THE HISTORY OF REGULATION OF CLEARING IN THE SECURITIES AND FUTURES MARKETS, AND ITS IMPACT ON COMPETITION

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I. Introduction

In 2008, the Antitrust Division of the United States Department of Justice ("DOJ") made the following comment in a letter to the Department of the Treasury:

> (T)he Department believes that the control exercised by futures exchanges over clearing services . . . has made it difficult for exchanges to enter and compete in the trading of financial futures contracts. If greater head-to-head competition for the exchange of futures contracts could develop, we would expect it to result in greater innovation in exchange systems, lower trading fees, reduced tick size and tighter spreads, leading to increased trading volume.[1]

In the futures industry today, as in the past, most clearinghouses are owned by a "parent" exchange, a model known as "vertical integration." By contrast, the securities and options markets use a model known as "horizontal integration" with a single centralized clearinghouse:respectively, the Depository Trust &

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[1] Comment letter from the United States Department of Justice entitled Review of the Regulatory Structure Associated with Financial Institutions, to the United States Department of the Treasury, TREAS-DO-2007-0018 (Jan. 31, 2008).

Clearing Corporation for equities and the Options Clearing Corporation for equity and equity index options. The central clearing model allows participants in the market to buy and sell the same instrument in multiple marketplaces while choosing their execution venue based on the best price available and the costs and efficiency of transacting at a venue.

After a series of mergers over the past decade, one company, the CME Group, is responsible for over 95% of the average daily volume of exchange-traded commodity futures contracts.[2] In the past 15 years, several competing exchanges have attempted to establish a futures exchange capable of competing with the CME Group or its affiliates in their established products. Such efforts have, at best, made small inroads into the CME's market share.

By comparison, in the other two major exchange markets in the United States, equities and securities options, no exchange claims more than a 30% market share. Unlike the futures industry, in equities a variety of trading venues exist today. These venues include so-called "dark pools" that offer block trading facilities, and both order- and price-driven markets. Even NYSE Euronext, the United States' biggest equities market, does not have more than a third of the average daily volume of trading in its own listed shares in the United States.[3] The markets for options on securities are similarly competitive, featuring a variety of execution venues. The industry's oldest exchange, the Chicago Board Options Exchange, leads the industry with approximately 30% of options cleared in the month of April 2010, with four other venues each capturing over 10%.[4]

In Parts II and III we examine the history of regulation of clearing and its integration with market structure in the stock trading and securities options markets. In Part IV we explore the trail of clearing regulation in futures much of it occurring concurrently, but very differently, from its cousin markets in securities. In Parts V and VI we discuss how the respective paths of regulation of clearing in securities and futures markets affected such different market structures and levels of competition among marketplaces. Finally, in Part VII the article discusses approaches to enhance the

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[2] Futures Industry Association, U.S. Volume Report, Feb. 2010.

[3] NYSE, Monthly Volume Summary (Sept. 2010), http://www.nyse.com/pdfs/NYSE_Euronext_Transactions_Data.pdf.

[4] The Options Clearing Corporation, http://www.optionsclearing.com/webapps/exchange-volume (last visited Oct. 12, 2010) (providing access to data regarding options and futures volume by exchange for April 2010).

competitiveness of the futures industry by focusing on the market structure of its clearinghouses.

II. Securities

A. Pre-1975 History

In 1934, Congress passed the Securities Exchange Act ("Exchange Act") to regulate securities exchanges at the federal level, mostly in reaction to concerns about the Stock Market Crash of 1929 and the ensuing Great Depression.[5] Section 4 of the Exchange Act created the Securities Exchange Commission ("SEC") to enforce both the Exchange Act and the Securities Act of 1933 ("Securities Act").[6] Although the Securities Act was passed a year prior to the Exchange Act, no comprehensive federal agency existed at the time to regulate the securities industry.[7] Securities regulation before this time was a piecemeal system of state laws colloquially referred to as "Blue Sky Laws."[8] The Exchange Act, created to regulate the secondary trading of securities, subjected the various exchanges to SEC regulation by requiring them to register with the SEC. Once an exchange registers, it must act in strict accordance with SEC regulations.[9] The SEC has the power to sanction a non-compliant exchange. Thus, the SEC wields a potent tool to incentivize the exchanges to comply with regulations. The creation of a single entity

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[5] Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. CORP. L 865, 876 (2008).

[6] 15 U.S.C. § 78d (2006) (transferring responsibility to enforce the Securities Act to the Securities and Exchange Commission and away from the FTC).

[7] Joel Seligman, THE TRANSFORMATION OF WALL STREET 51-52 (3d ed. 2003).

[8] Hall v. Geiger-Jones Co., 242 U.S. 539 (1917) (upholding the constitutionality of state securities laws).

[9] The Securities Exchange Act of 1934, enacted on June 6, 1934, is codified at 15 U.S.C §78f (2006) and regulates national securities exchanges. The Exchange Act did not confine itself to regulating only exchanges. It regulated secondary trading of securities, which included not only exchanges, but also brokers and issuers of securities. The Act also contained additional anti-fraud and anti-manipulation provisions and an ongoing duty of issuers to file current information on a regular basis.

operating at the federal level greatly changed the regulation of the securities industry.

Notwithstanding the innovation in securities regulation that arose in the 1930s, neither the Exchange Act nor the ensuing legislation expanding the SEC's powers over the next several decades gave the SEC comprehensive power[10]to regulate the clearance and settlement of securities.[11] In the absence of contrary federal legislation, state laws regulated the clearance and settlement of securities, a system that had evolved from the early Blue Sky Laws and continued until 1975.[12]

Clearinghouses have long existed as an intermediary for trades in order to improve the integrity and efficiency of capital markets by reducing the risk associated with trading.[13] Clearinghouses typically function to guarantee both sides of a trade, acting as both a buyer to every seller and a seller to every buyer in all transactions. This guarantee greatly reduces the risk of default inherent in bilateral transactions.

Traditionally, each exchange owned its own clearing agency. Each clearinghouse completed all clearing services for transactions that occurred on its parent exchange, precluding competition in the clearing industry. In 1975, the Stock Clearing Corp. ("SCC"), owned by the New York Stock Exchange ("NYSE"), and the American Stock Exchange Clearing Corp. ("ASECC"), owned by the American Stock Exchange ("Amex") accounted for the clearing of about 73% of all shares traded nationally.[14] National Clearing Corporation ("NCC"), the clearing agency owned by the National Association of Securities Dealers ("NASD"), accounted for 12%, and the major

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[10] In addition to the Exchange Act, the SEC also enforces the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, and most recently, the Sarbanes-Oxley Act of 2002.

[11]Larry E. Bergmann, Sr. Assoc. Director, Div. of Mkt. Regulation, Sec. and Exch. Comm'n, Speech at the International Securities Settlement Conference: The U.S. View of the Role of Regulation in Market Efficiency (Feb. 10, 2004) (transcript available at http://www.sec.gov/news/speech/spch021004leb.htm) [hereinafter Bergmann Speech].

[12]*Id.*

[13]U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS & BEARS: U.S. SECURITIES MARKETS & INFORMATION TECHNOLOGY, OTA-CIT-469, 94 (1990).

[14]Bradford Nat. Clearing Corp. v. Securities and Exchange Commission, 590 F.2d 1085, 1095-96 n. 13 (D.C. Cir. 1978).

regional exchanges' clearinghouses accounted cumulatively for another 15%.[15]

B. Paperwork Crisis

By the late 1960s, as trading volumes continued to rise, the securities industry faced a growing problem: paperwork. At the time, paper stock certificates physically changed hands after each transaction. According to the SEC, a brokerage firm used approximately thirty-three different documents when executing a single transaction.[16] Among these documents were a floor report, a comparison, transfer instructions, contract sheets and a settlement statement.[17] As trading occasionally reached twelve million shares a day, hundreds of messengers traveled all over Wall Street between broker-dealers, transfer facilities of banks, inter-dealer clearing systems and others, increasing the risk of errors every day.[18] The back offices of brokers and dealers were so overworked that exchanges began closing hours earlier than the traditional time, and even stopped trading on Wednesdays to give the back offices time to catch up with the massive amounts of paperwork.[19]

Even for the few broker-dealers that managed to take advantage of the limited computer technology available at the time, problems could escalate quickly. By the time a back office could effectively research errors of a specific date, the resulting errors had often increased to a point where a firm simply could not keep track of the actual physical securities that they were supposed to have in their possession. Losses caused by failures to receive and deliver

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[15] The regional exchanges and respective clearinghouses were the Boston Stock Exchange (Boston Stock Exchange Clearing Corp.), the Midwest Stock Exchange, (Midwest Clearing Corp.), the Pacific Stock Exchange, (Pacific Clearing Corp.), and the Philadelphia Stock Exchange (Stock Clearing Corp. of Philadelphia). *Id.*

[16] Bergmann Speech, *supra* note 11.

[17] Dale A. Oesterle, *Regulation NMS: Has the SEC Exceeded its Congressional Mandate to Facilitate a "National Market System" in Securities Trading?*, 1 N.Y.U. J.L. & BUS.613, 617 (Summer 2005).

[18] *No More Paper: A Brief History of Paper Certificates*,THE DEPOSITORY TRUST AND CLEARING CORP., http://www.dtcc.com/leadership/issues/nomorepaper/industry/history.php (last visited Nov. 4, 2010).

[19] Kenneth Silber, *The Go-Go Sixties*, RESEARCH MAGAZINE (March 31, 2008), http://www.researchmag.com/Issues/2008/4/Pages/The-Go-Go-Sixties.aspx.

securities ("fails") reached four billion dollars as problems escalated.[20] The pervasiveness of the fails problem ultimately caused volumes all over the industry to decrease and left many firms with substantial liabilities. Insufficient clearing and settlement capabilities and poor error resolution contributed to the crisis as well. Systems that were acceptable ten years earlier could not process the volume of shares traded daily, which had more than quadrupled since the beginning of the 1960s. In late 1969, a steep decline in share prices caused trading volumes to begin to drop.[21] The sudden loss in commission revenues combined with the operational issues resulted in approximately 160 NYSE member broker-dealers permanently closing, merging, or filing for bankruptcy during this period of time.[22]

C. Response

The SEC began altering the regulatory landscape by issuing several releases that restructured the back offices of broker dealers to increase both their efficiency and public confidence in the industry. The SEC "established new standards for the maintenance of books and records by brokers and dealers, imposed requirements for the custody, and limited use, of their customers' funds and securities and tightened net capital requirements applicable to them."[23] One new rule required quarterly accounting and verification of all securities held by brokers and dealers in an attempt to reduce fails and improve transparency in markets.[24] Another rule heightened net capital requirements for broker-dealers in an effort to prevent further

[20] Eli Weinberg, Joseph F. Neil. Jr. & Joseph P. Coricaci, *Development of a National System for Clearing and Settling Securities Transactions in* 2 EXPLORATIONS IN ECONOMIC RESEARCH 353, 356 (National Bureau of Economic Research ed. 1975).
[21] The Application of the National Securities Clearing Corp. for Registration as a Clearing Agency, Exchange Act Release No. 13163, 11 SEC Docket 1448, 1451 (Jan. 13, 1977) [hereinafter Exchange Act Release No. 13163].
[22] Bergmann speech, *supra* note 11.
[23] Exchange Act Release No. 13163, *supra* note 21, at 1451.
[24] Quarterly Securities Counts by Certain Exchange Members, Brokers and Dealers, Exchange Act Release No. 34-9376, 36 Fed. Reg. 21178, 21178 (Oct. 29, 1971).

liquidations of broker-dealers.[25] A third rule required a would-be broker-dealer registrant to provide more information regarding its finances and business arrangements.[26]

Congress also took several regulatory steps. In order to shore up investor confidence, Congress passed the Securities Investors Protection Act of 1970 ("SIPA"), which provided for the creation of the Securities Investor Protection Corporation ("SIPC").[27] SIPA was supposed to imitate the spirit and effect of the Glass-Steagall Act of 1933, which among other things created the Federal Deposit Insurance Corporation to insure the deposits of bank customers and help prevent runs on banks.[28] Similarly, because of the numerous failures of broker-dealers, the SIPC was intended to insure the accounts of broker-dealer customers up to a fixed amount with backing from the U.S. government.

Furthermore, Congress asked the SEC to study the securities industry to determine how the back office crisis developed in the first place, and to recommend remedial measures to prevent volume related problems from happening in the future. In 1971, the SEC produced its Study on Unsafe and Unsound Practices ("Study I") and its Institutional Investor Study ("Study II").[29]

Study I concluded that to pursue effectively the goal of creating a nationwide system for securities transactions, the SEC needed additional control of the clearing and settlement processes.[30] It believed that the "archaic method of achieving [clearing and settlement] which [had] nearly drowned the financial community in a tidal wave of uncontrolled paper," needed to be simplified into a "modernized nationwide system for securities transactions."[31]

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[25] Net Capital of Certain Brokers-Dealers; Restricted Rates and Minimum Requirements, Exchange Act Release No. 34-9633, 37 Fed. Reg. 11970, 11970 (June 14, 1972).
[26] Disclosures in Broker-Dealer Registration Application Respecting Personnel, Facilities, and Financing Required to Operate Business, Exchange Act Release No. 34-9594, 37 Fed. Reg. 9668 (May 12, 1972).
[27] 15 U.S.C. §78aaa (2006).
[28] 12 U.S.C. §227 (2006).
[29] SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231 (1971) [hereinafter Study I]; SEC, Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, Part 1 (1971) [hereinafter Study II].
[30] Study I, *supra* note 29, at 36.
[31] *Id.* at 36, 1.

In communicating the results of Study II to Congress, the SEC publically encouraged "the creation of a strong central market system for securities of national importance."[32] The central market would allow all investors, big or small, to compete equally. Furthermore, the central market would stand as a national system for the public dissemination of market information such as trading price and volume information.[33] The two pillars of the 1975 legislation, national clearing and competition between brokers and dealers, arose from these two studies.

The House and Senate also conducted their own hearings and studies on the paperwork crisis.[34] Those investigations reached similar conclusions on the importance of a national clearing system. They demonstrated that while trading and sales boomed in the 1960s, the broker-dealers responded by increasing their "front-office" sales support to interact with customers. However, broker-dealers did not implement a complementary investment in back-office operations to manage the growing demands of operations and processing.[35] The SEC later cited these studies to advocate for centralized common clearing, believing that a "lack of uniform methods of doing business and the failure of clearing and settlement entities to coordinate their various systems increased the brokers' and dealers' costs and their accounting and control problems."[36]Congress concluded that the main obstacle to solving this problem was a lack of coordination in the clearing industry. At the time, no single organization existed which could coordinate and direct the various stakeholders in the clearing and settlement industry.[37]

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[32] Study II, *supra* note 29, at xxiv.

[33] Oesterle, *supra* note 17, at 618.

[34] SUBCOMM.OFS. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 92D CONG.,SECURITIES INDUSTRY STUDY (2d Sess. Comm. Print 1972); SUBCOMM.ON SECURITIES OF S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 93D CONG.,SECURITIES INDUSTRY STUDY, (1st Sess. Comm. Print 1973); SUBCOMM.ON COMMERCE AND FIN.OF H.R. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 92D CONG., SECURITIES INDUSTRY STUDY, (2d Sess. Comm. Print 1972).

[35] Subcomm.on Commerce and Fin. of H.R. Comm. on Interstate and Foreign Commerce, 92d Cong., *supra* note 34, at 4.

[36] Exchange Act Release No. 13163, *supra* note 21, at 1452.

[37] *See*Subcomm. of S. Comm. on Banking, Housing, and Urban Affairs, 92d Cong., *supra* note 34, at 16-17.

D. Buildup

The securities industry, attempting to prevent another crisis, took steps that helped build momentum towards central clearing. One of these important steps occurred in July 1972 when the NYSE and the Amex founded the Securities Industry Automation Corporation ("SIAC") to handle the facilities management of their clearing-houses, the SCC and the ASECC respectively.[38] The NYSE owned two thirds of SIAC and the Amex owned the other third. By outsourcing the actual processing to SIAC, the parent organizations hoped to achieve significant cost savings with a more uniform process by utilizing economies of scale. Since the SCC and the ASECC were still operating separately and both exchanges still had rules tying their clearing functions to their own clearinghouses, this was not a true merger. Regardless, the creation of SIAC was an important first step.[39]

During this time period, the NASD's clearinghouse, the NCC, requested that both SIAC and Bradford National Corporation ("BNC") submit bids on a similar management contract because the NCC was losing significant amounts money as a result of low over-the-counter ("OTC") volume.[40] Ultimately, BNC won the NCC bid. As a result, the majority of the nation's securities clearing was for the first time under the control of two companies and was being handled in a uniform, professional manner which allowed the industry to operate in a much more efficient fashion.

