive supervision and regulation" in the home country.

**POLICY DIRECTIVE ON INTERNATIONAL
HARMONIZATION**

- o Dodd-Frank Section 752: CFTC, SEC and bank regulators "shall consult and coordinate" with foreign authorities on: Establishment of "consistent international standards" with respect to swaps and swap entities.

- o CFTC shall:
 - Consult and coordinate with respect to the regulation of futures; and
 - May agree to such information sharing arrangements as may be deemed necessary or appropriate"





Over-the-Counter (OTC) Derivatives Markets and Participants: A Regulatory Update from Europe

Sarah Harris
Manager
Clearing and Settlement
FSA
October 2011



The G20 agreement on OTC Derivatives

- In September 2009, G-20 Leaders agreed in Pittsburgh that:

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.



The G20 agreement on OTC Derivatives

- European implementation of this agenda falls into 3 pieces of legislation

- EMIR

- All standardised OTC contracts should be cleared through CCPs
- All derivatives should be reported to TRs
- Risk Management standards for non-cleared derivatives
- Pan EU regimes for CCP and TR supervision

- CRD4

- Non-centrally cleared contracts should be subject to higher capital requirements [... than cleared contracts]

- MIFID Review

- All standardised contracts should be traded on exchanges or electronic trading platforms, where appropriate

EMIR: Current timeline



- **EU Commission**
 - Proposed EMIR on 15th September 2010
- **EU Parliament**
 - Parliamentary amendments discussed at 4th July Plenary
- **EU Council**
 - Negotiations ongoing since October 2010
 - Agreement on approach reached on 4th October 2011
- **Next Steps**
 - Trilogue discussions and final agreement in Q4 2011 / Q1 2012
- **ESA Technical Standards**
 - Due for submission to the Commission by end June 2012
 - Limited potential for delay
 - Final implementation by end 2012

EMIR: Mandatory Clearing of OTC Derivatives



- **Process for defining products for mandatory clearing of OTC derivatives**
 - ESMA led Bottom Up and Top Down approaches
 - Processes to include public consultation
- **Product Scope**
 - All asset classes in scope (FX included)
- **Participant Scope**
 - All financial firms and non-financials if they transact non-hedges of an amount above the "clearing threshold"
 - Includes trades with 3rd country counterparties who would be subject to mandatory clearing if they were established in the EU
- **Implementation**
 - ESMA defined but may differ according to "categories of counterparty" and include phase-in for "front-loaded" contracts
 - No "back-loading" of trades executed before EMIR enters into force
 - Potential "front-loading" of trades executed post entry into force but before clearing obligation put in place
- **CCP location**
 - EU CCPs authorised by national authorities and 3rd country CCPs recognised by ESMA

EMIR: Mandatory Clearing of OTC Derivatives



- **Key Outstanding Issues**
 - Trilogue discussions
 - **Product Scope**
 - OTC vs. all derivatives
 - **For Implementation**
 - Models for access to CCPs by wide range of market participants
 - Consistency between EU and 3rd Countries legislative frameworks

EMIR: Mandatory Reporting of OTC Derivatives



- **Product Scope**
 - All asset classes in scope (FX included)
- **Participant Scope**
 - All firms
- **Implementation**
 - Potentially full "back-loading" of all active trades including those executed before EMIR enters into force
- **TR location**
 - EU TRs and 3rd country TRs which have been recognised by ESMA
- **Key Outstanding issue**
 - Product Scope: OTC vs. all derivatives

EMIR: Risk Management of non-cleared trades



- **Requirements for all market participants**
 - Timely confirmation, via electronic means where available
 - Regular portfolio reconciliation
 - Robust dispute resolution
- **Further requirements**
 - All financial firms and non-financials if they transact non-hedges of an amount above the "clearing threshold"
 - Daily trade valuation
 - Appropriate exchange of collateral
 - Holding of proportionate amount of capital (financial firms only)
- **Implementation**
 - No "back-loading" of trades executed before EMIR enters into force
 - "Front-loading" of trades between financial counterparties only
- **Key Outstanding Issues**
 - Participant Scope: Intra-group Transactions
 - Independent Amount vs. Variation Margin

EMIR: Pan EU Authorisation/Supervision of CCPs & TRs



- **CCPs**
 - EU CCPs national authority-led with input from college structure, 3rd country CCPs by ESMA
- **TRs**
 - EU and 3rd country TRs by ESMA
- **Regulatory rules**
 - Expected to be largely based on CPSS-IOISCO *Principles for Financial Market Infrastructures* (once finalised)
 - To be fleshed out in detail by ESA Binding Technical Standards
- **Key Outstanding Issues**
 - CCP/TR: Role of national authorities vs. ESMA concerning authorisation
 - CCP: Access to central bank liquidity
 - Numerous technical differences between Council and Parliament texts

EMIR: International agenda



- **Interaction with legislation in other jurisdictions critical**
 - consistency vs. regulatory arbitrage
 - potential extra-territoriality
- **International work underway to promote harmonisation**
 - Overview: FSB
 - Mandatory Clearing: IOSCO
 - Mandatory Reporting: CPSS-IOSCO
 - Risk management of non-cleared trades: CPSS, IOSCO, BCBS, CGFS
 - CCP/TR regulation: CPSS-IOSCO
 - EU/US dialogue ongoing
- **Opportunities for market participants to input into consultations**

Contact Details



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OTC Derivatives Regulation in Japan

Improving the Stability and Transparency of
OTC Derivatives Markets

17 October 2011

Makoto Seta



- Financial Services Agency
- Government of Japan

Policy Background and Regulatory Framework

LEADERS' STATEMENT AT THE PITTSBURGH SUMMIT (24-25 September 2009)

Strengthening the International Financial Regulatory System

*Improving over-the-counter derivatives markets: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regulatory implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.**

AMENDMENT TO THE FINANCIAL INSTRUMENTS AND EXCHANGE ACT (Approved by the Diet on 12 May 2010; Promulgated on 18 May 2010)

To improve the stability and transparency of OTC derivative transactions:

- Mandatory CCP clearing for high trade volume products
- Mandatory clearing by domestic CCPs for derivative trades that are closely linked with Japan's bankruptcy regime
- Storing and reporting of trade information

Mandatory CCP Clearing

For actively traded OTC derivatives, where the reduction of clearing and settlement risk through use of CCP would contribute to the stability of Japanese market
(e.g., "plain vanilla" type interest rate swaps)

Due to extensive cross-border trade relationships, mandatory CCP clearing may be undertaken by:

- Domestic CCP
- Foreign CCP
- Domestic CCP and foreign CCP under an interoperability arrangement

For OTC derivatives where the clearing criteria relates closely to the corporate bankruptcy criteria under the domestic law
(e.g., "Itraxx Japan" CDS Index)

Mandatory clearing by a domestic CCP

CDS
In determining whether a credit event has occurred, local commercial and legal practices, including court decisions made under the Japanese bankruptcy law, need to be taken into account.

Whilst respecting an internationally adopted protocol among contractual parties concerning the determination of a credit event, domestic CCPs should also be appropriately involved, and to be able to reflect their views concerning the determination.

Centrally cleared by domestic CCPs

Strengthening the CCP Infrastructure

Improving the financial strength of domestic CCPs

[Previous regulation]
No restrictions on major shareholders and no minimum capital requirements for CCPs

Considering the importance of CCP as an infrastructure to protect equal risk spreading within the financial system

[Revised regulation]

- Authorization requirement for shareholders intending to hold more than 20% by voting rights of the CCP
- Minimum capital requirement

Enabling foreign CCPs to enter the Japanese market

[Previous regulation]
Central clearing of financial instruments trades were permitted only by domestic CCPs

• Provision of central clearing services by foreign CCPs to domestic financial institutions were prohibited

In consideration of the treaties, among financial institutions in Japan, trade relationships enter across nations

[Revised regulation] Introduction of new regimes

• LINK BETWEEN INTEROPERABLE CCPs

Subject to authorisation regime

Requirements:

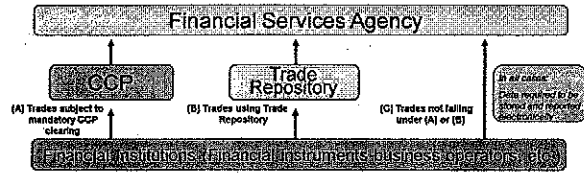
- Need to maintain an adequate infrastructure to operate appropriately and reliably during Japanese market hours
- Linked foreign CCP is subject to full supervision by its primary regulator

• DIRECT ENTRY

Subject to financing regime

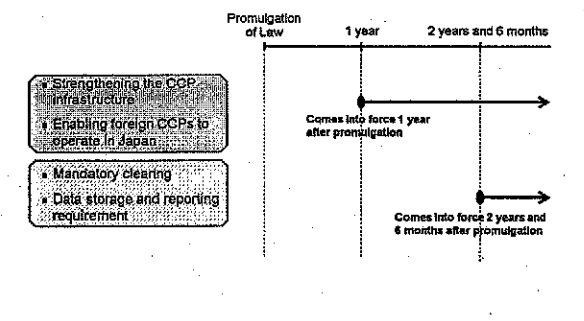
Need to satisfy the above requirements; same regime as for domestic CCPs is applied to foreign CCPs

Storing & Reporting of OTC Derivatives Trade Information



- I. For trades that are subject to mandatory CCP clearing, CCP stores the trade information and reports them to the regulator
- II. Designation of trade repositories (TR) by public notice
Designated Domestic TR: Designated upon an application by the TR
Designated Foreign TR: Designated if an international cooperative supervisory framework is established and is compliant with the domestic reporting regime
- III. Financial institutions can report trade information through TRs or directly to the regulator
- IV. Domestic TRs are required to store and to submit trade information to the regulator

Schedule for Implementation



Current Regulatory Issues

- OTC derivative products are frequently traded across different jurisdictions
- Regulatory arbitrage may occur and therefore there is a need to limit these activities to maintain the stability of the financial system

Need for international coordination / cooperation

A Participating in multilateral policy discussions

- G20 / FSB
- IOSCO Task Force on OTC Derivatives Regulation: international standards setting
- CPSS-IOSCO: "Principles for Financial Market Infrastructures"
- Others (on matters regarding CCP access, links and non-CCP cleared contracts)

B Promoting cooperation between authorities

- Seeking consistencies with Dodd Frank Act, EMIR and MiFID, etc.
- International supervisory cooperation on foreign TRs

Current Regulatory Issues in Japan

OTC Derivative Regulation in Japan - Current Issues

- (1) Take into account the characteristics of Japanese market (e.g., large proportion of the trades are cross-border with a limited number of global counterparties)
- (2) Create a robust market infrastructure
- (3) Envisage future development of the Japanese OTC derivatives market

A Multi-stage application of regulations

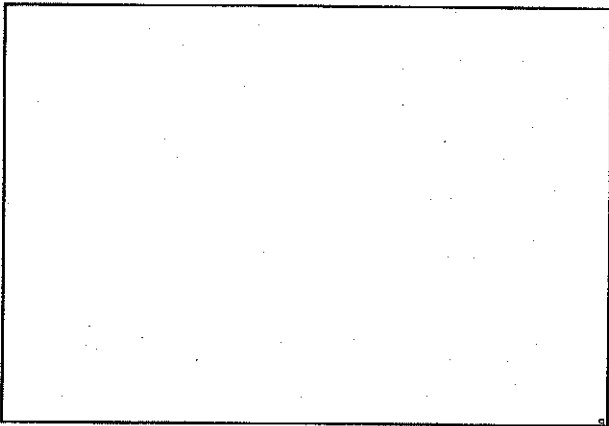
- Scope of central clearing
- Storing and reporting of trade data
- Electronic trading platform

B Practical matters - Current status

- Commencement of CCP clearing for CDS by JSCC (July 2011)
- Preparing for the establishment of interest rate swap CCP by JSCC (Nov 2012)
- Encouraging financial institutions in Japan to report to TRs

