

Recommendations For Regulators, Exchanges and Clearinghouses*

* It should be noted that some recommendations made by the Task Force refer to regulators, exchanges and/or clearing houses collectively. A particular recommendation may deal with an exchange/clearing house in its capacity as such or in its capacity as a regulator. Further, in a number of jurisdictions, exchanges and/or clearing houses might be the primary market regulators in the absence of any governmental bodies with authority over the futures or options markets.

Financial Integrity Issues

Member and Customer Protection

Each exchange/clearinghouse and/or regulatory authority should have and maintain appropriate mechanisms designed to identify and protect clearing member and customer property in respect of instruments that are traded and/or cleared under the rules of the exchange/clearinghouse against dissipation as a result of the activities of brokers/intermediaries and their affiliates. Such mechanisms should enable the exchange/clearinghouse or regulatory authority to facilitate the transfer or close out of positions and the return of clearing member or customer property, or other appropriate actions, as promptly as feasible upon the cessation of business or insolvency of a clearing member or other broker/intermediary. Relevant mechanisms used by exchanges/ clearinghouses might include trade registration requirements, record-keeping requirements for carrying and/or clearing firms calling for the identification of customer positions and property, segregation of customer property, sufficient guarantees by credible sources, insurance of customer accounts or compensation funds. Regulatory authorities should facilitate the use of appropriate mechanisms by exchanges/clearinghouses.

In the event of a default by a clearing member, the level of resources available to the exchange/clearinghouse should be sufficient to protect non-defaulting clearing members, and thereby their customers, against loss and to permit trading, settlement and clearing to continue without interruption. Such resources should be sufficient in light of market conditions and practices and should consist of liquid assets and/or committed lines of credit that are readily available for prompt application.

Margin Requirements

The primary purpose of an exchange/clearinghouse margin system should be the preservation and enhancement of the financial integrity of its marketplace. Margin requirements should be established through the use of risk-based systems that evaluate portfolios based on, among other criteria, pricing and volatility models. Such systems should provide the necessary flexibility to allow the exchange/clearinghouse to make prudential judgments regarding the appropriate level of margins for its market. The parameters of each pricing model should take into account, among other things, the timing of margin, settlement and other payment obligations in the relevant market. All open positions should be marked-to-market no less than daily.

Except where appropriate and legally permissible credit arrangements have previously been established, exchanges/clearinghouses or regulatory authorities should require that clearing members collect margin promptly from customers. In those instances in which margin is not collected within a reasonable period of time, exchanges/clearinghouses or regulatory authorities should require appropriate adjustments, which may include capital charges or additional collateral, to be made by such clearing members to reflect the potential exposure of such clearing members to their customers.

Payments obligated to be made to and from a clearinghouse should be irrevocable as of a time certain. Such payments should be made simultaneously or as close to simultaneously as is reasonably practicable in light of local market practices and needs.

Dissemination of Information

Each exchange/clearinghouse should make publicly available and periodically update information regarding its market protection mechanisms including:

- (a) the scope and operation of the market protection mechanisms;
- (b) the market participants covered by such mechanisms (including the applicability of such mechanisms to customers) and the extent to which such participants are covered; and
- (c) relevant bankruptcy law issues and treatment within its jurisdiction.

Each exchange/clearinghouse should make publicly available and periodically update a list of the sources of financial support available to it as part of the applicable financial integrity system and the amount available from, and the liquidity of, each such source. The order in which such sources will be drawn upon, whether such sources must be repaid (and by whom) and any limits on the right to draw on such sources should be included in the information made available.

Each exchange/clearinghouse should make publicly available and periodically update financial information regarding the exchange/clearinghouse. The financial information should include reasonably sufficient information to permit market participants to evaluate the credit risk of the exchange/clearinghouse, to evaluate changes over time and to make appropriate comparisons among various exchanges/clearinghouses.

Transfers of Customer Positions and Property

Each exchange/clearinghouse and/or regulatory authority should have in place rules and procedures to enable it to take appropriate actions to protect itself, its clearing members and thereby customer positions and property where a broker/intermediary is experiencing financial problems. Such actions might include effecting the transfer of positions and property from such broker/intermediary to a broker/intermediary in a stronger financial condition, or otherwise imposing additional financial or operational requirements and limitations on such broker/intermediary.

In the event of a broker/intermediary's cessation of business or default, an exchange/clearinghouse and/or regulatory authority should have both the regulatory authority and the processing capability to require either the prompt transfer of customer positions and assets to another broker/intermediary or the close out of open positions. The manner in which such transfers or close outs are effected, including the pricing of such transfers or close outs, should be determined in accordance with a procedure that, to the fullest extent possible, has been established in advance and has been made known to market participants.

Exchange/Clearinghouse Risk Assessment;

Reporting and Coordination

Information Sharing/Coordination

Each exchange/clearinghouse should, subject to applicable law, have in place procedures and systems for the sharing of information regarding market participants and their trading activities, either directly or through the applicable regulatory authorities, with other exchanges/clearinghouses (including both futures and securities exchanges) and regulators, in the same and in other jurisdictions. Regulatory authorities should establish systems for the sharing of information with exchanges/clearinghouses and other regulatory authorities in the same and different jurisdictions regarding market participants and their trading activities. All information provided regarding market participants should be maintained in strictest confidence and on the condition that it not be used for commercial purposes.

Regulatory authorities and/or legislators should effect any changes to existing laws and regulations that are necessary to permit exchanges/ clearinghouses to share information with other exchanges/clearinghouses and/or other regulatory authorities for the purposes described herein.