In an industry-wide undertaking that mirrored Studies I and II, the Securities Industry Association ("SIA") formed a committee in 1973 to discuss the "chaos" of the clearing industry.[41] The committee hoped to solve problems relating to coordinating with eight different clearinghouses for securities and physical delivery problems. The committee produced a seven-point proposal for the creation of a national clearing system. As a result, under the aegis of the SIA, the exchanges and the NASD appointed a twenty-two-person committee, the National Securities Processing Committee, to formulate a

[38] Bradford Nat. Clearing Corp. v. Sec. and Exch.Comm'n, 590 F.2d 1085, 1097 (D.C. Cir. 1978).
[39] *See Id.*
[40] Exchange Act Release No. 13163, *supra* note 21, at 1455-57.
[41] *See*WEINBERG, NEIL &CORICACI, *supra* note 20, at 358.

national proposal.[42] The Committee developed a twenty-two-point plan. Six of the most pertinent points were as follows:

> (1) It must be a continuous net settlement system. (2) A communications network is needed to tie the various facilities together. (3) Each broker must have the capability of having one position per security, regardless of where traded; in other words, each broker will be able to meet all his trades in General Motors into one accumulative position. (4) Positions will be marked to market daily. (5) All net money balances may be settled at one location, and securities may be deposited at various locations throughout the country for immediate credit without any discrimination in regard to geography. (6) Free securities may be withdrawn at various locations. The goal of this was to permit a firm that happened to be based on the West Coast and yet was a member of the New York and American and NCC to be able to clear all its trades in Los Angeles through facilities located there.[43]

While this Committee did not directly result in the formation of a national or central clearing system, these points would appear again soon during the formation and registration of the National Securities Clearing Corporation ("NSCC"). The formation of the Committee signifies that the government did not force central clearing on the industry, but instead had serious support from the market.

It is important to note that there were several significant voices that cried out at this time against taking the competition out of clearing, in particular, the regional exchanges and SEC Chairman Ray Garrett.[44] The regional exchanges believed that each of their clearinghouses performed functions that were specific to their business and quite distinct. Regional exchanges wanted the focus to be on a national clearing system, not a national clearing entity.[45] Chairman Garrett believed in the importance of a national depository

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[42] *Id.*
[43] *Id.* at 358-59.
[44] *Id.* at 368.
[45] *Id.*

and a clearing system but not a single central clearinghouse.[46] Garrett told the NYSE in a letter that he believed that the innovative techniques that would develop as a result of competition between clearing organizations provided significant incentives to keep those clearing organizations alive.[47]

Another major development in the evolution of a central clearing and settlement system for securities was the development of depositories in the late 1960s. The NYSE founded the Central Certificate Service in 1968 to serve as a depository for shares of stock that investors chose to leave with their brokers – instead of taking possession of them individually.[48] The goal was to immobilize the massive amount of stock certificates that, up until the creation of these depositories, had to physically change hands with every transaction. Using a "sophisticated computer system" which cost $8 million a year, the Central Certificate Service handled shares which accounted for 70% of the volume of at the NYSE, even though the deposited shares only accounted for 15% of total stock certificates.[49] Shares could simply be moved from one account to another and held in a broker's name at the depository instead of the certificates having to be physically transported. The Central Certificate Service soon became the Depository Trust Company ("DTC") and started handling the shares of both the Amex and NASD. By 1973, the DTC had over $65 billion worth of securities on deposit. One study showed that creating the DTC at that time resulted in a 30-35% reduction in the physical movement of certificates. Similar depositories sprung up in the Midwest (Midwest Securities Depository Company, $519 million on deposit) and the Pacific (Pacific Securities Depository, $520 million on deposit).[50] At the time, some complained that the DTC and a centralized clearing system were not integrated. Ultimately the creation of the NSCC as separate from the DTC set a standard for the industry that did not change until the merger of the DTC and the National Securities Clearing Corporation in 1999.[51]

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[46] Ray Garrett, Jr., Chairman, Sec. and Exch. Comm'n, Remarks at The Investment Association meeting in New York City: New Challenges for the Securities Industry (Oct. 3, 1973).
[47] *See* WEINBERG, NEIL &CORICACI, *supra* note 20, at 368.
[48] *Wall Street: Attack on the Snarl*, TIME, May 24, 1968, at 92-93.
[49] *Id.*
[50] Weinberg, *supra* note 20, at 360-61.
[51] *Responding to Wall Street's Paperwork Crisis*, DTCC.COM, http://www.dtcc.com/about/history (last visited Oct. 20, 2010).

E. Amendments

In March of 1972, the SEC presented to Congress the Securities Transaction Processing Act of 1972.[52] In 1975, Congress finally passed the proposed legislation in the form of the Securities Acts Amendments of 1975 ("1975 Amendments") to give the SEC the appropriate tools to develop a "national market system" in the securities industry.[53] As part of those amendments, Congress added a section on the "National System for Clearance and Settlement of Securities Transactions" to the Exchange Act.[54] The 1975 Amendments include congressional findings that state both the impetus and the goals behind the inclusion of this section in the 1975 Amendments. These findings focused on the importance of an efficient, linked clearance system to reduce costs and protect investors using up-to-date technology.[55] The chapter then directs the

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[52] William J. Casey, Chairman, Sec. Exch. Comm'n, Address at the Conference of State Bank Supervisors: The Securities Transaction Processing Act of 1972 (Apr. 8, 1972).

[53] Donald L. Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 Va. L. Rev. 785, 785 (1984); Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97.

[54] National System for Clearance and Settlement of Securities Transactions was added to the Securities Exchange Act of 1934 as Pub. L. No. 94-29, 89 Stat. 141 (codified as amended at 15 U.S.C. § 78q-1 (2006)).

[55](a) Congressional findings; facilitating establishment of system

> (1) The Congress finds that—
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> > (A) The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.
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> > (B) Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.
> >
> > (C) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.
> >
> > (D) The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.

SEC to use its authority "to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities."[56] The goals of the national settlement system were very clear throughout the legislative process: avoid another Paperwork Crisis and establish a safe, modern national clearing and settlement system.[57]

The 1975 Amendments require clearing agencies to register with the SEC, thus submitting them to extensive SEC regulation, similar to the original Exchange Act provision granting the SEC power over the exchanges through registration.[58] The 1975 Amendments direct the SEC to withhold registration unless the applicant is "so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions," and to have rules which support both that goal and the goal to "foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, [and] to remove the impediments to and perfect the mechanisms of a national system for [clearing and settling]."[59] Furthermore, in consideration of possible antitrust implications, the 1975 Amendments require that a clearinghouse's rules cannot "impose any burden on competition *not necessary or appropriate* in furtherance of the purposes of the Act."[60] This statutory language, when read closely, gives the SEC the ability to balance anticompetitive concerns against the purposes of the newly amended Exchange Act. After the passage of these Amendments in September 1976, thirteen clearinghouses applied for registration under an exemption that allowed the SEC to grant

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Id. 15 U.S.C. §78q-1(a).

[56] Market Reform Act of 1990, Pub. L. 101-432, 104 Stat. 931 (codified as amended at 15 U.S.C. § 78q-1(a)(2)(A) (2006)). In 1990, the following language was added: "(ii) to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options."

[57] *See*Bergmann Speech, *supra* note 11.

[58] National System for Clearance and Settlement of Securities Transactions was added to the Securities Exchange Act of 1934 at Pub. L. No. 94-29, 89 Stat. 141 (codified as amended at 15 U.S.C. § 78q-1 (2006)).

[59] *Id.* at 15 U.S.C. 78q-1(b)(3)(i) and (ii).

[60] *Id.* at 15 U.S.C. 78q-1(b)(3)(iii) (emphasis added).

registration for up to eighteen months while reaching a final determination.[61]

F. The National Securities Clearing Corporation ("NSCC")

The NYSE, Amex and the NASD decided to merge their respective clearinghouses together in the form of the NSCC and applied for SEC registration under 15 U.S.C §78q-1 on March 29, 1976.[62] Merger discussions had been ongoing as far back as 1973 in recognition of both the operational efficiencies and the cost savings that would result from such a merger.[63]After the passage of the 1975 Amendments, the parties involved renewed the discussions that resulted in the NSCC.[64]

After significant deliberation, the SEC announced on November 3, 1976 that it was considering approval of the application, subject to several conditions.[65] The SEC held an informal hearing in which twenty-three different organizations were represented and granted a far longer comment period than it usually granted registration applications. Broker-dealers across the country widely supported it. Regional exchanges, their affiliated clearing agencies and the DOJ Antitrust Division all registered their concerns with NSCC registration.[66]

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[61] The entities which applied were the Depository Trust Company, Bradford Securities Processing Services, Inc., American Stock Exchange Clearing Corporation, Stock Clearing Corporation of Philadelphia, Boston Stock Exchange Clearing Corporation, Stock Clearing Corporation, Midwest Securities Trust Company, the Options Clearing Corporation, Midwest Clearing Corporation, Pacific Securities Depository Trust Company, Pacific Clearing Corporation, National Clearing Corporation, and TAD Depository Corporation. Securities Exchange Act of 1934, Exchange Act Release No. 12759, 10 SEC Docket 352 (Sept. 1, 1976).

[62] National Securities Clearing Corporation, Exchange Act Release No. 12489, 41 Fed. Reg. 23255 (June 9, 1976).

[63] Bradford Nat. Clearing Corp. v. Sec. and Exch.Comm'n, 590 F.2d 1085, 1096 (D.C. Cir. 1978).

[64] *Id.* at 1097.

[65] Application of Nat'l Sec. Clearing Corp. for Registration as a Clearing Agency, Exchange Act Release No. 12954, 41 Fed. Reg. 49721 (Nov. 10, 1976).

[66] Bradford, 590 F.2d at 1099.

Finally, on January 13, 1977, the SEC granted the NSCC temporary registration, subject to four conditions set forth in the November 3rd Order ("Temporary Order") and further directives set forth.[67] The SEC cited the 1975 amendments as the base of its registration powers, stating "[t]he directive of the 1975 Amendments that the commission use its authority to facilitate the establishment of a national system [when deciding on the NSCC's application]."[68]

In its approval, the SEC cited Study I to support its conclusion that, "[t]here is no area of the securities business which offers more opportunity for reducing costs as well as exposure [to market disruption] . . . than the improvement and modernization of the systems for clearing, settlement, delivery and transfer of securities."[69] Continuing with this theme when discussing the actual NSCC application, the SEC noted, "[t]he importance of the NSCC's establishment . . . [to a national system] . . . can be gauged only against the backdrop of a decade of industry effort."[70] It was readily apparent that the SEC viewed the NSCC as the natural evolution of the clearing industry in reaction to the Paperwork Crisis and the 1975 Amendments. The SEC also pointed out that the lack of progress towards a national clearing system was attributable to the close relationship between the clearinghouses and their parent organizations, as well as the parent organizations fear that they could lose both the revenue from and the control of the clearinghouses.[71]

When reaching its determinations, the SEC cited the legislative history of the 1975 Amendments for the proposition that the "new authority conferred on the Commission 'is designed to . . . avoid any delay in achieving the comprehensive regulation.'"[72] The SEC believed that establishing a true national clearance and settlement system was essential to its larger goal of building a national market system.[73]In light of the direction in the 1975 Amendments section on the creation of national clearing to balance fair competition versus the other goals outlined, the SEC ultimately

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[67] *See* Exchange Act Release No. 13163, *supra* note 21.
[68] *Id.* at 9.
[69] *Id.* at 5.
[70] *Id.* at 12.
[71] *Id.* at 13.
[72] *Id.* at 20, quoting Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. 4 (1975).
[73] *Id*. at 40.

believed that the NSCC application must be considered in the context of the urgency of prompt implementation of the entire 1975 Amendments.[74] The SEC thought that the competition among brokers and dealers was the "paramount" concern of the Exchange Act.[75] The SEC stated that the existing rules and procedures tying Amex clearing to the ASECC and NYSE clearing to the SCC were effectively impeding competition between brokers and dealers located in major financial centers with those located outside financial centers. It believed that the 1975 Amendments could be used to effectuate substantial improvement.[76]

With those objectives in mind, the Temporary Order granted registration to the new NSCC organization with the following conditions: (1) the NSCC was required to offer to establish full interfaces with registered clearing agencies not part of the NSCC merger for free to assuage concerns that the NSCC would discourage the national system with anti-competitive behavior;[77] (2) users of the NSCC system would be able, regardless of location, to compare Amex, NYSE and OTC eligible transactions, further emphasizing the conception of a truly "national" market; (3) the NSCC would have to permit competing clearing organizations to use its branch network across the country, and allow clearing organizations to offer their services to brokers and dealers outside of New York City[78] to prevent the NSCC from discouraging brokers and dealers outside of New York City from using other clearing systems to compare transactions; and (4) the NSCC would be required to share its OTC comparison software with registered clearing agencies upon request, and comparisons of OTC transactions between agencies would be done by a single agency and shared freely.[79]

In granting the registration, the SEC also discussed the effect of the NSCC on competition among securities exchanges. As explored in greater detail in *Bradford v. SEC*, the portion of the 1975 Amendments that discusses clearing lists competition as one of several factors to be considered, contrasted with the section on the establishment of the national market system that mentions

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[74] *Id.* at 20-21.
[75] *Id.* at 28.
[76] *Id.* at 34.
[77] *Id.* at 26.
[78] *Id.* at 32. Participating clearinghouses would be required to pay their proportionate share of overhead.
[79] *Id.* at 33.

enhancement of competition as a main objective in reference to brokers and dealers.[80] Two regional exchanges claimed to have concerns over their economic viability going forward if their respective clearinghouses sustained significant economic losses, and a third believed that it would have an "adverse effect" on its operations.[81]The SEC believed that the above-imposed conditions would alleviate those concerns.[82]

In addition, the SEC considered alternative approaches to the registration of the NSCC to determine whether or not there was a less anticompetitive way to achieve the goals of the 1975 Amendments with equal or greater effectiveness. They considered (1) a network of fully interfaced clearinghouses; (2) a merger of the NCC with any other clearinghouses; and (3) the NCC discontinuing its clearing and settlement business and solely operating its OTC operations.[83]

The SEC believed that because none of the alternatives would be able to provide the same capabilities nationwide that the NCC's existing (and expanding) branch network offered, the alternatives could not encourage competition between brokers and dealers both inside and outside New York City in the same manner the proposed NSCC would.[84] Additionally, none of these alternatives could be executed with the same speed and cost savings.[85] The SEC's analysis makes it clear that it believed a central clearing agency was the best possible way to encourage competition.[86] The SEC stated, "rather than adopting approaches appropriate to a natural monopoly, the Commission has sought to free the competitive potential present in the clearing and settlement area by imposing conditions on NSCC's registrations designed to *sever existing restrictive ties* between clearing agencies and their affiliated securities markets."[87] Ultimately, the Temporary Order granted registration to the NSCC, subject to conditions and further monitoring.