For Further Information

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Making Electronic Markets More Resilient & Efficient

CFTC International Regulators Conference
October 17, 2011

Categories of Policies

- Good things that have been done
- Good things still to be done
- Bad ideas best left alone

Good Things That Have Been Done

- Elimination of stub quotes
- Price limits & stock-by-stock circuit breakers
- Limit up-limit down price limits
- Greater clarity & certainty on trade break or bust policies
- Kill buttons, but make more standardized

Good Things That Still Need to be Done

- Remove areas of unnecessary complexity
- Have all orders and transactions reported to a single place, but...
- Clearing firms should obtain written certification that DMA client trading firms are using
 - all agreed upon risk controls
 - With agreed-upon parameters that are not changed w/o ok of clearing firm

Bad Ideas Best Left Alone

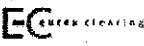
- Regulatory pre-approval of algos
- Forcing HF firms that make markets to become formal market makers
- Require a minimum resting time for orders before execution
- Transaction tax

Other Ideas

- Discouraging excessive messaging – a task for exchanges or regulators
- Fixed minimum tick sizes

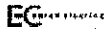
International Symposium and Training Program
 Regulation of Derivatives Products, Markets and Financial Intermediaries for International Market Authorities
 Chicago, October 17, 2011

Mariusz Gradlich
 Executive Director
 Head of Clearing Initiatives




Agenda

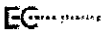
- Research and Regulatory Initiatives 2009-2011
- Central Counterparty Clearing at work



www.ecclearing.com

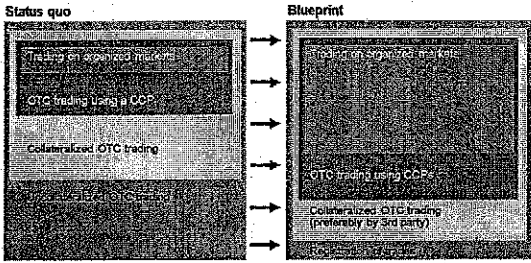
Against the backdrop of the financial crisis, parts of the derivatives market have proven resilient, parts have shown deficiencies

<p>Effective counterparty risk management and mitigation by CCPs with their netting and collateral management capabilities have proven resilient.</p> 	<ul style="list-style-type: none"> • Excessive buildup of bilateral exposure and unmitigated counterparty risk • Insufficient risk valuation and management capabilities for derivatives • High interconnectiveness of derivatives market participants and undesirable market complexity • Lack of transparency in OTC derivatives market • Operational inefficiencies and limited legal certainty
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www.ecclearing.com

Shift of current derivatives market towards a market structure with improved safety and integrity



Source: Deutsche Börse Group 2009, Whistler
 Please note: Size of a box represents the notional amount outstanding
 EC Clearing
 www.euroclearing.com

Agenda

- Recap: Lessons learnt from crisis in 2008
- **Centralized clearing**

EC Clearing
 www.euroclearing.com

Mission of Eurex Clearing: Safer Markets

Eurex Clearing's main concern is to provide a safer market, which is needed if derivatives are to deliver their full economic benefits

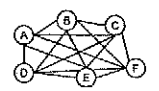
- A safer derivatives market is transparent, to inspire trust
- It's efficient, so processes are simple and capital costs are lower
- It ensures that investors' positions are protected
- And above all it's neutral, so that counterparty risk is mitigated

Which is exactly what Eurex Clearing helps to provide.
 Because the more people have faith in the markets, the more they'll feel clear to trade.

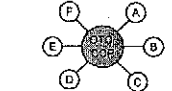
EC Clearing
 www.euroclearing.com

Central OTC clearing services improve soundness of market infrastructure and strengthen market integrity

Current OTC market structure - 1:n relationships

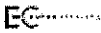


Proposed OTC market structure - 1:1 relationships



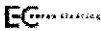
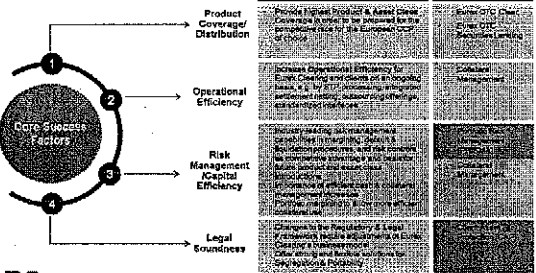
Benefits of multilateral clearing with OTC Central Counterparty

1. **Reduced systemic risk**
 - CCP takes over counterparty risk through trade novation
 - CCP advances strict risk control and adequate collateralisation of open positions
 - Multilateral netting reduces gross net exposures
2. **Increased transparency**
 - Transparency to position data by central ledger
 - Neutral position valuation by independent institution
 - Easy reporting transfer by daily multi-tenant (gross and net balances)
3. **Efficiency gains**
 - Full automation and straight through processing reduces market errors
 - Efficient use and management of collateral
 - Increased capital efficiency by reduced balance sheet exposure



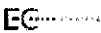
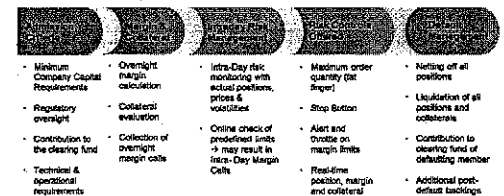
www.ecclearing.com

Eurex Clearing focuses on four success factors to increase market integrity, while delivering efficiencies to market participants



www.eurexclearing.com

Risk management services are key building block to improve soundness of market infrastructure and to strengthen market integrity



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EUREX

The new Default Management Process to comply with market expectations and regulatory guidelines

Overview of future Default Management Process framework

Covered by: Margins + Other Short Term Facilities Clearing Fund + Other Lines of Defense

Timing to match holding period for margining of the liquidation group

Process step	Description
1	Client position and collateral transfer Closing of Default Management Committee Close-out netting Portfolio and market evaluation
2	Handling of client positions, e.g. by rolling Cancellation or pending settlements* (Blue) portfolio grouping for liquidation
3	Define hedging for defaulting portfolio Hedge portfolio based on management decision Portfolio pinning
4	Ability for Eurex Clearing to sell portfolio based on priority
5	Counterparty ability to gross the positions Accepted Structured Aims to minimize CCP losses and market impact

Expiries, Allocations, CDO, etc.

* Only for markets where this is permitted, e.g. Euro trade with overnight front leg
** Interest rate Swaption may be exercised at any time while during the whole liquidation process

EC CLEARING

EUREX

Eurex Clearing ensures highest protection by providing segregation and timely portability

- We have introduced a further dimension to our proven clearing service by addressing segregation and portability needs that will benefit both Clearing Members and their clients
- Since the unprecedented example from 2008, there has been a growing demand from clients for mechanisms to effectively address the requirements for Client Asset Protection
- Our solution has been designed with a view to ensure compliance with regulatory initiatives that will be implemented during 2012

Benefits

- Our Client Asset Protection service has been designed to deliver
 - Maximum protection for clients under a proven legal construct
 - Segregation of client margin collateral mitigating the impact on clients in the event of a Clearing Member's (CM's) default
 - Portability of positions enabling continued trading in the event of a CM's default
 - Portability of client margin collateral in the event of a CM's default
 - Unique client segregation offering a higher level of protection with the Individual Clearing Model
 - Further capital efficiencies with upcoming regulations

EC CLEARING

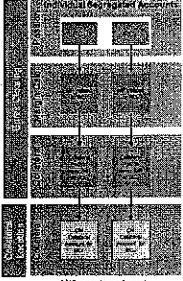
EUREX

In a first step the Individual Clearing Model was introduced in August 2011

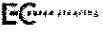
<p>Segregation Positions and collateral are separated from Clearing Member's proprietary positions and held in individual segregated accounts</p> <p>Portability Maximum portability of positions and margin collateral ensured through individual position collateral accounts and close-out netting and re-opening mechanism without interaction with the administrator</p> <p>Status The first building block of the Individual Clearing Model was launched in August 2011</p>	<p>Individual Clearing Model</p> <p>Segregation Positions and collateral are separated from Clearing Member's proprietary positions and held in segregated omnibus accounts</p> <p>Portability In the event of a Clearing Member default, any transfer of client positions and margin collateral would be dependent on the new CM accepting those positions, and the cooperation of the administrator</p> <p>Status The Omnibus Net Segregation launch planned for 2012</p>
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EC CLEARING

Individual Segregation – maximum portability through individual position and collateral accounts



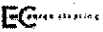
- Individual Segregation is offered to Registered Customers (RC)
- Positions are held on segregated RC position accounts
- The margin requirement (MR) of an RC is covered by a dedicated collateral pool, which only holds collateral for the purpose of this RC
- Collateral is segregated from the proprietary collateral of the CM
 - The securities collateral account remains within the account structure of the CM and is clearly labelled to hold collateral for the purpose of the segregated RC
 - Cash collateral is paid from the account of the CM with an identifier indicating the respective RC



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Thank you for your attention



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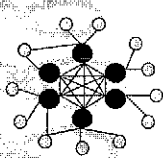
Using Central Clearing Counterparties (CCPs) in OTC Derivatives Markets

Sarah Harris
 Manager, Clearing & Settlement
 Market Infrastructure & Policy Department
 October 2011

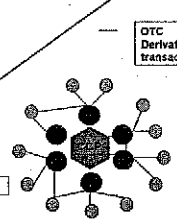
OTC Derivative Market Bilateral Risks vs Clearing



Bilateral Collateralisation



- Dealer
- Non-dealer
- OTC Derivative transaction
- Clearing member
- Non-clearing member



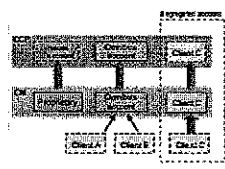
CCP Clearing

OTC Derivative transaction

Client clearing



- In the context of the G-20 commitments, standardized OTC derivatives will have to be centrally cleared
- Under EMIR and Dodd-Frank, clients will have to clear through a CCP
- Basel III gives favourable capital treatment to centrally cleared trades
- Because of CCPs membership requirements, most clients will have to find a clearing member to have access to CCPs
- Client's counterparty risk will be mitigated by
 - Segregation of client's accounts: Different levels of segregation will provide different protection from other client's default
 - Portability will facilitate transfer of positions and assets from a defaulting member to a back-up clearing member
- There are a variety of models of segregation and portability being developed and regulation should facilitate choice for underlying clients



Access to CCPs



- Only clearing members of a CCP are eligible to clear their OTC derivatives through the CCP
- Membership criteria for CCPs are the first step in a CCP's risk management framework and need to be appropriately restrictive and yet facilitate fair and open access
- Access requirements can be directly correlated to, or a proxy for, a risk to be mitigated
- Typical risk related access criteria include:
 - Capital and other financial membership requirements
 - Requirements to demonstrate operational capacity
 - Rules that obligate participation in a CCP's default procedures
 - Capacity to transact in the currencies and transact in the collateral used by the CCP
- Currently a focus amongst regulators and CCPs to review access criteria to ensure proportionality and appropriately justified in terms of the safety and efficiency of the FMI
- It is a matter for individual jurisdictions to determine whether they want to see established/mandate the use of a local CCP

Interoperability



- Potential benefits: greater efficiency (through netting and elimination of multiple CCP memberships), greater choice of CCPs
- Potential risks: increase in complexity and inter-CCP credit risk (contagion)
- Any additional or increased risks identified must be adequately mitigated
- Communication of Regulatory Position on Interoperability by AFM, DNB, FINMA, FSA and SBE
- Do OTC Derivatives face different hurdles to interoperability as compared to other asset classes?

EMIR, 23 September 2011 Presidency Compromise states that:

Article 1(1) of Title V (Interoperability arrangements) shall only apply to transferable securities and money market instruments.