If a market participant seeks to obtain financial, position, margin or other benefits from holding positions in similar instruments on more than one exchange, either for hedging or arbitrage purposes or for other reasons, each exchange/clearinghouse where beneficial treatment is sought should confirm the nature and existence of the market participant's positions in such instruments on other exchanges/clearinghouses. Such

confirmation may, where appropriate, be based on information or documentation obtained directly from the market participant. In addition, however, the confirmation procedures used by the exchange/clearinghouse should include the ability, where necessary, to access information from the other exchange/clearinghouse on a confidential basis and on the condition that it not be used for commercial purposes. On the same terms, an exchange/clearinghouse also should confirm the nature and existence of over-the-counter or other instruments if they form the basis for beneficial treatment.

Each exchange/clearinghouse and/or regulatory authority should develop and coordinate emergency action procedures to respond to crises in their markets or in other markets that may impact their markets. In developing these procedures, exchanges, clearinghouses and regulatory authorities should consider the use of mechanisms for the prompt transfer or close out of positions and the transfer of customer property. The operational aspects of these procedures should be tested on a regular basis.

Audits/Reviews

Each exchange/clearinghouse should be audited by an independent, external auditor on at least an annual basis. The relevant regulatory authorities should conduct routine reviews of the principal functions of exchanges and clearinghouses within their jurisdiction. Audits and reviews should include examinations of, among other matters, the risk management and market surveillance procedures, internal controls and financial condition of each exchange/clearinghouse.

Each exchange/clearinghouse and/or regulatory authority, as appropriate, should conduct periodic audits of all clearing member firms. In addition, each exchange, clearinghouse and/or regulatory authority, as appropriate, should conduct periodic audits of any other entities within its jurisdiction that carry customer positions. Such audits should include, at a minimum, reviews of internal controls, risk management procedures and compliance with customer protection requirements.

Exchange/Clearinghouse Risk Assessment

Each exchange/clearinghouse should establish minimum financial requirements for member firms and should conduct at least daily reviews of such firms' positions at the exchange/clearinghouse in relation to their financial condition, amongst other criteria. In addition, each exchange/clearinghouse should establish other requirements and/or limitations, as appropriate, which may include position and concentration limits based on financial condition, to manage the risks of member firms' trading activities. Each exchange/clearinghouse should also have and enforce appropriate procedures to separate internal risk management personnel from personnel with marketing responsibilities. Regulatory authorities should recognize the benefits of risk-based financial requirements.

Regulatory authorities should have ready access, on a need to know basis, to the size and ultimate beneficial ownership of customer positions, including the positions of customers carried in or through omnibus accounts. In the event such information is not made available to an exchange/clearinghouse, it should be able to impose on the clearing member carrying the account either additional financial requirements and/or appropriate limitations on trading. Regulatory authorities and/or legislators should effect any necessary changes to existing laws or regulations to facilitate access by exchanges/clearinghouses to information on the size and ultimate beneficial ownership of customer positions.

In those markets where segregation is used as a customer protection mechanism, each exchange, clearinghouse and/or regulatory authority should preclude the commingling of segregated customer positions and proprietary positions of the broker/intermediary or its affiliates in omnibus accounts, by the carrying firm. Gross margining of positions held in omnibus accounts should be required at the level of the initial broker/intermediary carrying customer accounts and margin should not be permitted to be netted between segregated customer and proprietary omnibus accounts. In those markets where segregation is not applicable, other mechanisms to identify and protect customer funds and property, which may include the use of separate customer and proprietary accounts at depositories, should be used.

Each exchange/clearinghouse should establish and maintain standards of creditworthiness for eligible depository institutions holding clearing members' property on behalf of the clearinghouse.

Legal/Regulatory Issues

Bankruptcy Issues

The bankruptcy or other relevant laws of each jurisdiction should provide for (or at least not prevent) the prompt close out of positions and/or transfer of customer positions and property from a defaulted broker/intermediary to another broker/intermediary. Where necessary, exemptions from any automatic "stay" or similar provisions should be implemented in order to permit such transfers or close outs to be made.

The bankruptcy or other relevant laws of each jurisdiction should clearly specify the rights of customers and brokers/intermediaries upon the default of a clearinghouse, broker/intermediary or depository with respect to the customer and proprietary assets held by such clearinghouse, broker/intermediary or depository, including any priority rights granted to customers with respect to such assets.

Margin or settlement payments made to or from a broker/intermediary or exchange/clearinghouse should be protected from reversal in a bankruptcy proceeding.

Legislators and regulatory authorities should attempt to harmonize conflicting bankruptcy regimes in different jurisdictions in order to provide, to the maximum extent possible, for consistent treatment of customer positions and property upon the bankruptcy of a clearinghouse, a depository or a broker/intermediary. In addition, the bankruptcy or other relevant laws should ensure that brokers/intermediaries and clearinghouses are permitted to exercise rights of netting and set-off in the event of a default by a customer, broker/intermediary or clearinghouse.

Coordination and Oversight by Regulatory Authorities

Regulatory authorities in different jurisdictions should, to the extent practicable, harmonize conflicting regulatory requirements with respect to market participants operating or trading in multiple jurisdictions. As part of this effort, regulatory authorities in each jurisdiction should clarify the scope of their authority with respect to domestic persons trading or engaging in other activities outside the jurisdiction and with respect to the trading or other activities of non-domestic persons within the jurisdiction.

Appropriate systems of regulatory oversight (which may include delegations of oversight responsibilities to exchanges, clearinghouses or other self-regulatory organizations) should be established and enforced in each jurisdiction. Such systems should include oversight and periodic reviews of the operations and activities of exchanges, clearinghouses, brokers/intermediaries and, where appropriate, other market participants.