The merger was to take place in two phases. During Phase I, the clearinghouses would remain tied to their associated exchanges

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[80] Bradford Nat. Clearing Corp. v. Sec. and Exch.Comm'n, 590 F.2d 1085, 1095 (D.C. Cir. 1978).
[81] *See* Exchange Act Release No. 13163, *supra* note 21.
[82] *Id*. at 35.
[83] *Id.* at 39.
[84] *Id.*
[85] *Id.*
[86] *Id.* at 39-40.
[87] *Id.* (emphasis added).

under the prior rules, but the NSCC, through SIAC, would operate all three clearing agencies as separate divisions.[88] During Phase II, the NSCC would actually convert the separate clearing divisions into a single integrated entity, with the goal of providing all of the services in one organization that were previously available at the NCC, SCC and ASECC.[89] One aspect of the plan that would later become controversial was geographic price mutualization ("GPM"); it had the express goal of fostering greater competition between brokers and dealers around the country.[90] This provision was inserted to help promote the growth of the national market system, which was the impetus behind the 1975 Amendments.[91] The NSCC planned to base its fee structure around the total cost of its clearing service, not the actual cost of the individual transactions.[92] As a result, while every customer around the country would have paid the same rate under this GPM scheme, it was argued that New York brokers and dealers, whose geographic proximity to the NSCC resulted in lower actual costs, would have been subsidizing the out-of-state brokers by paying the same fees without the same costs.[93]

Another development that helped clear the way for the eventual primacy of the NSCC was the rule changes outlined in SEC Release No. 14636, which approved rule changes by several exchanges promulgated at the request of the SEC.[94] In its 1978 Annual Report, the SEC stated that it had eliminated or amended over one hundred exchange and NASD rules in the prior year after

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[88] Bradford Nat. Clearing Corp. v. Securities and Exchange Commission, 590 F.2d 1085, 1098 (D.C. Cir. 1978).
[89] *Id.* at 1098.
[90] *Id.* at 1099.
[91] G. Bradford Cook, Chairman, Sec. and Exch. Comm'n, Speech: The Central Market System: Putting the Markets to Work for the Investor (Mar. 15, 1973).
[92] Bradford, 590 F.2d at 1099.
[93] *Id.*
[94] Am. Stock Exch., Inc, Et Al., Exchange Act Release No. 14636, Release No. 34-14636, 1978 WL 196700 (Apr. 7, 1978). The exchanges included the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Intermountain Stock Exchange, the National Association of Securities Dealers, the New York Stock Exchange, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. The Release notes that not all rule changes submitted in response to the September 1977 were approved in this Release. The rule changes were approved pursuant the power granted in §19(b) of the Exchange Act.

review.[95] The rule changes affected the rescission of the traditional industry-wide rules providing that trades on an exchange had to be cleared and settled on that exchange's affiliated clearinghouse. The changes were intended to remove what the SEC noted was a central obstruction to competition among clearinghouses for the clearance and settlement business of broker-dealers to the broker-dealers' freedom to select among clearing agencies.[96] The SEC eliminated these ties with the clear intent to promote competition in the clearing industry.

While some clearinghouses were concerned about the power the NSCC might wield in this new regulatory environment, other clearinghouses believed that eliminating the tradition of captive clearing would allow them to compete with the NSCC. Ironically, severing the ties which held the regional clearinghouses captive to their parent exchanges had the ultimate effect of allowing brokers and dealers trading on regional exchanges to clear and settle on the NSCC, removing another impediment to central clearing for equities. As discussed above, several exchanges were worried about the loss of revenue from clearing fees from their business as a result of experiencing competition in the clearing industry for the first time. Ultimately, while the 1975 Amendments would cause significant upheaval in the securities industry, it was not the loss of clearing fees that had the biggest effect on the regional exchanges; rather, it was the ease of trading on other exchanges facilitated by central clearing and new linkages.

G. Bradford v. SEC

While attaining registration from the SEC was a significant hurdle for the NSCC, the NSCC still had one major obstacle in its way. BNC, the facilities manager of the NCC and the Pacific Clearing Corporation, and Bradford Securities Processing Services, a registered clearing corporation, (collectively, "Bradford"), sued the SEC to force a review of the SEC decisions approving the NSCC registration.[97] Bradford brought two major claims: (1) The

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[95] 44TH ANN. REP. OF THE SEC at 32 (1978).

[96] *Id.*

[97] Securities Change Act of 1934, Exchange Act Release No. 13163, 1977 WL 173551 (Jan. 13, 1977); In re Nat'l Securities Clearing Corp, Securities Exchange Act Release No, 13456 (Apr. 21 1977); Bradford Nat. Clearing

anticompetitive impact of the NSCC's existence would outweigh any potential benefits and, as a result, registration should have been denied; and (2) even if conditional registration was appropriate, the SEC should have taken exception to some aspects of the NSCC plan as outlined.[98]

The newly formed NSCC had chosen SIAC to administer its actual clearing operations. Since SIAC already operated the clearing of both the SCC and the ASECC, the SEC believed that SIAC would have the ability to most efficiently assume the clearing and data processing responsibilities for the new combined entity.[99]Towards that end, the NSCC exercised a termination clause in Bradford's existing operations contract with the NCC.[100] Bradford, desiring the NSCC contract, attempted to submit a bid and was informed that the NSCC would not be accepting bids until SIAC negotiations were completed. Ultimately, Bradford was never allowed to submit a competitive bid for the facilities management and processing contract.[101]Bradford's concerns about both the future of the clearing industry as a whole and not being allowed to submit a competitive bid against SIAC were the catalysts for bringing suit.

While the suit dealt with competitive concerns, it was not an antitrust case, but an administrative review petition brought under the Exchange Act. The Court made it clear that antitrust concerns would not be given any more weight than they would normally when reviewing an administrative action.[102] Keeping this in mind, the Court, citing both the supporting legislation and the legislative history, stated its belief that Congress desired to give the SEC "substantial flexibility of choice in 'bold(ly) and effective(ly)' accomplishing the herculean task of rapidly restructuring an entire industry."[103] The 1975 Amendments gave the SEC extensive power over the shape of the national clearing system with the power to

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Corp. v. Securities and Exchange Commission, 590 F.2d 1085, 1085 (D.C. Cir. 1978).

[98] Bradford, 590 F.2d at 1106.

[99] *Id.* at 1098.

[100] Securities Exchange Act of 1934, Exchange Act Release No. 13163, 1977 WL 173551 (Jan. 13, 1977).

[101] Bradford, 590 F.2d at 1106.

[102] *Id.* at 1104.

[103] *Id.* (*citing*Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S.Rep.No.75, 94th Cong., 1st Sess. 1-88 (1975), U.S.Code Cong. &Admin.News 1975, at 179.)

register clearinghouses, and Congress expected them to exercise substantial discretion pursuing the goals and objectives outlined.[104] Therefore, the Court believed that the SEC deserved greater deference than usual in reviewing an administrative action because of the power explicitly delegated in the 1975 Amendments.

As described above, the SEC planned to put in place the national clearing and settlement system as quickly as possible. The Court believed that the goal of rapid implementation was apparent in the SEC's decision to grant temporary registration to the NSCC. Moreover, the SEC's willingness to take on significant monitoring responsibilities showed the importance that the SEC placed on national clearing. As it stood, the NSCC's temporary registration was granted with a host of conditions.[105] Even after the Temporary Order was issued, the SEC continued to have a series of public hearings and public comments to explore a delay in moving from Phase I of the merger to Phase II.[106] The Court believed that the hearings did not represent a loss of confidence in the NSCC by the SEC, but instead was a furtherance of the SEC's expanded regulatory presence in this area.[107]

When discussing the Temporary Order, the Court said, "[t]he upshot of the four conditions plus NSCC's proposal is that, for purposes of comparing NYSE and Amex transactions, NSCC is essentially a public utility that is afforded a monopoly but must offer its services to all qualified customers [its own participants or other clearing agencies] at cost."[108] This statement reflects the Court's position on the NSCC merger. The Court based its opinion on a crucial distinction in the way that competitive concerns are discussed in the 1975 amendments.

> Despite their interdependence and their common subjection to broad SEC authority, the national market and clearing systems were not perceived by Congress as identical pillars supporting the legislators' conception of a modernized approach to securities marketing. Most importantly, Congress' directives to the Commission with respect to the two

[104] *Id.* at 1094.
[105] *Id.* at 1099.
[106] *Id.* at 1102.
[107] *Id.*
[108] *Id.* at 1101

> systems vary slightly but significantly. Although in facilitating the establishment of both systems, the SEC is required to adhere to "the findings and to carry out the objectives set forth" in the first subsection of each of the two relevant provisions, those findings and objectives are not entirely parallel. [Sections 11A(a), 17A(a), 15 U.S.C. § 78k-1(a), § 78q-1(a).] Thus, while both lists of objectives include the full exploitation of technological advances in communication and data processing equipment, efficiency and the linkage of all relevant facilities nationally, only the national market system objectives include the "enhance(ment)" of "fair competition among brokers and . . . exchange markets . . . " and only the national clearing system objectives include promptness and the development of uniform standards and procedures. [Sections 11A(a)(1), 17A(a)(1), 15 U.S.C. 78k-1(a)(1), § 78q-1(a)(1)].[109]

Fair competition among brokers and dealers was listed as a primary objective for the national market system, but not the national clearing and settlement system. This distinction allowed the Court to view the NSCC registration in the light of support for the national market system, instead of solely in the context of competition in the clearing industry. The Court's interpretation of the goals of the 1975 Amendments was that:

> [they] would allow an investor anywhere in the United States to initiate and then complete a securities transaction with the aid solely of a local broker of his choice, dealing on a regional exchange and clearing through a regional agency also of his choosing, and having available throughout the process the most complete and up-to-date national information possible.[110]

In light of these important goals, the Court concluded that the 1975 Amendments only required the SEC to reach a conclusion that any

[109] *Id.* at 1095-96.
[110] *Id.*

anticompetitive effects of registration were "necessary or appropriate" to the achievement of its objectives.[111] The Court stated that an independent review of the 1975 Amendments and their legislative history supported the SEC's view that it need only balance fair competition against the 1975 Amendments' other important objectives instead of viewing fair competition as its primary concern.[112]

The importance of that balancing becomes evident when the Court, in support of upholding the Temporary Order, states, "even if the SEC could have struck a Better [sic] balance in favor of achieving the Act's goals and against anticompetitive impacts, its decision passes statutory muster so long as the former achievements by whatever margin outweigh the latter impacts."[113] The Court believed that, under the power granted to the SEC by the 1975 Amendments, the SEC decision was legal, even if it was not the decision that had the least anticompetitive nature. The Court also stated that it believed the SEC's choice to be a reasonable one, and that, even if it had the ability to review the decision outside of the mandated balancing, it would have supported the decision. The Court based its decision on the NSCC's potential for rapid development, as well as the belief that the NCC, either on its own or merging with another clearinghouse, might not have been able to compete with a ASECC/SCC clearing house, which would have instantly controlled over 73% trades.[114] If the NSCC had failed, the new national clearing system would have lost the benefit of the NCC's existing national network.

The Court balanced three main benefits against the consequences of granting a possible monopoly: the merger of the three industry leaders would bring significant cost savings by bringing together extensive experience and scale; the NSCC's technological and financial ability to contribute to the establishment of the national market system; and the significant improvement the NSCC would bring to competition among brokers and dealers.[115]The Court believed that, while the potential for a monopoly did exist, the SEC had actually taken several steps to provide for competition where, in the past, none had truly existed because of the rules tying

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[111] *Id.* at 1105 (*citing* S.Rep.No. 75, 94th Cong., 1st Sess. 1-88 (1975)).
[112] *Id.* at 1106.
[113] *Id.* at 1107.
[114] *Id.*; *see* note 13.
[115] *Id.* at 1108.

the regional clearinghouses to their respective exchanges.[116] The SEC had abolished those rules, imposed the four conditions on the NSCC registration discussed above, and had dedicated substantial resources to continual monitoring of the newly created NSCC.[117]The Court believed those steps to be sufficient and also believed that the SEC's "vigilance (could) forestall any irreparable anticompetitive harms from accompanying NSCC's registration."[118] Consequently, the Court did not see fit to overturn the registration granted by the temporary order.

The Court did not, however, agree with all of the SEC's decisions, remanding for further review two decisions of the Temporary Order. The first concerned the geographic price mutualization ("GPM") provision.[119] Both Bradford and the Justice Department vehemently opposed GPM for the way it forced New York brokers to subsidize out of state brokers and because the scale of the subsidy potentially allowed the NSCC to hurt rival clearinghouses by engaging in predatory pricing.[120]The SEC argued that GPM would help in establishing the regional branch offices envisioned by the NSCC, and believed that because regional competitors could participate in the branch offices this would not affect regional competitors.[121] Because the SEC had found that the clearing industry was not a natural monopoly, the Court believed the SEC should have reached the conclusion that regional competition could have forced prices down to competitive levels.[122] The SEC also argued that GPM allowed the NSCC to offset the costs of operating regional branches through the fees it charged its New York customers.[123]Regional participants who had to cover their share of operating costs for a regional branch office, unlike the NSCC, had no New York offices to subsidize the expense.[124]The Court did not

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[116] *Id*. at 1110.
[117] *Id.* at 1108.
[118] *Id.*
[119] *Id.* at 1112-13.
[120] *Id*. at 1111.
[121] *Id.* at 1112.
[122] *Id.*
[123] The Application of the National Securities Clearing Corporation for Registration as a Clearing Agency, Exchange Act Release No. 13163, 11 SEC Docket 1448, 1466 (Jan. 13, 1977) (stating that the revenues from the NY branch in addition to GPM will allow the NSCC to maintain an extensive branch network.)
[124] *Bradford*, 590 F.2d at 1112.

believe that Condition 3 did enough to promote competition in this area.[125] Since GPM would allow the NSCC to set prices below cost, the Court found this to be contradictory to the premise of encouraging competition between clearinghouses and not sufficient justification for allowing the pricing policy.[126] The Court remanded the GPM issue to the SEC to promulgate a better explanation or force the NSCC to abandon the Rule.[127]

The Court also remanded the SEC's decision not to force the NSCC to open the facilities contract to competitive bidding on the basis that the SEC reached its decision using improper reasoning.[128] The SEC said in its Temporary Order that as long as SIAC could guarantee safe, accurate and efficient services to the NSCC, the NSCC could render that decision on the facilities contract solely as an exercise of its business judgment.[129] In a brief, the SEC went so far as to claim that the 1975 Amendments regulated clearing, not data processors.[130] The Court disagreed with that statement.[131] It ruled that because the SEC had been given broad powers to effectuate the national market and clearing systems, without the ability to regulate the actual clearing processes, the SEC would be limited to "nothing more than the ability to regulate 'shell corporation(s)'."[132] Repudiating the SEC's argument, the Court stated that that proper test for determining the extent of the SEC's regulatory authority was "whether any exercise of 'business judgment' by a clearing agency may affect the realization of the national clearing system as envisioned by Congress."[133] Since the Court viewed SIAC as the actual data processor because it was doing the work, the impact of SIAC's bid and operations could be clearly shown to have a "statutory nexus to authority."[134] The Court remanded the decision on SIAC contract under the new stated test and then explained that nothing in the Temporary Order prohibited either the NSCC or the

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[125] *Id.*
[126] *Id.*
[127] *Id.* at 1112-13.
[128] *Id.* at 1113.
[129] The Application of the National Securities Clearing Corporation for Registration as a Clearing Agency, Exchange Act Release No. 13163, 11 SEC Docket 1448, 1470 (Jan. 13, 1977).
[130] *Bradford*, 590 F.2d at 1113.
[131] *Id.*
[132] *Id.*
[133] *Id.* at 1114.
[134] *Id.*

Court from taking interim steps or alterations in the process of pursuing full registration.[135]

Ultimately, while the Court did remand both the geographic mutualization and the NSCC's facilities management contract for further consideration by the SEC, it concurred with the SEC's decision to register the NSCC.[136] The SEC viewed the *Bradford* case as a "key step in achieving the national clearance and settlement system envisioned by the Congress."[137] The SEC also stressed in its 44th Annual Report that the Court reached its decision because the NSCC was "virtually certain to be dependable, stable, efficient – and more rapidly achievable than any other alternative," making clear to the public the benefits of the NSCC.[138] In the end, after more legal maneuvering, Bradford settled with the NSCC out of court, waiving the right to further contest the termination of its operations contract with the NCC, and the NSCC was able to begin clearing of OTC products from the NCC.[139]

The registration process of the NSCC continued over the next several years. The SEC, monitoring the NSCC merger process extensively, issued numerous orders and rulings pertaining to the geographic mutualization, the management contract and a few smaller issues that held up the process and the agency reaffirmed the registration.[140] The SEC approved the fully-merged phase of the

[135] *Id.* at 1116.
[136] *Id.*
[137] 44 SEC ANN. REP. at 30 (1978).
[138] *Id.* at 97-98
[139] The Application of the National Securities Clearing Corporation for Registration as a Clearing Agency, Exchange Act Release No. 17562, 22 SEC Docket 129, 132 (Feb. 20, 1981).
[140] Full Registration as Clearing Agencies, Exchange Act Release No. 20221, 28 SEC Docket 1175, 1191 (Sept. 23, 1983); *see also* Proposed Rule Change by National Securities Clearing Corp., Exchange Act Release No. 18327, 46, Fed. Reg. 61,379 (Dec. 16, 1981) (soliciting comments pertaining to a proposed rule change to fee schedules with geographically mutualized pricing); Submission of Report Evaluating Facilities Management Alternatives by the National Securities Clearing Corp., Exchange Act Release No. 18296, 46 Fed. 60,082 (Dec. 8, 1981) (acknowledging a report prepared by independent public accountants on NSCC's choice of facilities manager); Application of the National Securities Clearing Corporation for Registration as a Clearing Agency, Exchange Release No. 17562, 22 SEC Docket 129 (Feb. 20, 1981) (reaffirming registration decision).