Authorities info sharing arrangements

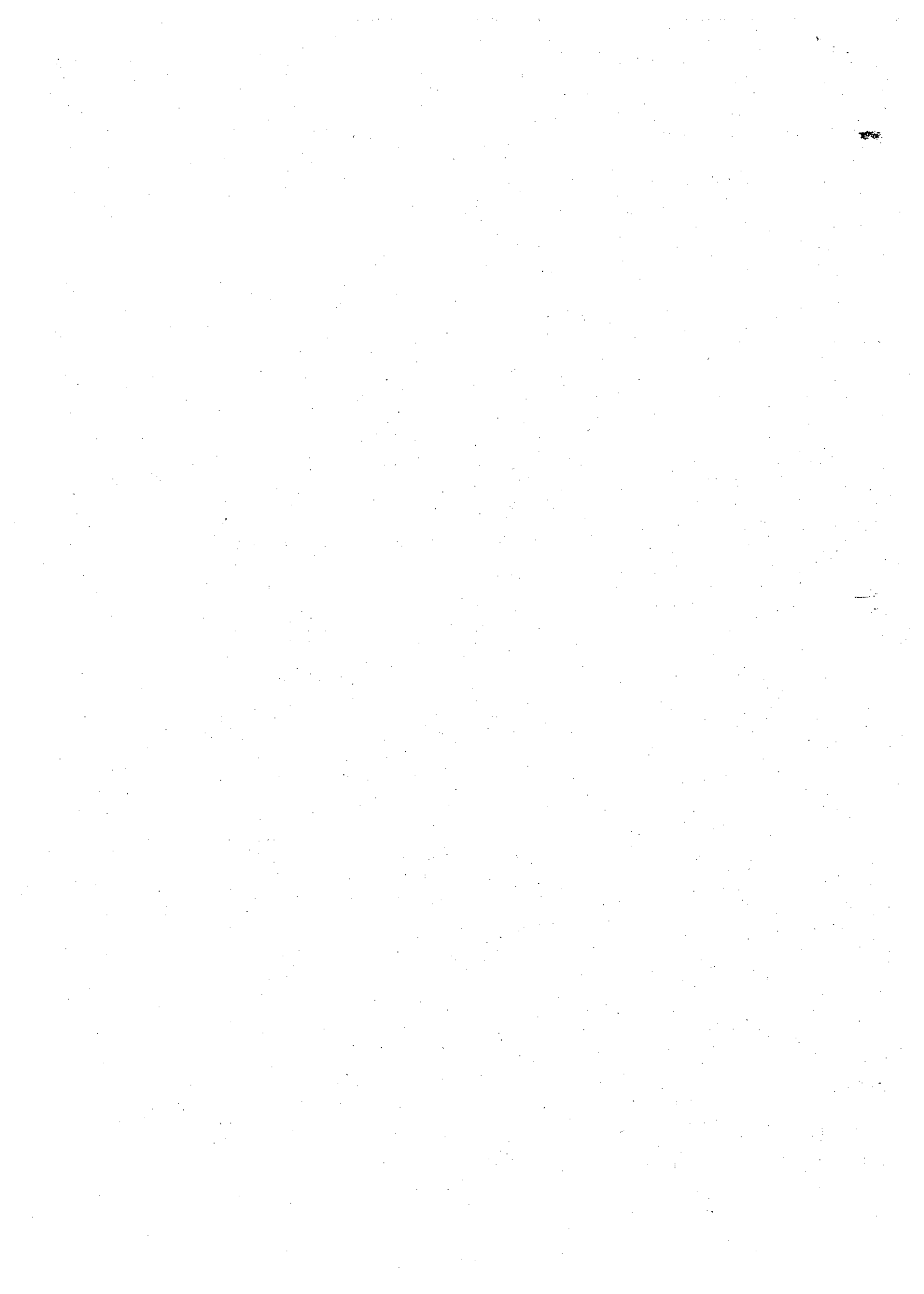


- Some developments on specific arrangements for OTC Derivatives CCPs within OTC Derivatives Regulators Forum
- Assessment of Impact of EMIR on European CCPs and how this will impact arrangements with Authorities outside of Europe
- How should crisis management arrangements be incorporated
- How to ensure consistency of application of approaches
- Next steps

Contact details



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Getting Over the Bar: Creating Clearing Options for Smaller Market Jurisdictions

17 October 2011
 Tim Hodgson
 Special Advisor to the Governor, Bank of Canada

C\$ IRS market is systemically important to Canada, primarily due to its centrality to financial system

Why important	Risk if stops functioning	Additional considerations
<ul style="list-style-type: none"> • Central to managing interest rate risk • Allows FIs to efficiently provide credit to the broader economy 	<ul style="list-style-type: none"> • Potential for reduced fixed-rate lending by banks • Increased borrowing and lending spreads • Negative impact on functioning of other interest rate markets • Higher volatility as banks attempt to replace IRS hedges 	<ul style="list-style-type: none"> • FIs use of other hedging strategies are imperfect and may: <ul style="list-style-type: none"> – Introduce basis risk – Not provide sufficient liquidity

Central clearing will help control the systemic risk in C\$ IR derivatives

A well risk-proofed CCP can reduce propagation of financial stress by:

Netting	• Reducing counterparty risk through netting
Risk controls	• Managing counterparty risk through a CCP's strong, transparent and consistent risk controls
Knock-on defaults	• Reducing knock-on defaults through novation, risk mutualization and an orderly close-out of defaulters' positions
Market freezes	• Reducing the likelihood of market freezes

The Bank of Canada has responsibility to oversee systemically important clearing and settlement systems

Our oversight responsibilities cannot be outsourced

Required elements to fulfill responsibility

- 1 Satisfactory cooperative oversight arrangements
- 2 Secure emergency liquidity arrangements
- 3 Sound solvency and resolution arrangements and procedures

Since the C\$ IRS market is systemically important, the Bank of Canada has a legal responsibility for its oversight

Co-operative oversight

Issue with offshore CCP	Minimum requirements
<ul style="list-style-type: none"> • Co-operative oversight arrangements not yet developed for OTC derivatives CCPs • Role of the Bank of Canada in any future cooperative oversight regime is uncertain 	<ul style="list-style-type: none"> • Co-operative oversight regime in which the Bank would have timely access to information and ability to have meaningful influence in ex ante CCP risk control configuration and in a stressed situation

The Bank of Canada is not comfortable with a long term offshore CCP solution where there is no plan for provision of emergency liquidity

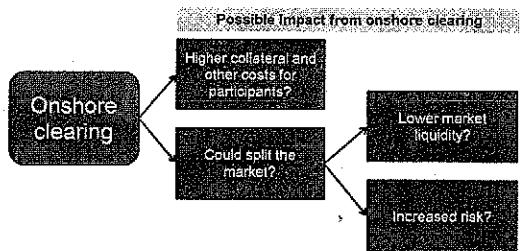
Emergency liquidity

Issue with offshore CCP	Minimum requirements
<ul style="list-style-type: none"> • Increased systemic risk if CCP cannot access liquidity needed as part of its default procedures • Currently no formal process for a central bank to provide coordinated multi-currency emergency liquidity to CCPs • Today the above process is a work in progress 	<ul style="list-style-type: none"> • Offshore CCP needs sufficient committed private sector liquidity facilities to meet liquidity needs (inc. C\$) from largest default • Home jurisdiction central bank should provide multi-currency emergency liquidity, including C\$, to the offshore CCP in pre-specified emergency circumstances

The Bank of Canada needs orderly solvency and resolution regimes in the home country jurisdiction to be comfortable with offshore CCP solutions

Resolution regime	
Issue with offshore CCP	Minimum requirements
<ul style="list-style-type: none"> No specific resolution regime applicable to CCPs today Normal bankruptcy laws could lead to asset freezes or disorderly liquidation, which would have major negative implications for financial system 	<ul style="list-style-type: none"> Existence of orderly resolution regime for offshore CCP Input into configuration of resolution regime for offshore CCP - to be consulted during emergency situation where CCP may need resolution

An onshore clearing mandate could trigger undesirable dynamic that could impose efficiency costs and increased systemic risk



An onshore CCP would offer oversight benefits in the event of a participant default

Default-management task	Onshore solution	Offshore solution
1. Set default rules	✓	
2. Declares a member in default		Neutral
3. CCP ports client positions to non-defaulting member	✓	
4. Default auction	✓	
5. Allocate losses to participants		✓
6. Liquidity for CCP to meet obligations	✓	
7. Resolve CCP (extreme scenario)	✓	

Getting Over the Bar: Creating Clearing Options
for Smaller Market Jurisdictions

The Clearing Process and Supervision of Clearinghouses

International Symposium and Training Program
Regulation of Derivatives Products, Markets and Financial Intermediaries for International Market Authorities

October 2011

Heidi M. Rauh, Special Counsel
Division of Clearing and Risk
Commodity Futures Trading Commission

Presentation Overview

- Clearing Process
 - What is it?
 - How does it work?
- Supervision of Clearinghouses
 - CFTC Regulation of Clearinghouses (Division of Clearing and Risk)
 - DCO Registration Process
 - DCO Core Principles
 - DCO Oversight

CLEARING PROCESS

Non-Cleared Markets

The Problem:

Will your counterparty be willing and able to pay his losses (your gains)?

Non-Cleared Markets (2)

- Market participants must:
 - Assess creditworthiness of potential counterparties.
 - Set counterparty credit limits.
 - Collect collateral.
 - Monitor counterparties' credit.
 - Make multiple payments to/from each counterparty or agree to net.
 - Pay to/collect from each counterparty.

What is Clearing?

- Clearing is the process by which
 - trades in futures contracts and options on futures contracts
 - Swap (OTC) contractsare processed, guaranteed, and settled by a clearinghouse.
- Each clearing member deals with the clearinghouse, rather than dealing with many counterparties.

Novation

- The clearinghouse becomes "the buyer to every seller and the seller to every buyer" ("novation").
- At the point where the trade becomes novated, the clearing guarantee becomes effective.
 - This means the clearinghouse guarantees the obligations of each clearing member.

Central Counterparty

- Clearing substitutes the credit of the clearinghouse for that of the counterparty.
- Clearing only minimizes credit risk; it does not eliminate it.

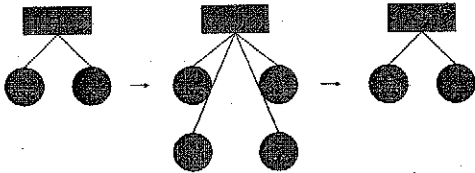
Clearing Relationships

- Each market participant (customer) must have its trades carried (guaranteed) to the clearinghouse by a clearing member.
- When the clearinghouse steps in, each clearing member contracts with the clearinghouse, not with the other party.
 - Each clearing member's obligations/rights resulting from trades run to/from the clearinghouse, not to/from other members.

Offset

- Because each contract is with the clearinghouse, a clearing member can liquidate a long or short position originally entered into with one counterparty by entering into a short or long position with another counterparty.
- The long and short positions are "offset."
- The important condition to offset is standardized contracts.
- Ease of offset contributes to liquidity of market.
- The vast majority of positions are not held to delivery.

Liquidation by Offset



Participants in a Clearinghouse

- Clearinghouses have a legal relationship only with entities that they have admitted as clearing members.
- Clearinghouses have no legal relationship with the customers of their clearing members.



Participants in a Clearinghouse

- Clearing members generally are financial institutions, such as futures commission merchants (FCMs) and banks.
- The clearinghouse only admits members that qualify with sufficient
 - Financial strength;
 - Risk management sophistication; and
 - Operational capabilities.
- The clearinghouse qualifies each member, so members do not have to qualify each other as counterparties.

Clearing Member Qualifications

- A clearinghouse has the ability to evaluate its members at several points: before initially admitting them, during the periodic review of financial reports, during periodic examinations, and in case of trouble.
- In the U.S., commodity brokers carrying customers (FCMs) are required by the CFTC to meet specific conditions of financial strength, which we will discuss later. However, clearinghouses frequently set higher requirements.
- A clearinghouse may expel or limit the privileges of members that become financially weak.