NSCC plan in April of 1983[141] and granted full registration on September 23, 1983.[142]The SEC also granted full registration of several other distinct clearinghouses and depositories at that time.[143]

III. Options

Compared to the relatively labored process of creating a single clearinghouse in the securities market, the establishment of a central clearinghouse in the equity options market was simple. As the modern options market system was founded in the 1970s, it was easier to establish industry norms at the outset rather than re-working the framework of an entire industry.

In 1973, the SEC approved the application of the Chicago Board Options Exchange, Inc. ("CBOE") for registration as a national securities exchange.[144] Prior to the registration of the CBOE as an exchange, options, as a general rule, were not traded on the exchange level.[145]All options trading transactions occurred in the OTC market through the Put and Call Broker and Dealers Association, at such low volumes that, in October of 1973 alone, volume on the CBOE exceeded that of the entire year of 1972.[146]

In the past, options writers almost always wrote a new option contract for every option they would sell, not using prior options

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[141] Order Approving Proposed Rule Change, Exchange Release No. 19705, 27 SEC Docket 955 (April 26, 1983) (stating the proposal to allow the NSCC to move into Phase II is approved).

[142] Registration as Clearing Agencies, Exchange Act Release No. 20221, 28 SEC Docket 1175, 1198 (Sept. 23, 1983) (announcing NSCC is granted full registration as a clearing agency).

[143] *Id.* (declaring the following are registered as clearinghouses: Midwest Clearing Corporation, Midwest Securities Trust Company, The Options Clearing Corporation, NSCC, The Depository Trust Company, Stock Clearing Corp of Philadelphia, Philadelphia Depository Trust Company, Pacific Clearing Corporation, and Pacific Securities Depository Trust Corporation).

[144] Application of The Chicago Board Options Exchange, Inc. for Registration as a National Securities Exchange, Exchange Act Release No. 9985, 1 SEC Docket, 11, 11 (Feb. 1, 1973).

[145] *Id.*

[146] George Lee Flint, Jr., *SEC and FRB Treatment of Options: An Experiment in Market Regulation*, 53 TEX. L. Rev. 1243, 1243 n.5 (1975), citing Berton, *Options Trading: A Booming Market*, FINANCIAL WORLD, June 20, 1973, at 25 (stating that volume in 1972 averaged around four thousand contracts per week).

contracts written by themselves or others.[147] The customization of each contract made valuing the options without a uniform market highly difficult, so the secondary market was quite small.[148] For an investor desiring to purchase a specific option, overhead was high because that investor's broker would be required to spend significant time making inquiries to find someone willing to write the required option.[149] Another factor, the lack of a liquid market, made it difficult to value options to allow traders to buy and sell them easily.[150] Without a robust secondary market, making a profit from options involved exercising the options and requiring the writer to physically deliver the underlying stock.[151]

The key to the success of the CBOE, in contrast to the prior OTC markets, was the standardization and clearing of the options contracts. The CBOE created a subsidiary clearinghouse, the Chicago Board Options Exchange Clearing Corporation ("CBOECC"), in the same manner as the captive clearinghouses of the securities exchanges.[152] Unlike a securities clearinghouse, however, the CBOECC cleared products not inherently uniform in nature.[153] Every share of the same class of stock of a company is fundamentally the same, and therefore is a fungible good. The terms of an options contract were, up until that point, entirely negotiable between the writer and the buyer. The CBOECC, much like a traditional securities clearinghouse, became the buyer to every seller and the seller to every buyer.[154] The consequence of this, however, was that the CBOECC directly issued the options itself, which gave the CBOECC, and through it, the CBOE, the power to dictate the terms of the options which traded on the CBOE.[155]

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[147] *Id*. at 1246, citing Stephen F. Gates, *The Developing Option Market: Regulatory Issues and New Investor Interest*, 25 U. FLA. L. REV. 421, 422 (1973) (declaring that options writers wrote each option contract anew, and paid little attention to previous options valuations).
[148] *Id*.
[149] *Id.*, citing Steven T. Anderson, *Chicago Options*, 27 BUS. LAW. 7, 9 (1971).
[150] *Id.* at 1246-47.
[151] *Id.* at 1246.
[152] *Id.*
[153] *Id.* at 1246-47.
[154] *Id.*
[155] *Id.* at 1246-47 n.24.

The existence and guarantee of a central counterparty for the options contracts greatly facilitated the growth of options trading.[156] It allowed the CBOE to standardize the options contracts, and thus encourage the existence of a secondary market for the options contracts after their origination.[157]Standardization eliminated the drawbacks of the OTC market, overhead costs and liquidity issues, which had once prohibited the formation of a market in these options.[158]

Recognizing the novelty of the "complex problems and special risks to investors and to the integrity of the marketplace" inherent in exchange trading of options, the SEC adopted Rule 9b-1 under the Exchange Act; the rule barred a national exchange from affecting any transaction in options without prior SEC approval of an exchange's submission outlining its options trading rules and regulations.[159] This new rule departed from the equity securities regulations under which exchanges would adopt rules under their authority as a self-regulatory organization ("SRO") and allowed the SEC to alter or augment the rules only in statutorily circumscribed circumstances.[160]

Under Rule 9b-1, a submission, which was either an initial plan or proposed modification by an exchange or the SEC itself, would first go through a notice and comment period under Section 4 of the Administrative Procedure Act.[161] As a part of rule 9b-1, the SEC required that plans filed under the rule had to include provisions to address a broad spectrum of factors, including the clearance or settlement of options.[162]

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[156] *Id*. at 1246-47.
[157] *Id.*
[158] *Id.*
[159] Adoption of Rule 9b-1, Exchange Act Release No. 10552, 3 SEC Docket 224, 224 (Dec. 13, 1973).
[160] *Id.*
[161] *Id.*; Administrative Procedure Act § 4, 5 U.S.C. §553 (2006).
[162] *Id.* "Plans filed by exchanges pursuant to Rule 9b-1 are required to include all rules, regulations, by-laws and other requirements of the exchange that related 'solely or significantly to transactions in options,' and must contain specific provisions related to:

(1) the effecting of transactions in options on the exchange by members thereof for their own account and the accounts of customers;
(2) The clearance and settlement of transactions in options;
(3) The endorsement and guarantee of performance in options;
(4) The reporting of transactions in options; and

The SEC granted registration to the CBOE to operate as a "pilot project" and limited trading of options based on approximately thirty underlying stocks, which had to be registered and listed on another national securities exchange and also have significant liquidity and volume.[163]When the CBOE actually launched on April 26, 1973, it listed call options on only sixteen underlying NYSE stocks and had only 305 members.[164] By the end of the fiscal year 1974, it had doubled the underlying stocks on which it listed options to 32 and had grown to include 560 members.[165] The average daily volume was up to 23,000 contracts,[166] as opposed to the roughly 4,000 contracts traded *per week* before the advent of the CBOE.

Other exchanges took note of the success of the CBOE and contacted the SEC with inquiries about launching their own options exchanges.[167] Taking into account the increased interest from both the exchanges and the public, the SEC chose to have public hearings in February of 1974 to consider several matters relating to options trading.[168] Among these questions were whether options trading served the public good, whether more than one exchange should trade options and what regulatory scheme should manage the budding options industry.[169]

As the SEC contemplated the future shape of the exchange-traded options marketplace it determined that prior to the expansion of the CBOE pilot program, all concerned parties should work together to develop a common clearinghouse.[170] This conclusion was communicated through a series of letters to both the CBOE and two exchanges, the Amex and the Philadelphia Stock Exchange, which both intended to launch options trading.[171] The letters also

(5) The listing and delisting and the admission to and removal of trading privileges on the exchange for options."

[163] Application of The Chicago Board Options Exchange, Inc. for Registration as a National Securities Exchange, Exchange Act Release No. 9985, 1 SEC Docket, 11, 11 (Feb. 1, 1973) [hereinafter Exchange Act Release No. 9985].

[164] 40 SEC ANN. REP. at 8 (1974).

[165] Exchange Act Release No. 9985, *supra* note 163.

[166] *Id.*

[167] Commission Study of Multiple Exchange Option Trading, Exchange Release No. 10490, 3 SEC Docket 39, 39 (Nov. 14, 1973).

[168] SEC ANN. REP, *supra* note 164, at 8.

[169] *Id.*

[170] Exchange Act Release No. 10981, 5 SEC Docket 41 (Aug. 22, 1974).

[171] *Id.*

recommended the exchanges work together on standardizing options terms, disseminating last-sale data and making provisions for the availability of options quotations.[172] Since there was no preexisting infrastructure in the options sector, the SEC was able to mandate central clearing and other national market system goals from the very beginning. The CBOECC, after significant input from the SEC, was spun off from the CBOE to become the common clearinghouse for the entire options industry, the Options Clearing Corporation ("OCC").[173]

IV. Futures

A. The Beginning

From the start, futures have been regulated separately and independently from securities and options. Consequently, significant differences exist in how both futures exchanges and their clearing-houses developed as compared to their counterparts in securities and options.

Futures contracts began trading in the 19th century as a standardized form of the forward grain contracts that farmers historically used to hedge against the cyclical nature of supply and demand for grains.[174] During harvest time a glut of supply would develop, driving grain prices down to a point sometimes less than the costs of production and transportation.[175] As time passed, however, supplies would eventually dry up and the cost of grain would increase at a rapid rate.[176] Forward contracts were developed to guarantee delivery of grain in the future at a price specified at the time of contract.[177] This innovation greatly stabilized the price of

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[172] *Id.* (stating that during this period of time, the Philadelphia Stock Exchange was referred to as the "PBW StockExchange."PBW stood for "Philadelphia-Baltimore-Washington, a reference to a wide area of the East Coast which the Exchange focused in.).
[173] Exchange Act Release No. 11146, 5 SEC Docket 774.
[174] Jerry W. Markham, *The Commodity Exchange Monopoly—Reform Is Needed*, 48 WASH. & LEE L.REV. 977, 979 (1991).
[175] *Id.*
[176] *Id.*
[177] *Id.*

grain as it allowed buyers and sellers to lock in prices in anticipation of future uncertainty.[178]

In 1848 organized trading began at the Chicago Board of Trade ("CBOT"), which opened for business as a centralized location for the buying and selling of commodities forward contracts.[179]Over time, the forward contract terms and conditions became standardized, facilitating growth of the secondary market for the resale of these contracts.[180] Once contracts were standardized, they could also be offset—where a sale extinguishes any responsibility for performing on the prior purchase, or the reverse—and this fungibility of standardized contracts greatly increased the amount of trading that was possible.[181] By 1873, the CBOT had adopted regular hours for futures trading.[182] At this point, commodities trading grew so much in popularity that alternate markets allowing trading in off-hours were established. Often referred to as "bucket shops," they operated by allowing patrons to gamble on the change in the price of the CBOT contract.[183] The CBOT attempted to exert control over the market by declaring that any after-hours trades were unenforceable.[184]

Eventually, the debate between farmers, exchanges and bucket shop operators attracted the attention of state legislatures. Several states passed anti-bucket shop laws, which were then challenged in court. Ultimately, these cases were consolidated into the *Board of Trade v. Christie*, in which the Supreme Court both determined the base legality of futures contracts and ruled that the commodity exchanges had a proprietary right to the prices coming

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[178] *Id.*

[179] Jake Keaveny, *In Defense of Market Self-Regulation: An Analysis of the History of Futures Regulation and the Trend Toward Demutulalization*, 70 BROOK L.REV., 1419, 1422-23 (2004-05) (*citing* JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 4 (1987)).

[180] Markham, *supra* note 174, at 979.

[181] *Id.* at 979-80.

[182] Markham, *supra* note 5, at 872, citing JERRY W. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 4-5 (1987).

[183] Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States*, 1875-1905, 111 AM. HIST. REV. 307, 316 (2006) (describing "bucket shops" and how they allowed the general public to gamble on futures contracts).

[184] Markham, *supra* note 5, at 872.

from their pits.[185] Therefore, without access to the prices, the bucket shops could not operate legally. Additionally, according to Jerry Markham, a noted scholar of the financial industry, the CBOT's successful efforts to enlist states in declaring bucket shops illegal and limiting access to its price quotations to members formed the basis of the legal monopoly given to the futures exchanges in subsequent federal legislation.[186]

Dating back to the original existence of standardized futures contracts, a clearinghouse guaranteed the performance of all parties to the contract.[187] The existence of a clearinghouse permitted a party to go long or short a contract, offset the two and unlike forward contracts, avoid delivery if so desired.[188] As a result speculators were more likely to inject volume into the market, encouraging a liquid market to function without concerns over delivery.[189] Phillip McBride Johnson, a former CFTC Chairman, believes that, around 1925, the CBOT's clearinghouse, the Board of Trade Clearing Corporation ("BOTCC"), became the first "true mechanism for addressing counterparty credit risk through a centralized guarantee system."[190] Chairman Johnson cited a statement by the Secretary of Agriculture of the time, William Jardine, "[t]his comment indicates that the development of . . . clearing systems by the futures markets had the full support of the Federal government at that time," in support of the argument that the development of a modern, captive clearinghouse had the blessing of the United States government.[191]

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[185] Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 248-51 (1905) (explaining the legality of futures contracts and that the prices coming from exchanges are due protection).

[186] Markham, *supra* note 5, at 872-72, citing Jerry W. Markham, *"Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments*, 25 SETON HALL L. REV. 1, 12-14 (1994).

[187] Markham, *supra* note 5, at 871.

[188] Merrill Lynch, Pierce, Fenner& Smith, Inc. v. Curran, 456 U.S. 353, 358 (1982).

[189] Markham, *supra* note 5, at 871 n.34, citing *Merrill Lynch*, 456 U.S at 359.

[190] Phillip McBride Johnson, *In Defense of 'Captive' Clearing*, 3 CAPITAL MARKETS L.J. 417, 418 (2008).

[191] The actual quote reads: "This comment indicates that the development of central clearing systems." However it is important to note that central clearing systems in that context does not carry the same meaning it does today, but in this context means a central clearinghouse for the CBOT. *Id.* at 417-18.

Like the securities industry before the 1975 Amendments, each commodity futures exchange had its own captive clearinghouse, a model that has persisted for the majority of the futures industry until this day.[192] Vertical integration of both trading and clearing was well established by the time of the passage of federal regulatory legislation in the 1920s.

Regardless of the fact that the Supreme Court approved of the legality of futures contracts in *Christie*, persistent nation-wide concerns about price-manipulation of commodities energized a national populist movement to either abolish or regulate futures trading.[193] The futures industry simply could not shake the popular belief that futures contracts amounted to little more than gambling. However, President Hoover believed in the futures markets, stating that the "CBOT is the "most economical and efficient agency of the marketing of foodstuffs anywhere in the world."[194] This debate culminated in the passing of the Futures Trading Act of 1921 ("FTA").

The FTA, passed on August 21, 1921, empowered the Secretary of Agriculture to designate exchanges meeting certain requirements as contract markets in grain futures.[195] Contracts not executed on a contract market were subject to a punitive twenty-cent per bushel tax.[196] The FTA acknowledged the legitimate purpose of futures contracts for the shifting of risk and the important role of speculators injecting liquidity into these markets.[197] The FTA also sought to instill confidence in markets by regulating price manipulation and keeping futures trading on the contract markets.[198] Much like the Exchange Act would 13 years later, the FTA exerted power over the exchanges by requiring them to meet certain criteria to

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[192] *Id*. at 417 (describing a Treasury invitation for comments regarding the possible divorcing of futures clearing organizations from particular futures exchanges).

[193] William L. Stein, *The Exchange Trading Requirement of the Commodity Exchange Act*, 41 VAND. L. REV. 473, 477 (1988).

[194] Keaveny, *supra* note 179, at 1424 (quoting *Hearing on Futures Trading Before the House Comm. On Agric.*, 66th Cong., 583 (1921)).

[195] Futures Trading Act of 1921, Pub. L. No. 67-66, 42 Stat. 187, *invalidated* by Hill v. Wallace, 259 U.S. 44 (1922)(declaring that the Secretary of Agriculture is empowered to designate exchanges as contract markets in grain futures).

[196] *Id.* (declaring a twenty cent per bushel tax on contracts not executed).

[197] Stein, *supra* note 193, at 477.