Clearinghouse as Monitor

- Clearinghouse qualification of each member brings great value to the financial system:
 - the reduction of credit-monitoring expense
 - concentration of credit-monitoring expertise
 - the use of a market "neutral" as a monitor.
- The clearinghouse has intense interest in the member's financial strength, but no competitive interest in the direction of the member's market positions.

Clearinghouse Organization

- An operating division of an exchange,
 - E.g., Chicago Mercantile Exchange (CME)
- An affiliate of an exchange,
 - E.g., ICE Clear and ICE Clear Europe (affiliates of ICE Futures US and Intercontinental Exchange)
- An independent entity that provides clearing services for one or more markets,
 - E.g., Options Clearing Corporation
- A stand-alone clearer of swaps
 - E.g., LCH

Clearing Process Overview

- Trade Processing and Position Management
 - How does the clearinghouse handle trades and positions?
- Financial Management
 - How does the clearinghouse handle mark-to-market pays and collects?
- Risk Management
 - How does the clearinghouse assess risk and calculate margin?

Trade Processing and Position Management

Trade Processing

- The clearinghouse matches and settles all trades between members.
- The clearinghouse receives the details from one or both parties to the trade and then confirms that those details (e.g., price, quantity, identity of contract and parties to the trade) are the same.

Position Management

- The clearinghouse registers positions resulting from trades:
 - the clearinghouse updates the positions that result from the trade.
 - a particular trade can either result in an addition to an existing position, a subtraction from an existing position, or the off-set of an existing position.

Final Settlement

- In settling contracts that are physically deliverable (rather than settled in cash), the clearinghouse
 - assigns longs to shorts (no relationship to original counterparties)
 - provides a venue for and assists with the verification of delivery
 - collects delivery margin, but does not guarantee delivery.
- For options, the clearinghouse
 - assigns a short to each exercised long.
 - may automatically exercise in-the-money options at expiration
 - converts exercised options to futures.

Financial Management

Margin

- Performance Bond ("Initial Margin")
 - This is the first and most important mode of risk management – liquid collateral in the possession and control of the clearinghouse.
- Variation Margin
 - The clearinghouse collects losses and pays gains at least once or twice a day, which ensures that losses don't accumulate.
 - Real-time prices are used.
 - The clearinghouse has the ability to make special calls in times of high stress.

Mark-to-market

- Each day, for each contract, a "settlement price" is determined.
 - For futures, options, and certain swaps
 - generally based on the price at which the contract traded on the market at the end of the day.
 - For each position, a profit or loss (compared to the previous settlement price) is calculated
 - For interest-rate swaps,
 - may be based on cash flows discounted using a consensus yield curve
 - Profit or loss is calculated based on the sum of the values of the cash flows.

Example: Mark-to-Market

- A is long corn (December).
- B is short corn (December).
- Yesterday's settlement price was \$1,000.
- Today's settlement price is \$1,010.
- A's position has profited \$10, and B's position has lost \$10.

Settlement Price

- Settlement price generally determined by reference to prices during the closing period of the trading day (e.g., last minute, last 30 seconds).
- If there is no trading in the closing period, the settlement price might be determined by:
 - Prices earlier in the trading day.
 - Price relationships (e.g., relationship between various expiration months in the same underlying on Day 1 might be used to determine settlement prices on Day 2, where there is no closing-period trading in a given expiration month).
 - The option curve (Black-Scholes).

Settlement Price (2)

- In the US, settlement prices generally are set by markets in the first instance, but the clearinghouse retains the right to set settlement prices for its own use.

Pay/Collect Gains/Losses

- For each clearing member, profits and losses on all positions/cash flows are aggregated to a single net amount.
- The clearinghouse collects from those members with aggregate losses, and pays to those members with aggregate gains.
 - Collections and payments are in immediately available funds.
- Over all clearing members, pays and collects will net to zero.

Settlement Banks

- Futures clearinghouses in the U.S. are not members of the Federal Reserve Bank's large value payment system called Fedwire.
- As such, they use the services of certain banks to effect money settlements on behalf of clearing members.
- Each clearing member is required to have settlement accounts at one or more approved settlement banks, and the clearinghouse has debit and credit authority over these accounts to effect the transfer of funds.
- After every mark-to-market calculation, the clearinghouse will send instructions to its settlement banks to debit accounts with losses and credit accounts with gains.
- The bank will confirm these instructions, and collections and payments are effected in immediately available funds.
- Once funds are transferred over Fedwire by these banks, there is finality of settlements as these transfers cannot be unwound.

Clearing payments cycle example

- 6 a.m. – Clearinghouse notifies settlement banks of collects from members.
- 7 a.m. – Deadline for settlement banks to confirm willingness to transfer funds.
- 8 a.m. – Settlement banks transfer funds for collects to the clearinghouse.
- 9 a.m. – Settlement banks receive funds for pays from the clearinghouse.

Performance Bond ("Initial Margin") (1)

- Performance bond is posted against loss on an open contract.
- It is not a down payment on purchase.
- It is posted by both the buyer (the "long") and the seller (the "short").

Performance Bond ("Initial Margin") (2)

- Performance bond is collected immediately after a position is established, and is held until the position is offset or delivered.
- If the member fails to make a payment when due, the clearinghouse may use all of the performance bond posted by the member to meet the member's obligations.
- In the U.S., customer performance bond is "segregated" from performance bond on proprietary positions. However, customers are treated in the aggregate.

Form of Performance Bond

- Performance bond is in the form of cash or highly liquid securities accepted by the clearinghouse.
- Securities accepted as performance bond are frequently "haircut" – valued at a discount to their current market price – to account for the possibility that they may lose market value.

Setting Performance Bond?

- Performance bond is set for each contract, using a statistical analysis based on the volatility of the underlying product.
- Historical and/or implied volatility may be used.
 - For historical volatility, clearinghouses look at volatility over, e.g. 30, 60, 120 days, and extreme moves over the past several years.
 - For implied volatility, clearinghouses use option pricing models (e.g., Black-Scholes) to calculate volatility implied from the price of the at-the-money option.
- The calculation generally covers the largest one-day loss at a confidence interval of 99%.

Futures Risk Management SPAN

- CME's Standard Portfolio Analysis of Risk (SPAN®) is used to assess risk for a portfolio.
- SPAN is the official performance bond (margin) mechanism of 50+ registered exchanges, clearing organizations, service bureaus and regulatory agencies throughout the world.

SPAN

- SPAN permits assessment of risk across related products.
 - Related underlyings (Oil vs. Natural Gas).
 - Same/related underlyings, different delivery months (September vs. December).
 - Options vs. futures (S&P 500 Long December future vs. S&P Short December Call at 1250).
 - Different option strike prices/directions.
- Evaluates a portfolio over 16 scenarios.
- Options priced using option pricing model.

Parameters

- Margin for each product.
- Volatility range for each option.
 - based on the largest expected daily change in volatility.
- Inter-commodity spread credit.
 - for related underlyings
 - based on the historical correlation of price movements
- Inter-month risk charge (same commodity).
 - based on the extent to which price movements in different months are *not* perfectly correlated.
- Short option minimum charge.

Risk Management

- The clearinghouse periodically will review performance bonds by:
 - Reassessing historical or Implied volatility on a periodic basis; and/or
 - Backtesting by looking at actual price changes for a period of time and determining how many times losses exceeded margin.
- If the intended coverage (e.g., 99%) is not met, the methodology for margin setting must be adjusted.
- In circumstances of high volatility (e.g., for oil, events in the Persian Gulf), the clearinghouse will consider a special increase in performance bond.

Intra-Day Settlement

- Most clearinghouses undertake mark-to-market and performance bond calculations during the trading day while trading is still going on (the "Intra-Day Settlement Cycle".)
- The clearinghouse will take a "snapshot" of prices and apply them to all open positions.
 - It will collect all losses, and pay out a portion of the gains. This provides an additional layer of protection.
 - The clearinghouse may also collect Performance Bond.

Financial Supervision of Clearing Members

- Clearinghouses monitor their members
 - Exposure limits may be set based on the characteristics of a firm (capital, parent guarantees, normal losses).
 - Stress testing may focus on potential exposure
 - Escalating action may be taken when limits are neared or exceeded
 - Clearinghouse may contact the member or settlement bank for reassurance
 - Early payments may be required

Default Management

- Where a member fails to meet its obligations, the clearinghouse can mitigate its risks by liquidating the defaulter's positions in an orderly manner.
- In ordinary circumstances, performance bond on deposit is designed to equal or exceed the losses incurred on liquidation. However, default is often associated with extraordinary circumstances.

Default Management -- Collateral

- The clearinghouse will first address the defaulter's liquidated obligations by using the collateral pledged to it by the defaulter.
 - The defaulter's Default Fund contribution supplements its performance bond on deposit.
- If Defaulter's collateral is insufficient to cure the entire defaulted amount, the clearinghouse will utilize the components of its financial safeguards package.

Default Management -- Safeguards

- Each Clearinghouse has a financial safeguards package, which may include:
 - Default Fund contributions from each member;
 - A specified amount of capital of the clearinghouse in excess of operational needs;
 - A standby letter of credit (for liquidity);
 - Default insurance; and
 - The ability to assess each member for specified additional contributions in excess of basic Default Fund contributions.

Default Fund -- How much

Lamfalussy standard:

- The single largest exposure based on a stress test.

Developing standards:

- The sum of the two or three largest exposures based on a stress test.

Default Fund -- How Allocated

- May set contributions based on a percentage of each member's average risk margin;
- May determine the total amount necessary and allocate based on a member's relative risk margin or number of contracts traded;
- May set contributions as a percentage of member capital; or
- May set minimum and maximum contributions, regardless of other factors (e.g., no less than \$2 million, no more than \$10 million).
- Default Fund contributions generally are reassessed periodically (e.g., quarterly).

Bankruptcy Issues

- US law provides specific protections for customers and counterparties of a bankrupt commodity broker.
- Customer property (primarily segregated funds) is protected against claims by other creditors.
- Customer property is paid out to customers in proportion to their net equity claims (futures).
- Counterparties (such as clearinghouses) holding collateral deposited by a bankrupt broker may liquidate and use that collateral despite the "automatic stay" in bankruptcy. Such collateral also is protected from a "preference" action in bankruptcy.

The Limits of Clearing

- No clearinghouse fully guarantees all possible obligations. Thus, clearinghouses do not eliminate counterparty risk.
- No clearinghouse has unlimited assessment power over its members.
- Clearing members always are subject to the risk of clearinghouse default or failure.
- Default Fund and performance bond deposits are at risk if a clearing firm defaults.
- Customers are always subject to the risk of their fellow customers because a firm may be unable to meet its obligations if another customer defaults.

SUPERVISION OF CLEARINGHOUSES

CFTC Regulation of Clearinghouses

- Any clearinghouse that seeks to provide clearing services with respect to futures contracts and options on such futures contracts traded on a U.S. Designated Contract Market, or with respect to swaps with effects in the U.S., must register with the CFTC as a Derivatives Clearing Organization (DCO) before it can begin providing such services.

How Is "DCO" Defined?

A DCO is a clearinghouse, clearing association, clearing corporation, or similar entity that:

- enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties;
- arranges or provides, on a multilateral basis, for the settlement or netting of obligations; or
- otherwise provides clearing services or arrangements that mutualize or transfer credit risk among participants.

DCO Core Principles

- To be registered, and to maintain registration, each DCO must comply with the 18 Core Principles set forth in Section 5b(c)(2) of the Commodity Exchange Act (CEA) and CFTC Rules (Part 39)
- Subject to CFTC Rules, the DCO has discretion in how to achieve compliance.
- CFTC in process of adopting DCO regulations:
 - Increase legal certainty for DCOs, clearing members, and market participants
 - Prevent DCOs from lowering risk management standards for competitive reasons and taking on more risk than is prudent
 - Assures DCOs are meeting minimum risk management standards

DCO - CHIEF COMPLIANCE OFFICER (CCO)

- Dodd-Frank Act amended CEA to require each DCO to designate a CCO
- Duties of CCO:
 - Report to Board or a senior Officer at DCO
 - Review DCO compliance with Core Principles
 - Resolve conflicts of interest
 - Administer compliance policies and procedures
 - Ensure compliance with the CEA and CFTC rules applicable to DCOs
 - Establish procedures for remediation of non-compliance issues
 - Prepare Annual Compliance Report

DCO Registration – Form DCO application (1)

- A. General
- B. Financial Resources
- C. Participant and Product Eligibility
- D. Risk Management
- E. Settlement Procedures
- F. Treatment of Funds
- G. Default Rules and Procedures
- H. Rule Enforcement

DCO Registration – Form DCO application (2)

- I. System Safeguards
- J. Reporting
- K. Recordkeeping
- L. Public Information
- M. Information Sharing
- N. Antitrust Considerations
- O. Governance Fitness Standards
- P. Conflicts of Interest
- Q. Composition of Governing Boards
- R. Legal Risk Considerations

DCO Registration – Form DCO application (3)

- Application includes:
 - Clearinghouse rules
 - Business Plan
 - Regulatory chart and analysis of how clearinghouse will comply with Core Principles
 - Copies of relevant agreements (with service providers and participants)
 - Descriptions of system test procedures, tests and test result
 - Usually a site visit to see facilities and meet staff

DCO Registration – Form DCO application (4)

- 180 day review period
- CFTC can “stay” (suspend) application review if warranted
- CFTC can deny approval
- If application is approved, the CFTC will issue an Order of Registration
 - Order may include conditions or limitations
 - DCO may ask CFTC to amend Order (use Form DCO for amendments)

Adequate financial, operational, and managerial resources.

- Financial Resources – Sufficient financial resources (capital) to meet its obligations as a clearinghouse, including
 - operating expenses for a year
 - coverage of potential default.
- Operational and managerial resources – Organizational structure, experienced professional staff, and other operational support necessary to meet its obligations as a DCO.

Participant and Product Eligibility (1)

- Participant eligibility requirements that demonstrate the financial and operational capacity of members, including member/customer risk management.
- Product eligibility requirements that demonstrate that the DCO will clear only products for which it can appropriately manage the risks.

Participant and Product Eligibility (2)

- DCO shall have procedures to verify, on an ongoing basis, compliance with participation / membership requirements
- Participation and membership requirements must:
 - Be objective
 - Be publically disclosed
 - Permit fair and open access.

Risk Management (1)

- Must be adequate and use tools and procedures appropriate to the risks the DCO will incur.
- Must measure credit exposures daily and monitor such exposures periodically throughout the business day.

Risk Management (2)

- Must use margin and other risk control mechanisms to limit exposure of DCO to losses from default to ensure that
 - Operations of DCO would not be disrupted
 - Non-defaulting members or participants would not be exposed to losses that they cannot anticipate or control.
- Models and parameters used in margin-setting must be risk-based and regularly reviewed.

Settlement Procedures (1)

- Ability to complete settlements on a timely basis under varying circumstances.
 - Operational capability to manage information and complete settlements under both normal and unusual circumstances.
 - Limit exposure of DCO to settlement bank risk
- Accomplish flows of funds.
- Interfaces with banks and other clearing organizations.

Settlement Procedures (2)

- Establish rules that clearly state obligations of DCO with respect to physical deliveries.
 - Ensure that risks arising from such obligations are managed.
- Possess the ability to comply with netting arrangements with other clearing organizations.

Protection of Member and Participant Funds

- Use of depositories/custodians to keep funds safe and limit concentration of risk.
- Standards for investment of member/customer funds.
 - Minimize risk of loss or delay in access.
 - Should be in instruments with minimal credit, market and liquidity risks.

Default Rules and Procedures

- Clearly state default procedures
- Make publically available default rules
- Ensure that DCO may take timely action to
 - Contain losses and liquidity pressures
 - Continue meeting each obligation of the DCO.

Rule Enforcement

- Adequate Arrangements / Resources to:
 - Monitor and enforce compliance with rules
 - Resolve disputes
- Maintain ability to discipline, limit, suspend or terminate the activities of a member which violates DCO rules
- Report rule enforcement activities and sanctions to CFTC.

Systems (1)

- Establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk.
- Automated systems must be reliable, secure, and have adequate scalable capacity.

Systems (2)

- Emergency procedures and a Plan for Disaster Recovery.
 - Timely recovery and resumption of operations.
 - Must periodically test those arrangements to ensure that backup resources are sufficient to ensure daily processing, clearing and settlement.

Reporting to CFTC

- Obligation to provide necessary reports to allow the CFTC to oversee clearinghouse activities
- As required or upon request

Recordkeeping

- Maintenance of all business records for five years in a form acceptable to the CFTC.
- Must demonstrate ability to reliably store and promptly provide required records.

Public Information (1)

- Must provide to participants in markets cleared rules, operating procedures, and default procedures.
 - Provide ability to identify and evaluate accurately risks and costs.

Public Information (2)

- Public disclosure
 - Terms and conditions of each contract cleared and settled.
 - Each clearing and other fee.
 - Margin-setting methodology, and size and composition of financial resource package
 - Daily settlement prices, volume and open interest for each contract settled and cleared.
 - Any other matter relevant to participation.

Information Sharing

- Participation in appropriate domestic and international information-sharing agreements.
- Use relevant information obtained from such agreements in risk management.

Competition

- Avoidance of actions that result in unreasonable restraints of trade or that impose material anti-competitive burdens on trading
 - Unless necessary or appropriate to meet the policies of the Commodity Exchange Act

Governance Fitness Standards (1)

- Establish governance arrangements that are transparent
 - To fulfill public interest requirements
 - To permit consideration of the views of owners and participants.

Governance Fitness Standards (2)

- Establish and enforce appropriate fitness standards for
 - Directors
 - Members of any disciplinary committee
 - Members of the DCO
 - Any other individual with direct access to settlement or clearing activities of the DCO
 - Any party affiliated with any of the foregoing.

Conflicts of Interest

- Establish and enforce rules to minimize conflicts of interest in the decision-making process of the DCO
- Establish a process for resolving such conflicts

Composition of Governing Board

- Ensure that Governing Board includes market participants.

Legal Risk

- Must have a well-founded, transparent and enforceable legal framework for each aspect of its activities.

DCO Oversight

- CFTC Division of Clearing and Risk
 - Chief Counsel
 - Risk Surveillance
 - Clearing Policy
 - Product Review
 - Examinations

DCO Oversight Reviews (1)

- To determine compliance with the DCO Core Principles, the CFTC's Division of Clearing and Risk (DCR) conducts periodic reviews that include:
 - Review of policies and procedures;
 - Interviews of DCO staff;
 - Walkthroughs of DCO procedures;
 - Analysis of Core Principle compliance; and
 - Presentation of conclusions and recommendations to the Commission.

DCO Oversight Reviews (2)

- The reports of DCIO's oversight reviews are delivered to the Commission but are otherwise kept confidential. Significant findings are shared with the applicable DCO.
- DCIO selects and times its oversight reviews based on risk and resource availability, as such reviews generally are staff and time intensive.
- DCIO staff also are in general communication with DCOs regarding supervisory issues on an ongoing basis.

DCO Risk Surveillance (1)

- Objectives:
 - To identify positions in cleared products that pose significant financial risk
 - Traders that pose risks to DCOs
 - Clearing firms that pose risks to DCOs
 - To confirm that the risks are appropriately managed
 - At the clearing firm
 - At the DCO
 - Identify traders/clearing firms/DCOs at risk
 - Based on current market conditions
 - Based on account characteristics

DCO Risk Surveillance (2)

- Account characteristics include:
 - Absolute size
 - Short options size
 - Size relative to market
 - Size relative to clearing firm's capital
 - Size relative to the PB on deposit at the clearing firm or at the DCO
 - Size relative to the clearing firm's assets
 - Size relative to the DCO's financial resource package
 - Cumulative size across multiple markets
 - News about a particular trader or FCM

DCO Risk Surveillance (3)

- Estimate magnitude of risk – conduct stress tests
- Assess risk management techniques
 - At DCO
 - At clearing member
- Discussions
 - With DCO
 - With clearing member
 - With trader
 - With other regulators

DCO Rule Submissions

- DCOs must submit to the Commission any new rule or rule amendment that impacts the rights and obligations of the DCO, its clearing members, or other market participants in connection with the clearing activities of the DCO.
- "Rules" is defined broadly - any constitutional provision, bylaw, rule, reg, resolution, interpretation, advisory, terms and conditions, . . . And any amendment thereto . . . Made or issued by the DCO
- Rules can be (i) self-certified to the Commission as compliant with the CEA (made effective after 10 business days) or (ii) submitted to the Commission for approval (45 day review period)

DCR – Product Review

- Dodd-Frank Act requires that swaps be submitted to the CFTC for review to determine whether they are required to be cleared
- CFTC is adopting regulations (§ 39.5) to implement Dodd-Frank provisions for review of swaps for a clearing determination

Dodd-Frank Act: Systemically Important DCOs

- Title VII of the Dodd-Frank Act allows the Commission to prescribe regulations for those DCOs that the Financial Stability Oversight Council has determined are systemically important (SIDCOs).
- SIDCOs may have additional requirements regarding, e.g., financial resources.
- CFTC must conduct examinations of SIDCOs annually.

How Firms Operate

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Registration Categories

Category	Acronym
Futures Commission Merchant	FCM
Retail Foreign Exchange Dealer	RFED
Introducing Broker	IB
Independent	IBI or IIB
Guaranteed	GIB
Commodity Pool Operator	CPO
Commodity Trading Advisor	CTA

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NFA Membership Totals by Highest Class

	As of February 23, 2011
Total Membership	3,734
Retail Foreign Exchange Dealers	12
Futures Commission Merchants	116
Introducing Brokers	1,491
Commodity Pool Operators	1,069
Commodity Trading Advisors	1,038
Exchanges	8
Associates	52,297

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Futures Commission Merchant

- Solicits or Accepts Futures/Options Orders
- Accepts Customer Funds
- Carries/Clears for other Registrants
- Must Maintain Minimum Net Capital and Accounting Books & Records
- Generally has the largest operations

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What an FCM Does

- Bring customers to the market
- Accept funds
- Set up accounts for each customer
- Broker trades
- Report activity
- Put firm capital at risk

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Focus of FCM's Business

- Commercial/Institutional
- Floor Traders
- Individual Investors
- IBs
- Managed Funds


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How FCM's Make Money

- Per trade commissions
- Fees
- Investment of excess segregated funds


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Other Services

- Research
- Advice
- Reports


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FCM Operations

• Credit	• Sales/marketing
• Clearing	• Accounting/reporting
• Risk management	• Margins
• Compliance	• Order processing
	• Research
	• Trading

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Retail Foreign Exchange Dealers

- Counterparty to an off-exchange foreign currency transaction with a person who is not an eligible contract participant and the transaction is either:
 - a futures contract, an option on a futures contract or an option contract (except options traded on a securities exchange), or
 - offered or entered into, on a leveraged or margined basis, or financed by the offeror, counterparty or person acting in concert with the offeror or counterparty on a similar basis

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RFED

- Must register unless the individual or organization is exempt
- Must be Members of NFA
- Must have at least one PRN who is approved as forex associated person

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Introducing Brokers

- 2 types
 - Independent
 - Guaranteed



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Independent Introducing Broker

- Solicits or Accepts Futures/Options Orders
- CANNOT Accept Customer Funds
- Must Clear through FCM(s)
- Must Maintain Minimum Net Capital and Accounting Books & Records
- Generally, smaller than an FCM

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Guaranteed Introducing Broker

- Solicits or Accepts Futures/Options Orders
- CANNOT Accept Customer Funds
- Must Clear through single FCM
- No Capital Requirements or Accounting Books & Records
- Generally, smaller than an FCM & IIB
- Similar to a branch office

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Managed Funds

- Individual Managed Accounts
- Commodity Pools

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Managed Funds

- Individual Managed Accounts
- Commodity Pools

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Commodity Trading Advisor

- Provides ADVICE on Trading Futures
 - Managing Accounts (POA)
 - Guiding Accounts
 - Newsletters/Hotlines/Trading Systems
- Cannot Accept Customer Funds
- Must Clear through FCM
- No Capital Requirements But Must Maintain Records for Performance

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How CTAs Make Money

- Management fee-% of assets under management
- Incentive fee-% of new net profits during period, or
- Subscription fees for newsletters, etc.