[198] *Id.*

qualify as contract markets. However, the next year, in May of 1922, the Supreme Court in *Hill v. Wallace* struck down the FTA as an unconstitutional use of the taxing power.[199] The Court believed that instituting a tax with the primary purpose of compelling the boards of trade to comply with federal legislation was an improper use of the taxing power.[200]

In response, Congress passed a similar, but not identical bill, the Grain Futures Act of 1922 ("GF Act"), four months later.[201] The GF Act, based on the constitutional underpinning of the Constitution's "Commerce Clause," asserted that market volatility burdened interstate commerce, thus banning the trading of futures contracts on any board of trade not licensed as a contract market.[202] Like the FTA, the GF Act required a board of trade to fulfill certain requirements to be qualified as a contract market.[203] These requirements formalized

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[199] Hill v. Wallace, 259 U.S. 44, 72 (1922) (granting an injunction preventing the taxing portions of the FTA from being enforced).
[200] *Id*. at 66-67.
[201] Grain Futures Act of 1922, Pub. L. No. 67-331, 42Stat. 998 (codified as amended at 7 U.S.C. §§1-25 (1925-1926)).
[202] *See* Keaveny, *supra* note 179, at 1426 (describing how Congress relied on the Commerce Clause in passing the Grain Futures Act and the influence of market volatility on contract bans).
[203] Requirements for designation as a contract market under the GF Act:

a. The keeping of a record with prescribed details of every transaction of cash and future sales of grain of the Board or its member in permanent form for three years, open to inspection of representatives of the Departments of Agriculture and of Justice.
b. The prevention of the dissemination by the Board or any member of misleading prices.
c. The prevention of manipulation of prices or the cornering of grain by the dealers or operators on the Board.
d. The adoption of a rule permitting the admission as members of authorized representatives of lawfully formed co-operative associations of producers having adequate responsibility engaged in the cash grain business, complying with and agreeing to comply with, the rules of the Board applicable to other members, provided that no rule shall prevent the return to its members on a pro rata patronage basis the money collected by such association in the business, less expenses.

US Futures Trading and Regulation Before the Creation of the CFTC, CFTC.gov, http://www.cftc.gov/About/HistoryoftheCFTC/history_pre

the exchanges' roles as self-regulators by requiring them to have measures and standards in place to prevent price manipulation. As part of that effort, exchanges, for the first time, were obligated to require the clearing members of each exchange to provide daily reports on customers.[204] The GF Act created the Grain Futures Commission (a predecessor of the Commodity Futures Trading Commission)—composed of the Secretary of Agriculture, the Secretary of the Treasury and the Attorney General—to license contract markets. It also created the Grain Futures Administration ("GFA") as an agency in the U.S. Department of Agriculture to administer the GF Act. Unlike its predecessor, the GF Act was upheld as constitutional the next year in *Chicago Board of Trade v. Olsen*.[205]

The words "clear" and "clearing" do not appear at all in the original Grain Futures Act in 1921.[206] The GF Act, while requiring that contracts be executed on a board of trade, did not refer to clearing.

Ultimately, the GF Act proved ineffective and was discredited by a variety of trading scandals and a ruling of the Supreme Court that significantly impaired the Grain Futures Commission's ability to pursue punitive actions against market manipulators.[207] Furthermore, the Great Depression exacerbated popular concern over securities and commodities markets. As the wave of sentiment for reform grew, the Securities Act in 1933, the Exchange Act in 1934 and lastly the Commodity Exchange Act ("CEA") in 1936 were passed into law.[208] These three acts, all passed during the same era, created a regulatory regime for futures and securities that exists to this day. The banking committees of Congress formulated the legislation and maintained responsibility for

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CFTC.html (last visited Nov. 13, 2010) [hereinafter Futures Trading History].

[204] *See* Keaveny, *supra* note 179, at 1427 (discussing the GFA's "new role" and its requirement that "the clearing members of each exchange to provide daily reports that include the market positions of its customers").

[205] 262 U.S. 1, 42 (1923).

[206] *See generally* Grain Futures Act.

[207] Markahm, *supra* note 174, at 981 ("The Grain Futures Act proved to be ineffective in preventing market abuses."). *See* Wallace v. Cutten, 259 U.S. 229, 237 (1935) (finding that cannot use GF Act to punish action that "on the face of the statute, is merely to be prevented").

[208] Commodity Exchange Act of 1936, Pub. L. No. 74-675, 49 Stat. 1491 (codified as amended at 7 U.S.C § 1-25 (2000)).

regulating securities[209] while the agriculture committees did so for commodity futures.[210]

B. The Commodity Exchange Act ("CEA")

The CEA kept much of the earlier GF Act as a starting point and, as a result, the statute continued to vary greatly from securities legislation of the time. One important distinction came in the regulatory bodies responsible for oversight of the separate industries. The SEC, created by the Exchange Act, existed as an independent federal agency.[211] The SEC has five independent commissioners who, once appointed by the President, serve staggered five-year terms, ostensibly free from political interference.[212]The Grain Futures Commission, renamed the Commodity Exchange Commission, was still composed of the Treasury and Agriculture Secretaries and the Attorney General, with the day-to-day operations being handled by the Commodity Exchange Authority ("the Authority"), which was an agency within the Department of Agriculture.[213] Consequently, commodity regulation was much more susceptible to political pressure, and unlike the SEC, its principal regulators had a variety of other responsibilities.[214]

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[209] The predecessors to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services wrote the securities legislation while the predecessors to the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agri-culture wrote the Commodity Exchange Act.

[210] At the time these divisions may have appeared logical when considering the agricultural basis of futures contracts, but especially when viewed in light of the later development of financial derivatives, the separation has less purpose today. When major reforms were made to the Exchange Act (1975 Amendments) empowering the SEC to pursue the formation of a national clearing system, a similar major reform bill, the Commodity Future Trading Commission Act of 1974, did not contain a like provision, at least partly because it was written by a different committee.*See generally* Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified at 7 U.S.C §§ 4-22 (1940)).

[211] Markham, *supra* note 174, at 982.

[212] Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 § 201 (codified in 7 U.S.C §§ 4-22 (1940) (establishing the board's composition).

[213] Commodity Exchange Act of 1936, Pub. L. No. 74-675, 49 Stat. 1491, § 3.

[214] *See* Markham, *supra* note 174, at 982.

The Exchange Act took the dual steps of prohibiting specific practices and empowering the SEC to adopt its own rules, defining and prohibiting fraud and manipulation as it saw fit. In contrast, while the CEA broadly prohibited fraud and manipulation, it did not attempt to define these terms, leaving these prohibitions largely powerless.[215] Furthermore, while the CEA prohibited some specific practices, it failed to define them precisely, leaving the statutory power of the Commission subject to interpretation, thus making it more difficult for the CEA to affect change at an industry-wide level.[216]

The CEA expanded the power of the earlier GF Act in several respects. The Authority was responsible for several additional commodities and was empowered, for the first time, to set speculative limits.[217] Additionally, one important regulation required brokerage firms to register as futures commission merchants ("FCMs") and imposed upon them the requirement of segregating customer funds from their own monies in trust accounts.[218] Still, there were significant problems with the way the CEA was structured. The CEA did not regulate individuals trading for their own accounts, and speculative limits did not apply to commercial traders—parties generally responsible for a large portion of speculative trading.[219]

The CEA statutorily expanded the role of clearinghouses but did not directly provide for regulation of the clearinghouses themselves.[220] The first time clearing is mentioned in Section 4b, the language of CEA simply assumes that clearing occurs with respect to

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[215] *Id.* at 982-83.

[216] *Id.* (comparing the terms "wash sales," "fictitious trades" and "accommodation trading") (citing 7 U.S.C. § 6 (1988)).

[217] Futures Trading History, *supra* note 203 ("The Commodity Exchange Act replaces the Grain Futures Act and extends Federal regulation to a list of enumerated commodities that includes cotton, rice, mill feeds, butter, eggs, and Irish potatoes, as well as grains."); s*ee* Commodity Exchange Act, *supra* note 213, § 4(a).

[218] Commodity Exchange Act § 4d(1)-(2) (requiring merchants to register and create separate accounts).

[219] Markham, *supra* note 174, at 983 (explaining that the CEA did not regulate individuals and did not apply limits to commercial traders).

[220] *See generally* Commodity Exchange Act.

futures trades.[221] The law requires such orders to be executed "on the floor of the exchange . . . at public outcry . . . and shall be duly reported, recorded and *cleared* in the same manner as other orders executed on such exchange."[222]

Notwithstanding the absence of a specific regulatory scheme for the clearing of futures trading, the CEA formally recognized the role that clearinghouses played. Section 4d of the CEA required FCMs to segregate margin accounts[223] and Section 6a banned from trading any association or corporation which, "shall fail to meet its obligations with any established clearing house or clearing agency of any contract market . . . ."[224] Thus, the CEA established legal obligations of market participants to clearinghouses. The requirement of segregating funds, a traditional fiduciary duty in many contexts, also cemented the view of clearinghouses as fiduciaries and as an essential component of customer protection underpinning the purpose of the CEA as a whole. The CEA also improved institutional credibility of clearinghouses by restricting clearinghouse access to corporations or associations in good standing and not in arrears.

Section 6a also declares that no contract market could exclude an association or corporation that had the requisite certifications and satisfied the various capital requirements.[225] By extension, since a trade on a contract market was expected to be cleared, a clearinghouse could not refuse any corporation or association meeting the requirements. In essence, clearinghouses had to be used as a necessary part of futures trading, and given this status, they had to be accessible to eligible parties in a non-discriminatory manner.

As commodities trading expanded, the CEA continually needed to be amended to expand the power of the Authority to regulate each new commodity futures contract. Enacting a broad grant of power giving the CEA blanket authority over commodities and futures contracts would have been entirely more efficient but was not the case when the CEA was adopted. While the power and

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[221] *See* Commodity Exchange Act § 4b (providing that exchanges will be "cleared in the same manner as other orders executed on such an exchange").
[222] *Id.* (emphasis added).
[223] *Id.* § 4d.
[224] *Id.* § 6a.
[225] *Id.* (declaring that no contract market could exclude any association or corporation "having adequate financial responsibility").

regulatory efforts of the government remained much the same over this period of time, the body administering it changed frequently.[226]

Over the next four decades, Congress passed several smaller amendments to the CEA that gradually increased the Authority's regulatory powers.[227] The Authority gained the ability to issue subpoenas, publish large trader reports, set fees for FCMs and other registrants and eventually publish monthly reports on trading activities.[228] In 1968, in the first major derivatives legislation passed since the CEA in 1936, the CEA was amended to give the Authority the ability to disapprove rules filed by a board of trade and the authority to suspend the contract market designation of any board of trade which failed to enforce its own rules.[229] Consequently, courts developed a body of law that supported the exchanges' power to enforce their rules to assure the compliance of members with defined standards of conduct.[230] Ultimately, however, the expansion of regulatory powers over exchange members failed to assuage the public's concerns about speculators inflating prices in the futures markets.

The 1968 amendments to the CEA for the first time added rules directly governing the conduct of clearing agencies. Section 6 of the 1968 amendments amended Section 4d of the CEA to include a prohibition against clearing agencies (among other parties) from "hold(ing), dispos(ing) of, or us(ing) any [sums deposited in a segregated account such as] money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission

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[226] In 1936, the Commodity Exchange Administration was formed within the USDA. In 1942, the Commodity Exchange Administration was merged with other agencies to be known as the Agricultural Marketing Administration ("AMA") and was re-labeled the Commodity Exchange Branch of the AMA. By the end of the year, the AMA was merged into the Food Distribution Branch, and the Commodity Exchange Branch became the Compliance Branch. After a few more wartime reorganizations, the authority settled with the Commodity Exchange Authority, an agency of the USDA, where it would rest until 1974. *See* Futures Trading History, *supra* note 203.

[227] *Id.* (documenting amendments to the CEA prior to 1974).

[228] *Id.*

[229] Act of Feb. 19, 1968, Pub. L. 90-258, 82 Stat. 26-34 (codified as 7 U.S.C. §9(a) (2000)) (allowing the Commission to not "promulgate rules" under certain conditions).

[230] *See* Keaveny, *supra* note 179, at 1431.

merchant . . . ."[231] While this regulation did not single out clearinghouses, it was the first direct regulation of them. Notwithstanding the foregoing statutory amendment covering the conduct of clearinghouses, Congress did not use the opportunity of amending the CEA to adopt a plenary scheme to regulate the business of clearinghouses. However, Congress was concurrently highly focused on clearinghouse oversight in the securities markets because of the havoc caused by the Paperwork Crisis.[232] In the near-term aftermath of the 1968 CEA amendments, public criticism of the futures markets continued. Market prices for grains and soybeans reached a record level in 1973, and critics blamed excessive speculation for the sharp run-up.[233] Advocates of an independent agency to regulate the futures industry pointed to the inherent conflict of the Department of Agriculture in maintaining responsibility for both market regulation and the income of farmers. Yet another reason cited to justify amending the CEA was the belief that the CBOT would soon offer futures contracts on financial products, which indeed soon came to pass.[234]

C. The Commodity Futures Trading Commission Act ("CFTC Act")

Responding to the situation, in 1974 Congress passed the Commodity Futures Trading Commission Act ("CFTC Act"), which replaced the Authority with the Commodity Futures Trading Commission ("CFTC").[235] The CFTC was an independent regulatory agency for the futures industry, a more SEC-like organization. The CFTC consisted of five independent commissioners serving staggered five-year terms with exclusive jurisdiction over its bailiwick, the trading of futures and options on all commodities.[236] No longer did Congress have to continually update the CEA as new

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[231] Act of Feb. 19, 1968, *supra* note 229, § 6(b).
[232] Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 360 (2003).
[233] Futures Trading History, *supra* note 203.
[234] House Comm'n On Agriculture, Commodity Futures Trading Commission Act of 1974, H.R. Rep. No 975 93d Cong., 2d Sess. 41 (1974).
[235] Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 § 201 (codified in 7 U.S.C §§ 4-22 (1940)) (granting jurisdiction to the Commodity Futures Trading Commission).
[236] *Id.*

contracts became popular on the exchanges. All contract markets had to submit rules regulating both futures contracts and trading requirements for prior approval.[237] The CFTC Act also authorized contract markets to discipline their members for rule violations, subject to the oversight and approval of the CFTC.[238] The goal of the CFTC Act was to greatly increase the oversight and regulation of the futures industry and give both the regulators and the exchanges the ability to influence the conduct of market participants. For example, the CFTC Act granted the CFTC the ability to intervene in the trading of contract markets when it believed circumstances dictated such intervention was necessary to prevent an emergency such as price manipulation.[239]

The passage of the CFTC Act, however, did not address, in any detail, the market structure or regulation of the clearinghouse part of the futures business. In contrast, at the same time the CFTC Act passed, the SEC and the banking committees in Congress were publically advocating for the National Market System that was to become the basis of the 1975 Amendments. In the two separate agriculture committees responsible for overseeing the futures industry, the concept of a national market system was never mentioned.[240] In the Joint Explanatory Statement on the CFTC Act, clearing is discussed in the context of a new requirement for clearinghouses to both maintain and deliver daily records of every trade made on an exchange; a requirement necessary for the CFTC to properly enforce the CEA.[241]

In contrast to the Congressional work in recasting securities industry regulation being done concurrently with the adoption of the CFTC Act, the new futures statute did not create a plenary scheme of regulating clearinghouses or the ownership of the clearing function by the associated trading business—an ownership structure that largely precluded multiple exchanges from offering fungible products and competing for trading volume. The Conference Committee mentions clearing two other times in its CFTC Act. The first is in the context of prohibiting CFTC commissioners and employees from accepting employment or compensation from "any

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[237] *Id.* § 210.

[238] *Id.* § 301(8).

[239] *Id.* § 215.

[240] *See generally* H.R. REP. No. 93-1383 (1974).

[241] H.R. REP. NO. 93-1383 at 42 (1974) (discussing the daily trading report requirement).

person, exchange, or clearinghouse subject to regulation by the Commission".[242] The second mention appears in Section 417 of the CFTC Act, which calls for the CFTC to submit a report discussing the insurance of "owners of commodity futures accounts and persons handling or clearing trades" in the case of bankruptcy or failure of an FCM.[243]

Unlike the 1975 Amendments to the Exchange Act passed a year later, there is little discussion in the CFTC Act of clearing and no discussion of the concept of a national clearing system.[244] The NSCC simply did not recognize the important and distinct role clearinghouses play in the futures industry, nor did it make any effort to synchronize the market structure of vertical integration of trading and clearing functions in the futures markets with the newly created structures in the securities markets. Most surprisingly, the issues that were of such concern in the banking committees amending the Exchange Act went unmentioned by the agriculture committees amending the CEA.