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Commodity Pool Operator

- Combines funds of many customers into a single entity (usually as a limited partnership) to trade futures
- Can Accept Customer Funds in the Name of the Pool
- Pool Must Clear through FCM
- No Capital Requirements But Must Maintain Accounting Books & Records for Pool(s)

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CPO Registration

- Commodity Pool Operators register, pools don't

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What a CPO Is Trying To Do

- CPO seeks to increase value of the pool via trading
 - Can trade according to own system
 - Can engage one or more CTAs to trade on the pool's behalf

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How CPOs Operate

- CPO forms pool by creating a limited partnership
- Separate entity from CPO
- If a public pool, files with necessary security regulators and states
- Solicits funds
 - CPO solicits
 - CPO has other intermediaries solicit on behalf of the pool

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How CPOs Operate

- Sets up bank accounts and records participant contributions
- Establishes other accounts and engages CTA(s) to trade the pool's assets
- After enough money comes in, CPO transfers funds to FCMs and other depositories for trading
- CPO monitors trading and sends out periodic statement to participants

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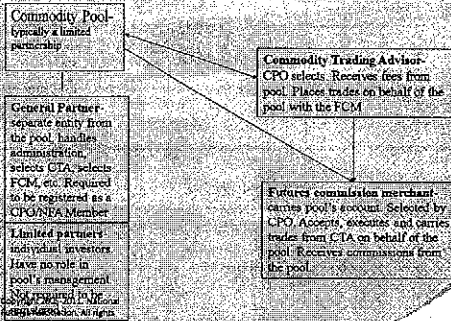
How CPOs Make Money

- CPOs make money from each pool they operate
 - Management fee
 - Incentive fee
 - Special allocation to the general partner

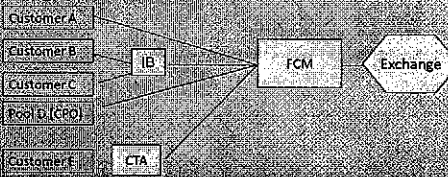
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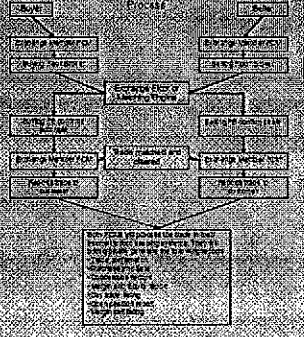
Organization of a typical commodity pool



How the Parties Relate



The Clearing Process



Other Registration Categories/Statuses

- Associated Person (AP)
- Principal (Prn)
- Branch Office/Branch Office Manager
- Floor Broker/Floor Trader

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Associated Person

- Solicits Customers, Customer Funds, and/or Customer Orders
- Supervises Persons Engaged in the Above Activities
- Does Not Include Someone Who Acts in a Clerical Capacity

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Principal

- Sole Prop, GP, Officer, Director, Designated Supervisor or Similar Person Having a Controlling Influence Over the Firm's Activities
- Holder/Owner of 10% or More of Firm's Stock
- Contributor of 10% or More of Firm's Capital

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Branch Office

- Any location, other than the main office, where individuals are acting as APs
- Location of branch office must be disclosed to NFA
- Each branch office must have a designated supervisor (Branch Office Manager)

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Floor Personnel

- Floor Broker
 - Executes trades in the pits of futures exchanges on behalf of firm's and/or customers
- Floor Trader
 - Executes trades in the pits of futures exchanges for own account

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Foreign Firms

- Required to register if they do business with US customers on US markets
- Foreign firms send their records to NFA to be audited or may go to foreign country

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Membership in NFA

- Bylaw 1101
 - NFA Members must conduct all futures related business with another NFA Member (unless entity is exempt from registration)
 - NFA Member firms

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Bylaw 301(b)

- Compulsory Membership for APs
- NFA Associate Members

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Not all registrants are NFA Members


- Only those firms that do business with the public through an FCM must be NFA members
- Many CTAs who only publish a newsletter or a hotline service are not required to be NFA members

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Registration and Fitness


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Registration

- Registration Screening
- Fitness Screening
- Information Center
- Records Custodian


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NFA Membership

- Open to any person registered with the CFTC (except Floor Brokers and Floor Traders) and all futures exchanges
- mandatory for any FCM, IB, CTA or GPO that transacts futures business with the public

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Bylaw 1101

- All members must conduct all futures related business with another NFA member unless the entity is exempt from CFTC registration requirements
- Bylaw 301(b)
- All employees of an NFA Member who are registered as Associated Persons must become Associate Members

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Registration Processing

- All applications, updates, withdrawals are processed through Online Registration System (ORS)
- Web-based registration system
- Available to anyone with access to the Internet

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Online Registration System

- Streamlined the registration process
- Designed with Member input
- Vastly reduced paper that firms have to submit or keep
- Enabled firms to reduce costs
- Reduced duplicative filing requirements
- Electronic communications

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Records

- Firms won't need to keep paper
- Firms can access/print records
- Certifications and verifications

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Security Management

- Critical function
- Firm responsibility to supervise security access
- Conduct periodic reviews/audits

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Fitness Screening

- NFA performs an extensive background check to determine whether a disqualification from registration exists under the Commodity Exchange Act
- Fingerprint cards
- Securities and Exchange Commission ("SEC") name check
- Application Forms-Disciplinary History Questions

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Fitness Screening

- Additional checks are performed for foreign applicants
 - Firms - check with foreign SROs/Governments where applicant is located
 - Individuals - Conduct a criminal background check from the International Police (Interpol)
- NFA also receives information from various other sources, such as the National Association of Securities Dealer's Central Registration Depository System

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Statutory Disqualifications

- Statutory disqualifications based on legal presumption that a firm or individual is unfit for registration
- Sections 8a(2) and 8a(3) of the Commodity Exchange Act list specific disqualifiers

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Disqualifiers Examples

- Criminal Proceedings
- Regulatory Disciplinary Actions
- Civil Judicial Proceedings
- Other Miscellaneous Matters

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Dealing with a Disqualification

- Internal Review
 - Registration/Compliance/Legal Committee
 - Membership committee
 - Nine members of NFA's Board of Directors
 - Subcommittee hears all registration cases
- CFTC review

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Records custodian

- Holds registration records on behalf of CFTC
- Handle Freedom of Information Act Requests
- Subpoenas

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Proficiency testing

- National Commodity Futures Examination (NCFE or Series 3)
- Branch Manager Examination (Series 30)
- Forex (Series 34)

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Alternatives

- Futures Managed Funds Examination (Series 31)
- Limited Futures Examination – Regulations (Series 32)
- Financial Instruments Examination (Series 33)

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Restitution

- Judgments awarded in CFTC fraud cases
- NFA named to administer the restitution process
- No fees charged

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Restitution

- 15 new cases in 2010
- 164 cases being reviewed
- 611 checks distributed to harmed investors
- \$2,283,701 distributed

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NFA Compliance Rule 2-29: Communications with the Public and Promotional Material



NFA

What kind of communications do NFA Rules govern?

- Sales solicitations to potential investors
- Advertising (print, radio, TV, Internet)
- Newsletters
- Sales or educational literature, including 'Reports'
- 'Reprints' of previously published articles
- Seminars, webinars, & chat room or web forum postings
- Standardized phone solicitations & sales scripts



NFA

Basic Standards

- In communicating with the public, no Member or AP shall:
 - be fraudulent or deceptive
 - employ a high-pressure approach or
 - state that futures trading is appropriate for everyone



What is a high-pressure approach?



- "You must act now...the market is not going to wait!"
- "If you don't get in right now, you'll be missing out on huge profits - c'mon, jump on this train!"
- "I'll have Fed Ex at your door in the morning to pick up those signed papers."



Do Brokers Really Say Stuff Like That??!

- AP Martin Snow walked ESP Agent MG through the account opening process...and told her to skip the Risk Disclosures!
- AP Bobby Allen called every day for weeks, and left nearly twenty minutes of voice mails hyping silver for ESP Agent VF



Examples

...sorry for calling you back again today...you know what I'm not sorry at all, I'm gonna make u money in this market...when I spoke to you before silver was up a couple pennies, now it's jumped up 22 cents

I'm just trying to get you in this market, that's all, as the experts are sayin' I hate to use this phrase but the experts are sayin' they expect this thing to go thru the roof, once the regulators approve this fund

let's get on board this train before we miss it, okay??



Example

"silver is up this morning again as we speak & guess what silver is up another 32 cents

hopefully we can get together on this; if it's the liquidity that's not there I understand, I have no problem with that.

but if it's there, it sounds like you have the mental wherewithal to get into this thing.

let's not hesitate anymore. time is costing us...

NFA

Example

"give me a call tonight let's walk thru the paperwork & get into the silver market before we miss it... right now the market's up in the after-market that is

we'll get it done, you'll email it over to me tonight we'll get you in the market tomorrow - it doesn't matter what you start off with but the key is to get started...

NFA

When reviewing promotional material, ask yourself...

• Is the statement true? for everyone?

• Is it an opinion? Can the opinion be supported by facts?

• Is there any discussion of risk of loss? If not, should there be?

• All relevant info has been included? Is everything you would want to know if you were planning to invest included?

• Have all commissions and costs been factored into profit examples?

• Can you tell if performance is actual or hypothetical?

• Is it clear that past performance is not necessarily indicative of future results?

• Are futures/options prices or cash market prices discussed? Is the difference explained?

NFA

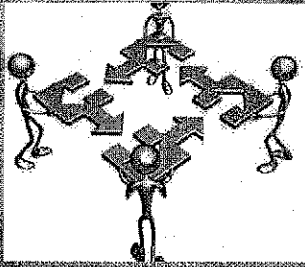
Ask yourself...



- Do you think the material is deceptive or misleading in any way?
- Does it make trading appear so easy that anyone can succeed?
- Does the material seem to use high pressure?
- Is the material discussing current events or known news without also explaining that these are already factored into futures/options prices?
- Does the material imply that prices change seasonally or that events which occurred in the past are likely to be repeated?



Look at Some Examples...



Can you identify any potential issues?



"\$14,375 on each contract in just one day. This system seems to pick the good days out of the blue. That's what's so incredible!"

[Faded, illegible text, likely a testimonial or advertisement for a trading system.]



Additional Standards

- How do we evaluate the content of promotional material?

NFA

Material Statements or Omissions

- No Member or AP should use promotional material that is likely to deceive the public.
- Statements made in promotional material must be factually accurate.
- Material may not omit information, if the omission causes it to be misleading.

NFA

Opinions

- Statements of opinion must be identifiable as such and must have a reasonable basis in fact.
- Statements that are not considered to have a reasonable basis in fact.
 - "We believe the stock market will crash next week so go short on the S&P NOW!!"
 - "In my opinion, in two months gold will be in excess of \$1200 an ounce. The time is now for gold futures."
 - "We consider our trading signals to be the BEST in the business!!"

NFA

Testimonials

- Testimonials must be representative of all reasonably comparable accounts
- Must state that the testimonial is not indicative of future performance or success
- Must state that it's a paid testimonial, if applicable



Balancing Profit and Loss

Statements or indications regarding the potential for profit must be balanced with an *equally prominent* discussion of the risk of loss



To assess balance, you should review the promotional material as a whole

- Balance is not based on quantitative measures, such as the number of times the word profit or loss appears
- Nor is it as simple as balancing the size of the print used, although very small print may downplay risk disclaimers



- There may be multiple interpretations of a single piece
- Don't be afraid to trust your gut impression



Past Performance

- References to specific past performance must always be accompanied by the statement:
- Past performance is not necessarily indicative of future results.