Instead, the CFTC accepted that, as a result of the close relationship between the contract markets and their captive clearinghouses, "any clearing organization would be a creature of the exchange(s) that it served."[245] In 1976, the CFTC, responding to a claim by the BOTCC that it was a separate corporate entity from its parent contract market, stated that it saw "little significance in [that] statement, particularly in light of its view of the public interest test contained in section 5(g)."[246] The CFTC believed that, as a result of the integration in the trading and clearing functions and the duty of contract markets to insure the integrity of their contracts, the contract markets themselves were responsible for their clearing. Since the contract markets were regulated by the CFTC under the CEA, separate regulations overseeing clearing were not on the CFTC's list of priorities.[247]

Soon after passage of the CFTC Act, the role of the futures industry in the finance world greatly changed with the introduction of futures on financial products, including indexes on securities. The

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[242] Commodity Futures Trading Commission Act § 101, *supra* note 212.
[243] *Id.* § 417.
[244] *See generally id.*
[245] Johnson, *supra* note 190, at 421.
[246] *Id.* (quoting 41 F.R. 40091 (17 September 1976), *reprinted in* [1975-77 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,208, at 21,140).
[247] *See id.*

CFTC approved the first certificate futures contract, a contract on Government National Mortgage Association ("Ginnie Mae") pass-through mortgage-backed certificates, on September 11, 1975.[248] Two months later, the Chicago Mercantile Exchange ("CME"), another major futures exchange, offered, with CFTC approval, the first money market futures contract—a futures contract on 90-day Treasury bills.[249] Over the next several years, as some of these contracts proved highly successful, several more types of contracts were introduced, including those on longer term U.S. government debt and the contract that was to become the most successful, the Eurodollar futures contract series.[250] Today the Eurodollar futures contract is widely recognized as the most traded money market contract in the world.[251] By 1996, financial futures accounted for over half of the total volume of exchange-traded futures contracts.[252]

The approval and subsequent trading of financial futures resulted in a jurisdictional dispute between the CFTC and the SEC that lasted several years.[253] The SEC asserted that the futures on the Ginnie Mae mortgage-backed certificates were securities, and thus, the SEC had responsibility. When the SEC approved the application of the CBOE to trade options on the same Ginnie Mae mortgage-backed certificates, the CBOT sued, claiming that the CFTC held authority over the mortgage-backed certificates.[254] Discussions between the two regulatory agencies resulted in the "Shad-Johnson Accord," which delineated the extent of the two agencies' respective authority.[255] The accord gave the CFTC jurisdiction over futures on

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[248] *History of the CFTC in the 1970s*, CFTC.gov, http://www.cftc.gov/About/HistoryoftheCFTC/history_1970s.html (last visited Oct. 8, 2010) (describing the first financial futures contract).
[249] *Id. See* Galen Burghardt, THE EURODOLLAR FUTURES AND OPTIONS HANDBOOK 7-8 (2003) (recounting the first money market futures contract).
[250] Burghardt, *supra* note 249, at 7-8.
[251] *See id*. at 15 (comparing Eurodollar futures to CDs and the Three-Month Treasury Bill).
[252] Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 12 (1996).
[253] David B. Esau, *Joint Regulation of Single Stock Futures: Cause of Result of Regulatory Arbitrage and Interagency Turf Wars?*, 51 CATH. U. L. REV. 917, 921 (2001-2002) (recounting the "jurisdictional dispute" between the SEC and CFTC).
[254] *Id.*
[255] *See generally* Shad-Johnson Jurisdictional Accord of 1982, Pub. L. No. 97-303, 96 Stat. 1409 (codified in the Futures Trading Act of 1982, Pub. L.

broad-based stock indexes and individual government securities, the SEC jurisdiction over security-based options, and prohibited the trading of futures on individual stocks and narrow-based stocks indexes.[256] Futures contracts on broad-based stock indexes traded on futures exchanges created, for the first time, a direct nexus between the two industries.

D. The Commodity Futures Modernization Act ("CFMA")

In 1999, at the direction of agriculture committees in Congress, the President's Working Group ("PWG") submitted a report entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange Act ("OTC Report")."[257] The OTC Report, requested by Congress to analyze and develop policy relating to the OTC derivatives market, was the first major step towards what would become the Commodity Futures Modernization Act of 2000 ("CFMA").[258]

The OTC Report's main recommendation was to exclude the trading of financial derivatives by certain eligible parties from the CEA. The report indicated that this would remove "legal uncertainty" and "unnecessary regulatory burdens" from OTC markets.[259] As part of the effort to "promote innovation, competition, efficiency and transparency in OTC derivatives markets, to reduce systematic risk and to allow the United States to maintain leadership in these rapidly developing markets," the PWG analyzed the clearing of

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No. 97-444 96 Stat. 2294 and the Securities Act of 1982, Pub. L. 97-303, 96 Stat. 1409) (amending the CEA and the Exchange Act).

[256] *See generally id.* (clarifying jurisdictional questions and adding prohibitions on trading). The Shad-Johnson Agreement was named after the chairman of the two agencies who negotiated the agreement.

[257] The President's Working Group at this time consisted of Lawrence Summers, Secretary of the Treasury; Alan Greenspan, Chairman of the Federal Reserve; William Rainer, Chairman of the CFTC; and Arthur Levitt, Chairman of the CFTC. Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group (Nov. 9, 1999), *available at* http://www.ustreas.gov/press/releases/reports/otcact.pdf [herein President's Working Group Report].

[258] Commodity Futures Modernization Act of 2000, Pub. L. 106-554, 114 Stat. 2763 (2000).

[259] President's Working Group Report, *supra* note 257, at 1.

derivatives.[260] Noting that the CEA did not explicitly provide for direct oversight of clearing systems by the CFTC, the PWG believed that "Congressional action [was] necessary to establish appropriate policy guidance for the establishment and oversight of clearing systems for OTC derivatives."[261] While acknowledging that the CFTC had always exercised its regulatory power over clearinghouses via its oversight of their parent exchanges, the PWG recommended that Congress enact legislation that would provide a "clear basis for the regulation of clearing systems" by the CFTC.[262] The PWG made seven recommendations: 1) clearing organizations clearing futures, commodity options, and options on futures should clear non-security related OTC derivatives subject to CFTC regulation; 2) securities clearing organizations should also clear OTC derivatives other than certain non-financial products; 3) the CFTC should have authority to regulate the clearing of OTC derivatives other than certain non-financial commodities; 4) all clearing systems for OTC derivatives should organize subject to some jurisdiction; 5) the CFTC should mandate that a clearing system would not become subject to another regulator as a result of clearing OTC derivatives; 6) the CFTC should establish a trading system which clears OTC products which does not submit, by itself, that trading system to the CEA; and 7) should allow clearing through foreign clearing systems under approved regulation.[263]

The next major step in creating the CFMA was the release of a "New Regulatory Framework ("Framework")," a CFTC staff report to Congress on February 22, 2000, that recommended significant changes to the CEA.[264] The framework recommends promulgating many of the proposals of the OTC Report and notes that all of the recommendations could be implemented under the CEA using its administrative authority.[265] The Framework sought to create a "flexible structure that [would replace] the current one-size-fits all

[260] *Id.* at 15.
[261] *Id.* at 1.
[262] *Id.* at 20.
[263] *Id.* at 20-21.
[264] Report of the Commodity Futures Trading Commission Staff Task Force, A New Regulatory Framework (Feb. 2000), *available at* http://www.cftc.gov/files/opa/oparegulatoryframework.pdf.
[265] *Id.*, Executive Summary, at i.

style of regulation."[266] It recommended establishing three separate types of trading facilities subject to different levels of regulation; differentiated by the type of products traded on them and the sophistication of the market participants. The Framework also aspired to replace the rules-based structure of the existing regulatory structure and replace them with flexible "core principles."[267]

The Framework made three main recommendations in support of the goal of encouraging competition and flexibility in the clearing of derivatives: 1) A clearinghouse or clearing agency should be able to operate independently of an execution facility; 2) The CFTC should explore schemes under which a clearinghouse regulated by another approved regulatory body could clear transactions for some trading facilities; 3) Clearing organizations should henceforth be expected to follow a set of governing core principles.[268]

The PWG's recommendations directly resulted from the OTC Report's findings that a "clear basis" for the regulation of clearing by the CFTC should be established for the first time. The Core Principles outlined in the Framework, later added to the CEA after some revision by the CFMA, covered a wide range of topics, including competition, risk management and procedures.[269] The core principles gave enormous discretion to the exchanges to devise their contracts and practices while placing difficult time limits on the CFTC to object.[270] The CFMA also contained a discreet section on the registration and regulation of clearinghouses, including a bar against anticompetitive rules and practices.[271]

On November 22, 2000, the CFTC approved a set of final rules that promulgated the majority of the Framework, while noting in a press release that the new regulations in no way diminished the need for prompt action on the CFMA which was under debate in

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[266] *Id.*, Letter from William J. Rainer, Chairman of the Commodity Futures Trading Commission, (Feb. 22, 2002) at 1.
[267] *Id.*
[268] *Id.* at 22.
[269] *Id.* at 23-26.
[270] Provisions Common to Registered Entities, 17 C.F.R. § 40.6 (c)(2)-(c)(3) (2008), LEXSTAT 17 CFR 40.6.
[271] Commodity Exchange Act, ch. 545, § 5b, 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7a-1 (2006)).

Congress at the time.[272] The CFTC championed the replacement of the "one-size-fits-all" regulations with the "broad, flexible 'Core Principles'."[273]

One month later, President Clinton signed the CFMA into law. The statute overhauled much of the CEA by providing legal certainty to OTC markets by exempting many of them from the jurisdiction of the CFTC, and set out to provide "greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations."[274] Simultaneously, the CFTC withdrew most of the New Regulatory Framework in light of the superseding legislation covering the reforms.[275]

The CFMA enacted much of the clearing framework described in the OTC Report and Framework in the form of the new Section 5b of the CEA.[276] The CFMA officially mandated that contracts traded on Designated Contract Markets ("DCM") must clear through a derivatives clearing organization ("DCO"), with the exception of security futures products cleared on a registered securities clearinghouse. The newly enacted legislation, much as other similar legislation, uses a registration requirement as the mechanism through which the CFTC gains regulatory power over the clearing organizations.[277] Section 5b(a) states that a DCO may not act

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[272] CFTC Approves Rules Implementing New Regulatory Framework, C.F.T.C. Release #4475-00 (November 22, 2000). *See also* A New Regulatory Framework for Clearing Organizations, 65 Fed. Reg. 78020 (December 13, 2000) (to be codified at 17 C.F.R. pt. 39); A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing OrganizationsPart II, 65 Fed.Reg. 77962 (December 13, 2000) (to be codified at 17 C.F.R pts. 1, 5, 15, 36, 37, 38, 100, 170 and 180).

[273] CFTC Approves Rules Implementing New Regulatory Framework, *supra* note 272.

[274] Commodity Futures Modernization Act of 2000, *supra*note258.

[275] A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations; Rules Relating to Intermediaries of Commodity Interest Transactions; A New Regulatory Framework for Clearing Organizations; Exemption for Bilateral Transactions, 65 Fed. Reg. 82272 (Dec. 28, 2000) (to be codified at 17 C.F.R pts. 1, et al.).

[276] Commodity Exchange Act, ch. 545, § 5b, 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7a-1 (2006)).

[277] Commodity Exchange Act, ch. 545, § 5b(a), 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7a-1(a) (2006)).

as a DCO (as defined by the CEA) for futures contracts, commodity options and options of futures contracts unless registered with the CFTC.[278]

The CFMA defined a DCO as follows:

> The term "derivatives clearing organization" means a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, with respect to an agreement, contract, or transaction—
> (i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties;
> (ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; or
> (iii) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants.[279]

There are exceptions for certain exempted or excluded products—mostly OTC products—and for securities futures products to be cleared by a clearing agency registered under the Exchange Act. Single stock futures, formerly illegal before the passage of the CFMA, could be cleared by either a DCO or a registered clearinghouse under the Exchange Act.[280] The CFMA included a clause to "grandfather" existing clearing organizations from a new registration requirement provided they had cleared for a DCM prior to the enactment of the CFMA.[281] This clause ensured that the clearing

[278] Commodity Exchange Act § 1a, 7 U.S.C. § 1a (2006).
[279] *Id*.
[280] *See* 7 U.S.C. § 7a-1(a)(2) (2006).
[281] Commodity Exchange Act, ch. 545, § 5b(d), 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7a-1(d) (2006)).

organizations already in existence would immediately be governed by the CFMA.

The CFMA also introduced the above-mentioned principle-based regulation. For DCOs, the CFMA introduced fourteen core principles with which a DCO had to demonstrate compliance to achieve and maintain registration with the CFTC.[282] By contrast, DCMs had eighteen core principles and the newly created derivatives trading execution facility ("DTEF") had nine.[283] The DCO Core Principles discussed, among others, the following subjects: Financial Resources; Participant and Product Eligibility; Risk Management; Settlement Procedures; Treatment of Funds; Default Rules and Procedures; Rule Enforcement; System Safeguards; Reporting; Recordkeeping; Public Information; Information Sharing; and Antitrust Considerations.[284]

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[282] Commodity Exchange Act, ch. 545, § 5b(c)(2), 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7a-1(c)(2) (2006)).

[283] Commodity Exchange Act, ch. 545, § 5b(d), 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7(d) (2006)); Commodity Exchange Act, ch. 545, §5 a(d), 49 Stat. 1491 (1936) (codified at 7 U.S.C. § 7a(d) (2006))

[284] Commodity Exchange Act, ch. 545, § 5b(d), *supra* note 283. The CFTC website summarizes Core Principles B-N as follows:

1. (B) Adequate financial, operational, and managerial resources.
2. (C) Appropriate standards for participant and product eligibility.
3. (D) Adequate and appropriate risk management capabilities.
4. (E) Ability to complete settlements on a timely basis under varying circumstances.
5. (F) Standards and procedures to protect member and participant funds.
6. (G) Efficient and fair default rules and procedures.
7. (H) Adequate rule enforcement and dispute resolution procedures.
8. (I) Adequate and appropriate systems safeguards, emergency procedures, and plan for disaster recovery.
9. (J) Obligation to provide necessary reports to allow the CFTC to oversee clearinghouse activities.
10. (K) Maintenance of all business records for five years in a form acceptable to the CFTC.
11. (L) Publication of clearinghouse rules and operating procedures.

The CFTC published its proposed implementation of the CFMA's section on clearing in the "New Regulatory Framework for Clearing Organizations" on May 14, 2001, and after a comment period, made the new clearing rules final on August 29, 2001.[285]

V. The Impact of the Regulatory Schemes for Clearing on Market Competition

A. Securities

In the securities markets, as discussed above, central clearing came about in response to the 1975 Amendments. While central clearing had an immediate effect on the national clearing system, the goal of bringing about true competition between markets did not occur as quickly. The writers of the 1975 Amendments hoped to create a national market system where large institutional investors, wealthy individuals and small retail investors would participate equally in the market. At that time concern over the growing role of large investors hung over the industry and the SEC hoped to prevent the existence of different markets for the different tiers of investors with different execution costs and prices. One SEC report on a possible future structure of a national market system stated that "[i]nvestors should not pay more than the lowest price at which someone is willing to sell nor sell for less than the highest price a

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12. (M) Participation in appropriate domestic and international information-sharing agreements.
13. (N) Avoidance of actions that are unreasonable restraints of trade or that impose anti-competitive burdens on trading."

(capital letters added) Clearing Organizations—CFTC, http://www.cftc.gov/industryoversight/clearingorganizations/index.htm (last visited October 28, 2010).