Information about performance must also...



- be representative of the firm's overall customer performance during the applicable time period - in other words, no "cherry-picking"
- account for applicable commissions and fees
- avoid references to "average" or "annualized" rates of return unless accompanied by appropriate additional disclosure



Hypothetical Performance

- What is hypothetical performance?
- Cannot be used if at least 3 months of actual performance exists for a program
- Must be accompanied by a verbatim disclaimer, as prescribed in NFA Compliance Rule 2-29(c)
- Must disclose information regarding the past performance of all accounts traded pursuant to a power of attorney
- If less than one year trading customer accounts, then all proprietary performance must be disclosed
- Must adhere to NFA's Interpretive Notice on hypothetical results (Paragraph 9075)



Common Problems

- Let's try to identify deficient or potentially misleading promotional material using some more examples.



Structuring Off-Peak Futures, Trade-Related Derivatives

It is not a good idea to structure a trade-related derivative that may affect the net

margin of a trade-related derivative. A common mistake is to structure a trade-related derivative that is not a good idea to structure a trade-related derivative that may affect the net

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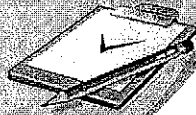
Are you Participating in the Commodities Boom?

Options Plus (100% financial inception) offers a Diversified Program in Commodities, Energy, Metals, and more. We have demand for all types of commodities. In the US, demand in China, India, and the rest of Asia is creating many consumers who are buying more. We believe we will continue to create many commodities buyers to come. We offer positions using a variety of methods to determine price level and position runs, creating a strategy that can help you achieve professional financial environments. www.optionsplus.com



Other Requirements

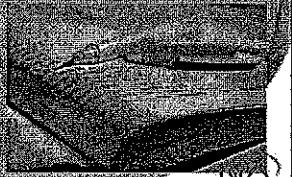
- What else must Members do?



NFA

Written Procedures

- Members are required to have written procedures regarding the review and approval of promotional material and supervision of sales solicitations



NFA

Recordkeeping

- Firms are required to:
 - maintain copies of all promotional material
 - support for the material,
 - and a record of the review and approval of the material for five years. (CFTC Reg. 61.31)



NFA

Pre-Approval

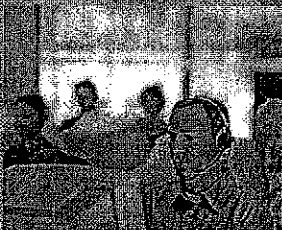


- Certain promotional material **MUST** be submitted to NFA for review and approval at least 10 days prior to its first use.
- Any Audio or Visual Advertisements which make specific trade recommendations or refer to profits that have been obtained in the past or could be achieved in the future (See Interpretive Notice 9063 for guidance)
- Material related to Security Futures Products (See Compliance Rule 2-29(j) for specific content requirements)
- Material prepared by certain disciplined firms



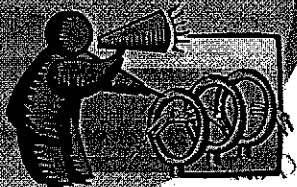
Telemarketing Rule: 2-9

- Eligibility based on percentage of "disciplined" AP, a firm's employ. & other factors
- Certain firms must have all communications with customers
- Must submit all promotional material to NFA for pre-approval
- Must be registered or have SEC or CAC (Iran)
- Must have \$100,000 AOC III or CIA (SEC)



NFA's Oversight

How does NFA monitor sales solicitations and the use of promotional material?



Promotional Material Investigations



- Audits
- Pre-review program
- NFA Rule 2-29(g)
- On-going review of newspapers, magazines, TV & internet
- Submissions by regulatory agencies or outside parties
- Enhanced Surveillance Program (ESP)



Things to Consider on an Audit...

Briefly review content to determine if checklist needs to be completed

Has the material previously been submitted to NFA for review?

If so, and deficiencies were noted, make sure deficiencies were corrected

Perform any applicable testing, especially claims regarding past performance which is generally not tested during our in-office review

Who receives the piece of material?

Discuss scope with Field Supervisor

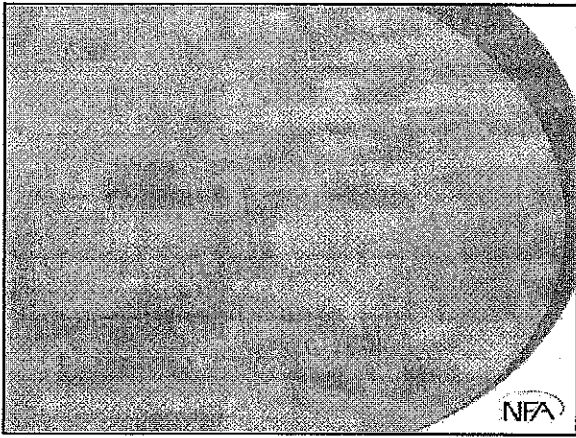


Turtle Futures, Inc./Russell Sands

BCC Complaint issued June 30, 2010

Rule	Description
2-2(a)	No Member shall cheat, deceive or defraud customers
2-29(b)(1)	Promotional Material cannot deceive
2-29(b)(3)	Promotional material must be balanced
2-29(b)(6)	Use of Testimonials
2-29(c)(3)	Hypothetical performance must be representative
2-29(c)(5)	Hypothetical performance must disclose material assumptions
2-36(a)	Solicitations for forex transactions must comply with CR 2-36
2-36(b)(1)	Forex solicitations cannot cheat, defraud or deceive
2-36(j)	Hypothetical performance in forex must comply with regs.





Overview of the Disciplinary Process

NFA

Regulatory Principles (from IOSCO)

- Comprehensive inspection, investigation and surveillance powers
- Comprehensive enforcement powers
- The regulatory system should ensure
 - an effective and credible use of inspection, investigation, surveillance and enforcement powers and
 - implementation of an effective compliance program

NFA

Enforcement in US

- Federal criminal authorities for violations of criminal law
- Commodity Futures Trading Commission for violations of the Commodity Exchange Act
 - Administrative actions
 - Civil actions
- Self-Regulatory Organizations

NFA

Types of Actions

- Complaint
- Member Responsibility Action
- Associate Responsibility Action



Who is Involved

- Staff
- Business Conduct Committee
- Hearing Committee
- Appeals Committee
- Executive Committee (Member Responsibility Actions)



NFA and the CFTC

• NFA

- Take action against members and associates
- Violations of NFA Requirements
- Remedies through NFA Committees
- Can not go to court
- Must refer illegal activity

• CFTC

- Can prosecute registrants and non-registrants
- Violations of Commodity Exchange Act
- Can seek injunctive action



Potential Sources of Disciplinary Cases

- Audits
- Investigations
- Financial issues
- Customer complaint

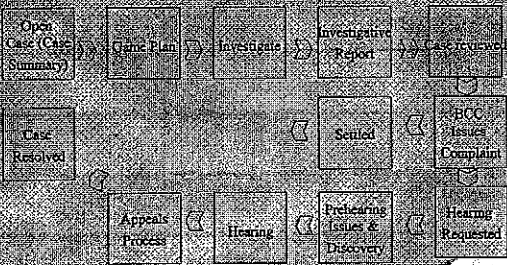
NFA

Trends in disciplinary cases

- From
 - FCM insolvency
 - Failure to maintain books and records
- To
 - Sales practices and solicitations
 - Misappropriation of funds
 - Misleading advertising

NFA

A Typical Disciplinary Case Process



NFA

Case Management

- Consult with Enforcement Coordinator
- Create log
- Attorney assigned
- Case plan
- Additional investigation as needed
- Summary Report



Summary Report Review

- Allegations supported?
- What is our theory?
- How will the firm respond?
- What potential defenses will the firm raise?
- What sanctions are we seeking?



Gathering and storing evidence

- Chain of custody
- Evidentiary considerations
- Veracity of Recollections/documents
- Credibility
- Consequences of poor evidence handling
 - Lose allegation
 - Lose case



Issuing a Complaint

- Staff presents case to Business Conduct Committee
- BCC either accepts or rejects recommendation
- If BCC accepts, Complaint issued within 30 days
- Becomes public record

NFA

After Complaint

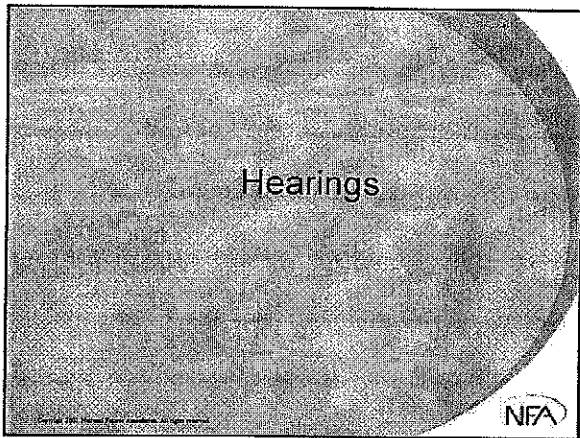
- Must be served within 30 days
- Respondent has 30 days to respond
- Failure to respond deemed to be admission
- Failure to answer deemed to be waiver of hearing

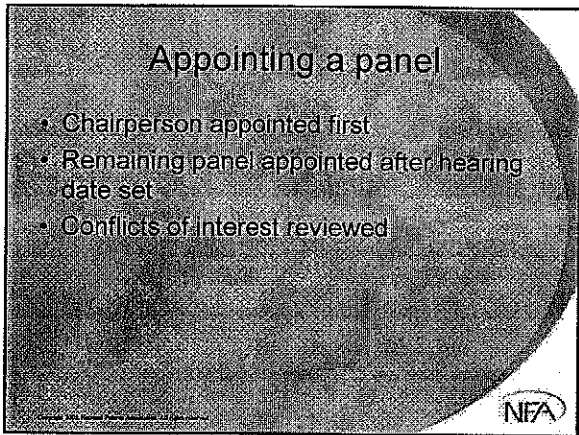
NFA

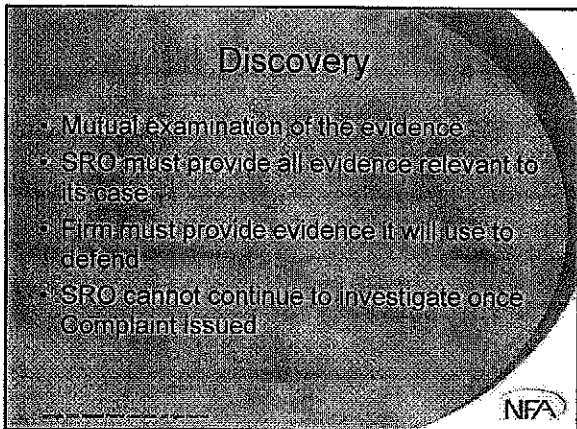
Resolving a Complaint

- There are 2 ways to resolve a Complaint
 - Hearing
 - formal procedure to hear evidence and find facts
 - last resort
 - subject to continuances and delays
 - Settlement
 - negotiated resolution
 - can occur at any time
 - Preferred in most cases

NFA







Pre-hearing Conference

- Hearing chair presides
- Within 30 days of chair's appointment
- Used to set
 - Hearing dates
 - deadlines for discovery and pre-hearing motions

NFA

Pre-hearing Motions

- Chair authorized to decide most motions
- Full panel decides material motions
- Should be filed within deadlines
- Continuance motions must have affidavit

NFA

Settlement Offers

- Full panel decides
- Panel receives offer and SRO's response
- Panel should accept if circumstances warrant
 - consider allegations
 - sanctions for similar conduct

NFA

Hearing sequence

- Chair makes opening statement
- Parties make opening statements
- SRO presents case in chief
- Firm cross examines
- Firm presents defense
- SRO cross examines
- SRO presents rebuttal witnesses or evidence
- Closing arguments