[285] A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, Proposed Rule, 66 Fed. Reg. 14262 (Mar. 9, 2001) (to be codified as 17 C.F.R. pts. 1, 5, 15, 36, 37, 38, 40, 41, 100, 166, 170, 180); A New Regulatory Framework for Clearing Organizations, Final Rule, 66 Fed.Reg. 45604 (Aug. 29, 2001) (to be codified as 17 C.F.C. pt 39).

buyer is prepared to offer."[286] In the 1975 Amendments, findings regarding the national market system were articulated as follows:

> (C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—
>
> (i) economically efficient execution of securities transactions;
>
> (ii) *fair competition among brokers and dealers, among exchange markets and between exchange markets and markets other than exchange markets*;
>
> (iii) the availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities;
>
> (iv) *the practicability of brokers executing investors' orders in the best market*; and
>
> (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.
>
> (D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and investors, facilitate the offsetting of investors' orders and contribute to best execution of such orders.[287]

While the 1975 Amendments had admirable goals, it took over twenty years to see true competition among exchanges. The intermarket linkages created by the 1975 Amendments did not immediately have their intended effects. While the new "Consolidated Quotation System," more commonly known as the Consolidated Tape, widely disseminated last sale information for equities, there was no obligation for a broker or dealer other than the

[286] David A. Lipton, *Best Execution: The National Market System's Missing Ingredient*, 57 NOTRE DAME L. REV. 499, 451 (1982) (*quoting* SEC Future Structure of the Securities Markets, 37 Fed. Reg. 5286, 5287 (1972)).
[287] 15 U.S.C. § 78k-1(a) (2006) (emphasis added).

one posting the best bid or offer to use those quotes or go to the best market.[288] Another system, the Intermarket Trading System (ITS), allowed a broker to execute an order in the best market from any exchange.[289] The Consolidated Tape and ITS sought to create a truly national market system where brokers learned where the best price in the market was and either changed their bid-ask to follow suit or simply executed their trades on that market.[290] However, when NYSE, Amex and five regional exchanges in 1978 created ITS, it was a voluntary system.[291] As a result, brokers had no obligation to use the best price when executing their orders and often specialists on regional exchanges simply quoted at NYSE prices because they did not want to compete with the NYSE market makers.[292] Consequently this system had the unintended effect of reinforcing the dominance of the NYSE.

Over the next three decades, four significant developments brought about the current composition of the equities markets. The first was the growing role of technology in the finance world. Since the development of the 1975 Amendments, both dealers and markets have moved away from trading floors to electronic markets. This is best illustrated by the growth of Nasdaq, which started as an electronic quotations system for OTC dealers in 1971.[293] In 1980 the system began showing the best bid and offer, but a trader still needed to make a phone call to make the deal. Four years later, Nasdaq created an electronic matching system and small order automatic execution system. While large trades were still handled over the phones, increased ease of use due to the new technology caused the market to quickly grow and, by 1992, Nasdaq accounted for 42% of

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[288] Temporary Order, Exchange Act Release No. 34-15009, 34,851, 34,852 (July 28,1978). *See also* Exchange Act Release No. 16518, 19 SEC Docket 367 (Jan. 22, 1980).
[289] Temporary Order, Exchange Act Release No. 34-14661, 43 Fed. Reg. 17,419, at 17,421 (Apr. 24, 1978).
[290] Lipton, *supra* note 286, at 488.
[291] *Id.*
[292] Daniel J. Harty& Jerry W. Markham, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. CORP. L. 855, 879 (2008).
[293] NASDAQ.COM FAQ, http://www.nasdaq.com/help/helpfaq.stm (last visited Oct 20, 2010).

total volume share on all U.S. equity markets,[294] beating out the NYSE for volume of annual shares traded.

Mindful of its mandate to provide the best price to all investors, in 1996 the SEC adopted the Order Handling Rules, the second major catalyst for market competition. The SEC promulgated the rules in reaction to the growing popularity of electronic communications networks ("ECNs").[295] ECNs started as alternative trading systems that provided after-hours trading to large investors electronically.[296] Although they originally were not a part of the national market system created in 1975, as ECNs became more efficient and popular, ECN spreads would occasionally become narrower than the public markets.[297] The Order Handling Rules required a market maker or specialist to either report quotes made on ECNs to an exchange or the NASD or otherwise trade on an ECN that provided its quotes to an exchange or the NASD.[298] Because the Order Handling rules did not regulate ECNs directly nor require all participants in the market to follow the reporting rules, the SEC promulgated Regulation ATS in 1998.[299]

Regulation ATS, the third spur to market competition, aimed to "establish a regulatory framework for alternative trading systems and to more fully integrate them into the national market system."[300] Under this regulation, alternative trading systems ("ATS") like ECNs could choose to register either as a broker-dealer or to register as an exchange.[301]In addition, ATSs that registered as broker dealers were required to submit quotes to the public market for NMS-regulated stocks in which they accounted for five percent or more of trading

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[294] JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES VOL. III: FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970-2001) 208 (M.E. Sharpe 2002).

[295] *See generally* Order Execution Obligations, Exchange Act Release No. 34-37619A, 61 Fed. Reg. 48290 (Sept. 12, 1996).

[296] S.E.C. Division of Market Regulation, *Special Study: Electronic Communication Networks and After-Hours Trading* (June 2000), *available at* http://www.sec.gov/news/studies/ecnafter.htm.

[297] *Id*.

[298] Order Execution Obligations, 61 Fed. Reg. 48,290 (Sept. 12, 1996).

[299] ATS stands for "Alternative Trading Systems." Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 68 S.E.C. Docket 2045 (Dec. 8, 1998) (promulgating regulations for Alternative Trading Systems).

[300] SEC Division of Market Regulation, *Special Study*, *supra* note 296.

[301] *Id*.

volume in that security.[302] Exchange members could only execute publicly displayed orders.[303] The regulations subjected ATSs with 20% or more of trading volume in the market to various system and discrimination requirements to make qualifying ATSs function more as an exchange.[304] Over the next several years, ECNs like BATS, Archipelago, Instinet, Brut and Island began to capture significant market share from the more traditional exchanges.[305]

In 2005, intending to drive even more significant changes in the equities markets, the SEC promulgated Regulation NMS to modernize and update its rules while maintaining a balance between "vigorous" competitive markets and obtaining the best price for the average investor.[306] Regulation NMS, the fourth regulatory effort to enhance competition, consisted of four different rules: the order protection rule, the access rule, the sub-penny pricing and the market data rules.[307] The "trade-through" rule, as the order protection rule is commonly referred to, aims to prevent the execution of trades on a trading center at prices inferior to trades executed on NMS regulated-stocks.[308] The rule defines a trading center as including "national securities exchanges, exchange specialists, ATSs, OTC market makers and block positioners."[309] One complaint about the order protection rule is that although the rule requires brokers to execute trades on the market that have the top of the book price, the rule does not take into consideration the rest of the book for filling out the order nor the quickest trade execution.[310] Critics also point to another problem: the quickest execution may not be offered by the trading venue with the cheapest top-of-book price.[311] The access rule seeks

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[302] *Id*.
[303] *Id*.
[304] *Id*.
[305] MICHAEL GORHAM & NIDHI SINGH, ELECTRONIC EXCHANGES: THE GLOBAL TRANSFORMATION FROM PITS TO BITS 73 (Elsevier, Inc., 2009).
[306] Regulation NMS, Exchange Act Release No. 34-51808, 70 Fed. Reg. 37,496, 37499-37500 (June 25, 2005).
[307] *Id*. at 37501-37504.
[308] *Id*. at 37504.
[309] *Id*.
[310] *See* Stavros Gadinis, *Market Structure for Institutional Investors: Comparing the U.S. and E.U. Regimes*, 3 VA. L. & BUS. REV. 311, 350 (2008).
[311] Stavros, *supra* note 310, at 250.

to allow non-discriminatory access to quotes and the sub-penny rule allows quotations to occur at sub-penny prices.[312]

With the increase in volume in electronic trading and sub-penny trading, spreads have narrowed. In addition, electronic trading has helped give rise to high-frequency traders, who utilize powerful computers and highly specialized algorithms to make trades at millisecond speed.[313]Although critics contend that high frequency trading takes profits away from the average investor without access to the same technical capabilities, these traders greatly increase market liquidity.[314] Additionally, transaction costs continue to fall as competition between securities trading venues increases and the ease of transacting in multiple markets increases.[315] One ECN founded in 2005, BATS Exchange, Inc., acquired significant market share in the past five years and ultimately made the decision in August 2008 to register as an exchange.[316] As a result of the new regulatory scheme, competition among exchanges has become fierce, resulting in the reduction of market share by listing venues for their own listed stocks. In March 2010, trading on the NYSE accounted for approximately 33% of trading of NYSE-listed securities (down from 84% in 2004) and 12.7% of the overall market.[317] For the same month, the trading of Nasdaq-listed stocks on Nasdaq only accounted for approximately 28% of the market for its listed stocks (down from 56% in the final quarter of 2003), and its overall U.S. securities market share was 19.24%.[318] BATS Exchange, the third largest

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[312] Regulation of the National Market System, 17 C.F.R. § 242.610 (2005), LEXSTAT 17 CFR 242.610; Regulation of the National Market System, 17 C.F.R. § 242.612 (2005), LEXSTAT 17 CFR 242.612.

[313] Mark D. Perlow & C. Dirk Peterson, *SEC Publishes Concept Release on Market Structure, Proposes Risk Management Rules for Sponsored Access*, K&L Gates Newsstand (Feb. 15, 2010), http://www.klgates.com/newsstand/detail.aspx?publication=6219.

[314] *Id.*

[315] Nina Mehta, *SEC Opens Discussion of Regs ATS and NMS*, Traders Magazine (Oct. 9, 2009), http://www.tradersmagazine.com/news/sec-strategic-plan-ats-nms-104472-1.html?ET=tradersmagazine:e417:47854a:&st=email (last visited Apr. 21, 2010).

[316] Serena Ng & Aaron Lucchetti, *BATS Exchange Gains SEC's Approval*, WALL ST. J. (Aug. 19, 2008).

[317] *See* NYSE Euronext Monthly Volume Summary, http://www.nyse.com/pdfs/NYSE_Euronext_Transactions_Data.pdf (last visited Oct. 13, 2010).

[318] *See* Market Share Statistics, http://www.nasdaqtrader.com/trader.aspx?id=marketshare (last visited Apr. 20, 2010); *Nasdaq losses widen as*

exchange, captured approximately 9.5% of the market for that month.[319]

B. Options

The securities options markets had a much simpler, although not completely turbulence-free, route to bringing about competition between markets. After the SEC-mandated spin-off of the OCC from CBOE to create a central clearinghouse, the SEC slowly approved options pilot programs at four more exchanges, the Amex, the Philadelphia Stock Exchange, the Pacific Stock Exchange and the Midwest Stock Exchange.[320] With the options exchanges in their nascent developmental stages, the SEC initially opted to delay imposing the requirements of the full national market system to give the exchanges a chance to build trading volume. The SEC even enforced a moratorium on multiple listings and expansion of options contracts for the majority of the 70s.[321] In 1980 the SEC ended the moratorium, but deferred further action hoping to spur the creation of a "fairer, more efficient market structure within which multiple trading would occur."[322] Meanwhile, the SEC approved an "Allocation Plan" submitted by the options exchanges.[323] This plan designated specific exchanges to be the trading venues for new options resulting in a monopoly system for specific option contracts.[324]

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market share continues to decline, FINEXTRA.COM (Feb. 26, 2004), http://www.finextra.com/News/fullstory.aspx?newsitemid=11278.

[319] BATS Global Markets Reports March Volumes (Apr. 1, 2010), http://batstrading.com/resources/press_releases/BATSGlobal_March2010_FINAL.pdf.

[320] *See* Order Directing Options Exchanges To Submit an Inter-Market Linkage Plan Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-42029, 64 FR 57674 (Oct. 26, 1999); Exchange Act Release No. 11423, 6 S.E.C. Doc. 894 (May 28, 1975); Exchange Act Release No. 34-12283, 41 FR 14454 (Apr. 5, 1976); Exchange Act Release No. 34-13045,41 FR 54783 (Dec. 15, 1976).

[321] Termination of the Options Moratorium, Exchange Act Release No. 16701, 19 SEC Docket 998 (March 26, 1980).

[322] *Id*.

[323] *See* Exchange Act Release No. 16863 (May 30, 1980), 20 S.E.C. Docket 237 (June 5, 1980).

[324] *Id*.

Over the next decade, the SEC encouraged the options exchanges to pursue the development of intermarket linkages and to study and discuss multiple listings.[325] The exchanges submitted a study of these proposals and concluded pursuing linkages and multiple listings was not in the interest of the exchanges.[326] In 1986 the SEC came to a different conclusion, and released a Staff Report which indicated that, although their volume was concentrated in a single exchange venue, multiple-listed options on OTC stocks had significantly narrower bid-ask spreads than single listed options on the exchange-listed stocks.[327] One of the studies used data in support of the "'contestable markets' theory, which maintains that effective competition does not depend on the number of actual competitors, but rather only upon the ease of entry and exit into the market."[328] Because central clearing existed in the options industry, as opposed to the futures industry, investors could buy contracts on one exchange and sell them on another to close out their positions, making the decision on execution venue much simpler. As a result, after deliberation, in 1989, the SEC adopted Rule 19c-5 of the Exchange Act, which provided that "no rule, stated policy, practice, or interpretation of this exchange shall prohibit or condition, or be construed to prohibit or condition or otherwise limit, directly or indirectly, the ability of this exchange to list any stock options class because that options class is listed on another options exchange."[329]

In spite of the promulgation of Rule 19c-5 and quite a bit of discussion in the 1990s, the SEC's request for intermarket linkages did not come to immediate fruition.[330] With the Allocation Plan no longer in place, the options exchanges agreed to a "Joint Plan"

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[325] *Id.*; Exchange Act Release No. 34-22026, 50 FR 20310 (May 15, 1985); Exchange Act Release No. 34-24613, 52 FR 23849 (June 25, 1987).

[326] Multiple Trading of Standardized Options, Exchange Act Release No. 34-26870, 54 FR 23963 (June 5, 1989); Interim Report of the American, Pacific, and Philadelphia Stock Exchanges and the Chicago Board Options Exchange in Response to Release No. 34-16701(Jan. 8, 1981).

[327] Exchange Act Release No. 26870, *supra* note 326 (*citing* Directorate of Economic and Policy Analysis, *The Effects of Multiple Trading on the Market for OTC Options* (Nov. 1986); *citing* Office of the Chief Economist, *Potential Competition and Actual Competition in the Options Market* (Nov. 1986) [herein "OCE Study"]).

[328] *Id*. (citing OCE Study at 2).

[329] *See* Exchange Act Release No. 26870, *supra*note 326; 17 C.F.R. § 240.19c—5(a)(3) (2010).

[330] *See* Securities Exchange Act Release No. 42029, *supra* note 320.

approved by the SEC in 1991 that delineated the procedures for the exchanges to follow for multiple listings of new options and for the listings of existing options.[331] A purported "gentleman's agreement," however, kept exchanges from listing options on securities already listed on another exchange for the next decade.[332]

The state of limited competition among listing venues persisted until the end of the decade when three events occurred: (1) the first all-electronic options exchange was founded, (2) the SEC increased its pressure on the industry to properly comply with Rule 19c-5 and its earlier requests to develop intermarket linkages and (3) the exchanges began multiple listings of each other's biggest contracts following intervention by the DOJ. In 1998, two years before it would actually begin operations, the International Securities Exchange ("ISE"), the first new exchange registered in over two decades, announced plans to compete with the existing exchanges by listing their best performing options contracts.[333] ISE brought competition to the options industry, planning on competing by offering improvements in price, technology and speed. When ISE launched in May 2000, it began listing contracts rapidly, establishing its viability. By the end of 2003, ISE was the world's largest options exchange.[334]

In November 1998, the DOJ opened an investigation into the alleged collusion between the existing options exchanges, and the SEC opened one shortly thereafter.[335] Soon thereafter, in August 1999, the "gentleman's agreement" broke down when the CBOE announced it would trade options on Dell, traditionally a Philadelphia Exchange contract. When the Amex soon followed suit, the Philadelphia Exchange quickly retaliated by listing options on several CBOE- and Amex-exclusive contracts.[336] Soon the Amex and the CBOE were directly competing in their most active contracts and the fourth options exchange, the Pacific, followed suit as well.

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[331] Exchange Act Release No. 29698, 56 FR 48594 (Sept. 25, 1991).

[332] Carl A. Royal, *Competition Among Options Exchanges Heats up*, FUTURES INDUSTRY MAGAZINE (Aug./Sept. 2000), http://www.futures industry.org/fi-magazine-home.asp?a=653.

[333] GORHAM & SINGH, *supra* note 305, at 136.

[334] Daniel Gross, *The Collapse of the American Stock Exchange*, SLATE MAGAZINE (Jan. 13, 2004), http://www.slate.com/id/2093830.

[335] Comparative Impact Statement, United States v. AMEX, (Sept. 11, 2000), http://www.justice.gov/atr/cases/f6400/6460.pdf.

[336] *See* Royal, *supra* note332.