Hearing Panel's Role

- Finder of fact and law
- Chair responsible for controlling hearing
- May ask for additional documents/legal briefs
- May question witnesses



Ex-Parte Communications

- Parties, including SRO, may not contact panel directly
- Motions/communication processed through docketing or counsel to the committee



Deliberations

- Must address each allegation
 - did the respondent commit the alleged acts?
 - If so, did the conduct violate SRO rules?
- Counsel to panel attends deliberations
 - procedural questions
 - understand reasoning
- Panel decides appropriate sanctions

NFA

Written decision

- Counsel to panel drafts decision
- Panelists review prior to issuance

NFA

Evidence

- Formal rules of evidence (as defined by statute) do not necessarily apply
- Fundamental fairness and common sense do apply
- Formal rules used to guide common sense
- NFA Compliance Rule 3-9 and GFTC Regulations part 170 and 171 govern

NFA

Evidence Considerations

- Hearsay
- Relevance



Impeachment

- Prior inconsistent statements
- Prior acts of bad conduct



Sanctions

- Available under NFA Rule 3-14
 - Expulsion or suspension
 - Bar or suspension from association with NFA member
 - Censure or reprimand
 - Monetary fine
 - Cease and desist order
 - Other penalty or remedial action



Factors to consider

- Gravity of offense
- Culpability
- Frequency, duration and number of violations
- Financial gain and financial condition
- Losses to customers
- Deterrent effect
- Past disciplinary history
- Mitigating circumstances
- Similar cases



Appeals process

- Either party can appeal a BCO decision
- Must appeal within 15 days
- Matter goes to Appeals Committee
- Matter automatically stayed



Appeals Process

- After the Appeals Committee renders decision, Parties can appeal further
 - CFTC
 - not automatically stayed
 - US Court of Appeals
 - NFA no longer a party
 - Can petition US Supreme Court



Proving Common Allegations

- Sales Practices
- Fraud
- Financial Issues



Case Discussion

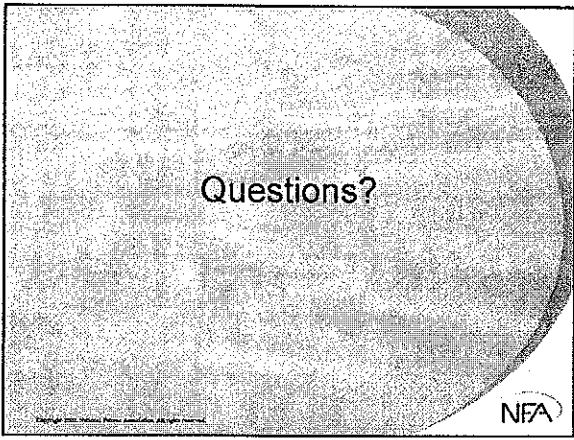
Commonwealth Financial Group




Commonwealth Financial Group

Date	Event
October 4, 1994	NFA issues MRA
October 28, 1994	CFS requests hearing
February 27, 1995	Hearing panel issues decision
March 8, 1995	CFS appeals decision to CFTC
March 14, 1995	CFTC stays the Hearing panel's order
March 18, 1997	CFTC issues decision affirming NFA's decision
April 2, 1997	CFS files emergency appeal with US Court of Appeals
June 22, 1999	Appeals court affirms CFTC's ruling






National Futures Association
The US Self-Regulatory Model



NFA's Mission


To provide innovative regulatory programs and services that ensure integrity, protect market participants and ensure our Members meet their regulatory responsibilities.

To be the model for regulatory organizations by providing the most efficient and effective regulatory environment possible.



NFA's Background

- Operating since 1982.
- Authorized by Congress to act as a self-regulatory organization for the futures industry
- Subject to oversight by the Commodity Futures Trading Commission and the Securities Exchange Commission



Profile

- Governed by a Board of Directors comprised of public and industry representatives
- Staff of approximately 305
- 3,700 Member firms and 53,000 individuals
- Offices in Chicago and New York
- Not for profit, not a trade or lobbying association



Congressional Intent (CEA Section 17)

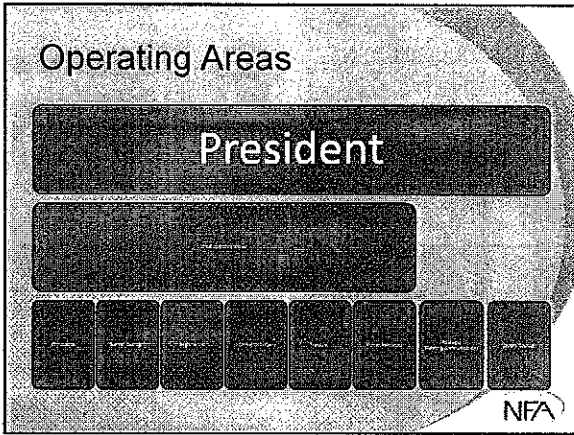
- Mandatory membership
- Compliance rules
- Appropriate discipline
- Customer arbitration process
- Rules submitted for approval
- Perform registration functions
- Equitable allocation of dues

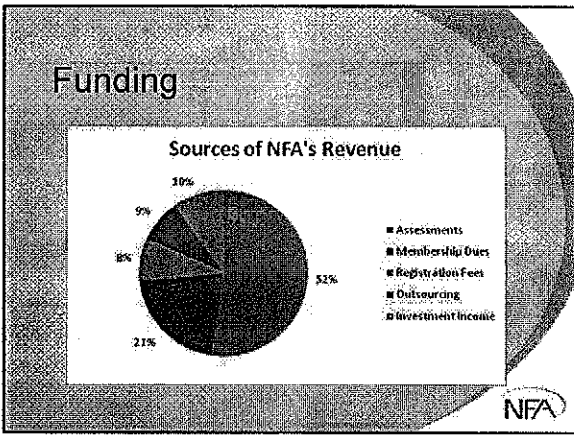


NFA Governance

- Board must have at least 20% nonmembers
- Assure fair representation in the adoption of rules and selection of officers and directors
- 28 Directors-Exchanges(4), FCMs/IBs(10), CPOs/CTAs(4), nonmembers(10)
- Executive Committee
- Committees







NFA Dues

Category	2013	2012
Annual Dues	\$1,200,000	\$1,150,000
Registration Fees	\$1,100,000	\$1,050,000
Assessments	\$1,000,000	\$950,000
Membership Dues	\$900,000	\$850,000
Outourcing	\$800,000	\$750,000
Investment Income	\$700,000	\$650,000
Registration Fees	\$600,000	\$550,000
Assessments	\$500,000	\$450,000
Membership Dues	\$400,000	\$350,000
Outourcing	\$300,000	\$250,000
Investment Income	\$200,000	\$150,000
Registration Fees	\$100,000	\$50,000
Assessments	\$50,000	\$25,000
Membership Dues	\$25,000	\$12,500
Outourcing	\$12,500	\$6,250
Investment Income	\$6,250	\$3,125

The NFA logo is located in the bottom right corner of the slide.

Categories of NFA Membership

- Futures Commission Merchants (FCM)
- Retail Foreign Exchange Dealer
- Commodity Pool Operators (CPO)
- Commodity Trading Advisors (CTA)
- Introducing Brokers (IB)



SRO Functions

- Set standards
- Monitor for compliance with those standards
- Take disciplinary action when standards violated



NFA's Core Functions

- Registration and Membership
 - Screen firms and individuals
 - Ensure knowledge and fitness standards are met
 - Bar or condition unfit applicants
 - Membership committee hears cases



NFA's Core Functions

- Compliance/Enforcement
 - Conduct audits of our Members' business operations
 - Analyze our Members' financial information
 - Investigate irregularities and complaints
 - Take disciplinary action when needed



NFA's Core Functions

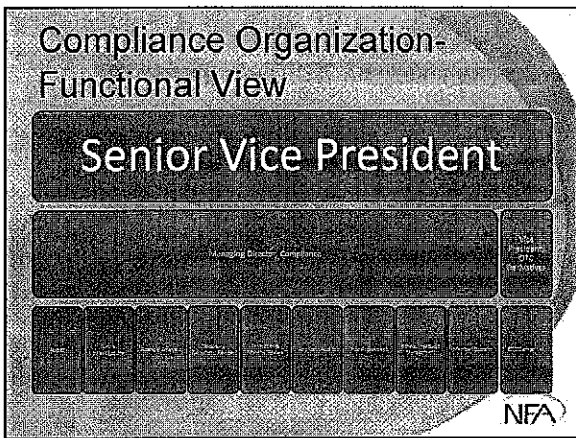
- Compliance/Enforcement
 - Risk based approach
 - Which firms to audit
 - What to audit
 - Relationship tracking
 - Centralized audit software

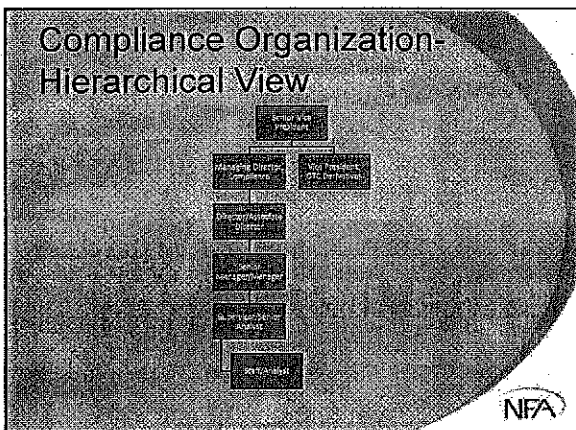


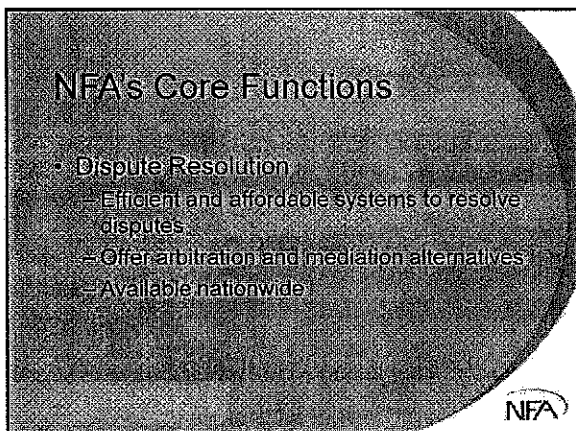
NFA's Core Functions

- Compliance/Enforcement
 - Business conduct committee
 - Hearing committee
 - Appeals committee
- Sanctions









NFA's Core Functions

- Education
 - Assist membership in understanding and meeting regulatory responsibilities
 - Help investors better understand trading opportunities and risks
 - Provide staff with complete training curriculum



Market Oversight

- Market Regulation
 - Contract Markets
 - SEFs
 - Forex



Dodd-Frank

- Swap Dealers and Major Swap Participants
 - Registration
 - Process
 - 4 s submission
 - Oversight
 - Swap Execution Facilities



Keys to NFA's Success

- Reliable and adequate funding
- Accountable for its activities
- Mandatory membership
- Responsive to changing business environment



NFA's Track Record

- Trading volume has increased exponentially
- Customer complaints have dropped more than 70%
- Firm insolvencies have been virtually eliminated
- All while NFA has consistently taken on more responsibilities




NFA's Information Technology

- Background Affiliation Status Information Center (BASIC)
- Online Registration System
- FACTS 2000
- EasyFile and WinJammer financial statement submission
- Online Dispute Resolution




NFA Information Technology

- Pool Quarterly Reports
- Segregated Funds Investments
- Forex Pricing Data



Government Oversight

- Primary oversight by CFTC
 - Rules reviewed and approved
 - Disciplinary and registration cases reviewed
 - Rule enforcement reviews
 - Access to NFA databases
 - Oversight fee
- SEC oversight for Security Futures Products



NFA/CFTC Dialogue

- Quarterly report
- Meetings with Commissioners after Board meetings
- Commissioners invited to Board meetings
- Regular staff meetings with CFTC divisions
- Referrals
- Cooperative enforcement efforts