Market share in the formerly monopolized contracts was soon democratized by the multiple listings, and by the end of 2001 almost every moderately active options contract was listed and traded at multiple exchanges.[337]

Ultimately, the DOJ filed an antitrust claim in June 2000 against the options exchanges seeking to enjoin the exchanges from continuing their collusion, regardless of their actions since the previous summer.[338] The DOJ noted that this sudden change in behavior was not "explained by concurrent changes in the market or the fundamentals of the underlying stocks."[339] In December 2000, the Washington D.C. Federal District Court found in favor of the DOJ, enjoining the defendant exchanges from engaging in anti-competitive conduct.[340]

The SEC pursued multiple actions simultaneously. The first was to reiterate its earlier requests regarding intermarket links to enable the creation of an efficient national market with best execution for customers. Starting in February 1999, the SEC repeatedly requested the development of such a plan, ultimately ordering its submission by October 1999.[341] Then, the next July, the SEC approved a plan combining proposals from ISE, CBOE and Amex.[342] The combined proposal focused on exchange competition on a variety of fronts, not solely on price and time priority. They also focused on competition by including quick turnaround on fills, low costs, superior order handling systems, low error rates and enhanced liquidity and depth of the markets. [343]

The SEC also believed that the traditional options exchanges had inadequately discharged their responsibilities over the prior ten

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[337] *Id.*; GORHAM & SINGH, *supra* note 305, at 136.

[338] Complaint, United States v. AMEX (Sept. 11, 2000), http://www.justice.gov/atr/cases/f6400/6468.pdf.

[339] Comparative Impact Statement, *supra* note 335.

[340] Final Judgment, United States v. AMEX,2001-1 Trade Cas. (CCH) P73258 (D.D.C. Dec. 6, 2000), *available at* http://www.justice.gov/atr/cases/f201200/201201.pdf (holding in favor of the DOJ).

[341] *See* Exchange Act Release No. 42029, *supra* note 320.

[342] Joint Industry Plan; Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC, Exchange Act Release No. 43086, 65 FR 48023 (Aug. 4, 2000).

[343] *See* Royal, *supra* note 332.

years as SROs to comply with the Exchange Act on several counts.[344] The allegations were based on their efforts to limit multiple listings and frustrate Rule 19c-5.[345] As a result, the SEC issued an Order requiring the exchanges to take a variety of actions aimed at encouraging competition in the options markets and furthering the goal of a national market system.[346]

In the ensuing decade, clearing and execution fees have decreased while volume on the options exchanges has increased. In 2000, the year the ISE launched, ISE traded 50,000 contracts a day, the CBOE traded 1.2 million contracts a day and the industry as a whole traded just 2.9 million contracts a day. By the end of the decade, in 2009, ISE traded 3.8 million contracts a day, the CBOE traded 4.5 million contracts a day and the entire options industry traded 14.4 million contracts a day. The CBOE, after the increase in competition, increased volume approximately 366% and the industry increased volume by a staggering 498%.[347]

VI. Compare and Contrast

Having reviewed the history of the securities and securities options markets subsequent to the imposition of central clearing, this work now turns to a discussion of clearing in the futures industry. Regardless of central clearing, the equity and equity options markets have been significantly affected by the rapid growth of technology in the last two decades. In the securities markets, the creation and subsequent popularity of ECNs, as well as the promulgation of

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[344] *See* Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Exchange Act Release No. 43268 (Sept. 11, 2000), Administrative Proceeding File No. 310282.

[345] *Id*. at 5.

[346] *See id*.

[347] *See* Historical Volume Query, THE OPTIONS CLEARING CORP., http://www.optionsclearing.com/webapps/historical-volume-query (last visited May 10, 2010); Volume and Share Statistics, ISE.COM, http://www.ise.com/WebForm/volume_statistics.aspx?categoryId=482 (last visited May 10, 2010); CBOE Annual Report 2000, CBOE.COM, http://www.cboe.com/AboutCBOE/AnnualReportArchive/AnnualReport2000.pdf (last visited May 10, 2010); Press Release, *CBOE 2009 Trading Volume Exceeds One Billion Contracts for Second Straight Year* (Jan. 4, 2010), http://www.cboe.com/AboutCBOE/ShowDocument.aspx?DIR=ACNews&FILE=cboe_20100104.doc (last visited May 10, 2010).

Regulation ATS, eased entry into the market, which made competing with traditional exchanges like the NYSE a much more realistic objective for a new entrant. Similarly, the founding of ISE marked a major turning point in the options industry, both in total volume and in competition. For the average trader or broker, trading on different exchanges or execution venues has now become as easy as a click of a mouse. Central clearing greatly facilitates such ease of access to multiple venues because traders do not have to worry about which exchange they trade on. All shares clear at a common venue.

In the futures industry, although similar technology has taken root, there is no common or central clearing venue, thus a contract bought on one exchange must have its matching sale done on the same exchange in order to offset the position. Market participants do not enjoy the same flexibility in transacting on multiple competing execution venues as a result of the long-standing structure of vertical integration of a trading venue with its clearinghouse. Despite occasional efforts by upstarts to take liquidity away from the dominant exchange, the CME Group enjoys 95% of the market for domestic futures and options contracts.[348] As the primary regulator, the SEC has played a significant role in the development of market competition for equities and securities options markets by mandating central clearing and consistently advancing new rules to further market competition.

In contrast, the futures industry has no national market system. Consequently, the futures exchanges do not have a consolidated tape, national best bid and offer, or a best execution requirement to benefit customers in those few situations where the same contract trades at different venues. Elsewhere, the SEC took vital pro-competitive actions in pursuit of encouraging competition between trading venues. In securities, among other important actions, the SEC directed the exchanges to rescind any existing rules tying clearing and settlement to one specific venue.[349]

The 2008 DOJ review of the futures markets, specifically financial futures, finds that the current clearing structure "discourag[es] innovation and perpetuat[es] high prices for exchange

[348] *See* Futures Industry Association, U.S. Volume Report (Feb. 2010).
[349] Securities Exchange Act Release No. 14636 at 1, 1978 WL 196700 (S.E.C. Apr. 7, 1978).

services."[350] As a part of its argument, it noted that competition in the futures industry typically was limited to the introduction of new products, and that lasted only until one exchange had captured the majority of the liquidity in the product.[351] Because traders worry about not being able to exit a position, brokers most often execute orders on the exchange with the most liquidity.

Central clearing of futures products would allow fungibility between similar contracts traded on different exchanges, which would enable traders to execute according to the best price without worrying about liquidity problems.[352] The DOJ also believed that a single clearinghouse for the entire industry would allow more correlated contracts and financial products to offset each other, thus reducing the total sum of money necessary to margin a clearing member's positions, citing the $1.4 billion reduction in clearing liabilities which occurred subsequent to the CBOT's switch to the CME clearinghouse.[353] The DOJ analyzed the repeated failures to challenge the CME Groups hold on the financial futures market and noted both that (1) during the brief periods of competition, the market benefits in better prices and innovation and (2) that exchange control over the open interest and clearing facilities inhibits both competition in and entry to the market.[354]

Noting that the CFMA's new direct authority over DCO's did not require that the current clearing structure be maintained, the DOJ urged the Department of the Treasury to initiate a more formal study of the benefits that central clearing could bring to the futures industry.[355]

VII. Possible Routes for Central Clearing to Happen in the Futures Markets

The CFTC does not have a congressional mandate to create a national clearing system for futures as the SEC did in the 1970s.

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[350] U.S. DEP'T OF JUSTICE, REVIEW OF THE REGULATORY STRUCTURE ASSOCIATED WITH FINANCIAL INSTITUTIONS, 1 (Jan. 31, 2008), http://www.justice.gov/atr/public/comments/229911.pdf.
[351] *Id.* at 6.
[352] *Id.*
[353] *Id*. at 7, n. 18 (citing *Q3 2003 Chicago Mercantile Holdings, Inc. Earnings Conference Call,* Fin. Disclosure Wire, Nov. 5, 2003, at 8).
[354] *Id*. at 16.
[355] *Id.* at 22.

However, if as the DOJ suggested in its letter to the Treasury of January 31, 2008, the CFTC were to decide to press for central clearing due to its new principles-based regulation, there appear to be several viable paths for it to do so as a regulator without any specific action or directive of Congress to change the market structure.

Core Principles in the CEA require both DCOs and DCMs to avoid anticompetitive conduct. DCO Core Principle N, "Antitrust Considerations," reads:

> (N)Antitrust considerations
> Unless appropriate to achieve the purposes of this chapter, the derivatives clearing organization shall avoid—
> (i) adopting any rule or taking any action that results in any unreasonable restraint of trade; or
> (ii) imposing any material anticompetitive burden on trading on the contract market.[356]

Additionally, DCM Core Principle 18 provides an even tougher standard for exchanges in abiding by antitrust obligations. Its language is identical to that of DCO Core Principle N, except that in the first sentence the phrase "necessary or" appears before "appropriate."[357] Thus, DCMs cannot engage in prohibited anti-competitive conduct unless doing so is "necessary," not just appropriate. Given such a high bar governing anticompetitive conduct by DCMs, the CFTC may act on the basis of the parent exchange using its control of the captive DCO to refuse clearing access by competing exchanges that offer the same or similar contracts to those offered by the offending DCM.

Under Section 12(a)(1), the CFTC has the power, to ensure "efficient execution" of the CEA, to "make such investigations at it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to the provisions of this chapter"[358] The CFTC's investigative power can be used to support a finding of anticompetitive DCM and DCO conduct in violation of Core Principles 18 and N, respectively. If the CFTC were to make a finding that a futures exchange used its control of the captive

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[356] 7 U.S.C. § 7a-1(c)(2)(N) (2006).
[357] 7 U.S.C. § 7(d)(18) (2006).
[358] 7 U.S.C. § 12(a)(1) (2006).

clearinghouse to restrict competition with other futures exchanges in violation of Core Principles 18 and N, the CFTC as regulator would have the authority to remedy what it finds in violation of the statute it was created to uphold. If such a finding is made, the CFTC has the power to alter or supplement the rules of a registered entity that fails to alter their rules upon request of the CFTC as long as it had ample opportunity for notice and hearing. Section 12a(7) provides this power, "insofar as necessary or appropriate by rule or regulation or by order," if the CFTC deems that such an alteration is needed for "the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on such registered entity, or the product or byproduct thereof, or *for the protection of traders or to insure fair dealing in commodities traded for future delivery on such registered entity*."[359]

> Such rules, regulations, or orders may specify changes with respect to such matters as—
> (A)terms or conditions in contracts of sale to be executed on or subject to the rules of such registered entity;
> (B)the form or manner of execution of purchases and sales for future delivery;
> (C)other trading requirements, excepting the setting of levels of margin;
> (D)safeguards with respect to the financial responsibility of members;
> (E)the manner, method and place of soliciting business, including the content of such solicitations; and
> (F)the form and manner of handling, recording and accounting for customers' orders, transactions and accounts.[360]

Section 12(a)(1), added by the CFMA, replaces a previous section, 5a(a)(12)(A), with some key differences. First, section 12(a)(1) replaced the phrase "contract market" with "registered entity", thus extending this power of the CFTC over all entities registered with the CFTC, including DCOs.[361] Second, the list of matters outlined in

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[359] 7 U.S.C § 12a(7) (2006) (emphasis added).
[360] *Id*.
[361] PHILIP M. JOHNSON & THOMAS L. HAZEN, DERIVATIVES REGULATION 1038-39 (Aspen Publishers 2004).

Section 12a(7) is expansive, not exhaustive, awarding the CFTC the ability change additional rules as appropriate.[362]

Separate from the CFMA's Core Principles, the CFTC Act added the following language to the CEA in 1974:

> The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this chapter, as well as the policies and purposes of this chapter, in issuing any order or adopting any Commission rule or regulation (including any exemption under section 6(c) or 6(b) of this title), or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 21 of this title.[363]

The foregoing provision requires the CFTC to consider the least anticompetitive means of achieving the goals of the CEA when issuing its own orders and regulations as well as approving those of DCMs. The CFTC, however, has in the past asserted that "antitrust policy must recede to regulatory needs" in arguing that it does not always have the responsibility to choose the least anticompetitive means of achieving the goals of the CEA.[364]

The provisions and core principles in the CEA are not the same as the definitive, powerful mandate the SEC received in the 1975 Amendments. Even with that mandate, the securities exchanges themselves made the pro-active decision to merge their clearinghouses to form the NSCC. Although the SEC forced the spin-off of the OCC, that came about as a function of both the SEC's statutory authorization and the timing of the founding of the options industry.

Even if mandating the creation of a central clearinghouse were beyond the regulatory powers of the CFTC without a specific act of Congress, the CFTC could still "alter or supplement" the rules of existing DCOs to accommodate competition, where very little exists today.

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[362] *Id.* at 1038.
[363] 7 U.S.C. § 19(b) (2006).
[364] *See* Johnson, *supra* note 362, at 971.

Viewing the options for clearing as a spectrum between the vertical and horizontal clearing model, the proposal closest to the common clearing model would be to require non-discriminatory open access to clearing facilities, including the ability to transfer open position between clearinghouses in order to offset obligations or reduce margin requirements. In this model, market participants would be able to clear their trades at a clearing venue of their choice, causing the venues to compete for business as well as exchanges. Inasmuch as each clearinghouse would have the responsibility to risk manage the positions within its four walls, such “open access” would not create any new systemic risk.

At the other end of the spectrum would simply be the ability to move blocks of open interest from one exchange to another. Since 2002, the NYMEX, now a part of the CME Group, has offered traders a transaction that enabled a trader to simultaneously liquidate a Brent Crude Oil futures contract at the International Petroleum Exchange (now ICE Europe) and establish an identical position at NYMEX via matched block trades.[365] As the NYMEX/ICE transaction currently operates, both sides of the trade pay a fee to execute such a trade, so it does not represent true fungibility. This mechanism, on a wider scale, could at the very least build confidence in market participants about their ability to move open interest if needed.

In addition to the CFTC’s powers to force competition among exchanges, the DOJ could choose to follow up on its 2008 comments to the Department of the Treasury with an antitrust lawsuit against exchanges that control their clearing organizations to protect their trading activities against competition.

If the DOJ continues to believe that the current regulatory structure allows a dominant futures exchange to exercise its control over its clearinghouse for monopolistic market power in violation of the Sherman Antitrust Act, it is possible that the DOJ might simply take matters into its own hands and bring suit to sever the clearinghouses from their parent exchanges. While an extensive analysis of antitrust is not within the scope of this article, it is the authors’ view that the current clearinghouse structure in the futures markets frustrates competition.

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[365] *See* Letter from Jean A. Webb, Secretary, CFTC, to J. Robert Collins Jr, then-President, NYMEX (May 2, 2002) (notifying NYMEX of the CFTC’s approval of NYMEX Rule 6.21D).

VIII. Conclusion

The difference in the current state of the SEC-regulated markets and the CFTC-regulated markets is striking. The roots of this difference can be traced back to several key divergences in the developmental history of their markets, especially the differences in clearing over the last forty years. For the securities industry, from the very beginning the existence of an independent federal regulator, the SEC, gave the markets the protection of a powerful governmental agency with a clear mandate. Additionally, oversight from the finance committees in Congress enabled regulation to be in sync with the realities and needs of the finance industry. The SEC's mandate and regulatory abilities grew even stronger with the 1975 Amendments. By the time the options markets came into existence, the SEC had been operating for forty years. The experience and established role of the SEC played a significant role in its actions in mandating central clearing in these markets as well.

In contrast, the futures industry, with its roots in agriculture, has not received the same regulatory attention throughout its existence. From the beginning, the futures markets did not have an independent or powerful national agency regulating them. Unlike the finance committees, the agriculture committees overseeing the commodities industry did not have the same experience regulating investment markets, nor the same goals and aims in regulating them. As a result, in the 1970s, when the CFTC was finally created, Congress did not anticipate the regulatory powers needed in light of the explosion of growth in the industry subsequent to the introduction of financial futures, nor did it recognize the pivotal role that the clearing industry would play in the market structure of the financial markets. Over thirty years later, the futures industry features a monopoly and the other two major markets do not. While several factors have contributed to the current environment, the stark difference in clearing models stands out as a major contributing factor. With the growing interest in regulating derivatives as a key driver of our financial markets, regulation of the commodities industry should now mature to provide for competitive market structures in the way the securities industry has over time.

The CFTC Act was written right before the explosion of financial futures contracts that changed the landscape of the futures industry. Thus, it did not anticipate the regulatory powers needed in light of the impending changes in the futures markets. More than thirty years later, the futures industry is being recognized as a crucial

part of the economy, yet it features an exchange monopoly while the other two major exchange markets do not. Improving the level of competition in the futures industry, whether through regulatory action, legislative changes, or enforcement action in the antitrust arena, would enhance services, customer pricing and innovation as it has in so many other industries.