PEDRO BLANCO'S GROUP PRESENTATION

Commodities

Futures Exchanges Battle OTC Over Derivatives

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CHICAGO -- Where are the keys to the clearinghouse?

The question once was a joke, posed to hapless interns on their first day on the job at various U.S. exchanges. Now, world market turmoil and the related bailout of Long-Term Capital Management LP have raised concerns about credit and risk in the secretive "over-the-counter" (as opposed to exchange-traded) markets for derivatives. And clearing, the once nonsexy back-office business of acting as a central counterparty to trades conducted on exchanges, has become both a marketing tool for futures exchanges and a key issue for the big Wall Street firms who are their customers.

At the Futures Industry Association's annual exposition here, the buzz was all about a full-page ad taken out in several major newspapers, including The Wall Street Journal, headed "The Power of Derivatives Works Best Within the Safeguards of a Futures Exchange." Paid for by the Chicago Board of Trade, the Chicago Mercantile Exchange and the New York Mercantile Exchange, the ad cited, among other factors, "clearinghouse protection against credit risk" as a central reason futures exchanges "offer the power, flexibility and sophistication of financial derivatives" but with greater safety than the over-the-counter market.

Speaking last Wednesday on a panel that discussed the future of Chicago's derivatives markets, Patrick Arbor, the CBOT's chairman, called the debate that emerged from the LTCM debacle "a problem and a gift. It highlights the exchanges' role, and the purity of trades done on an exchange." Scott Gordon, the CME's chairman, added, "It's an opportunity. Exchange-traded products have lost ground to competing [OTC] products. But now we've seen the benefits" to trading derivatives on exchanges.

Other exchanges throughout the world are poking around for opportunity as well. Leslie Hosking, chief executive and director of Australia's Sydney Futures Exchange, noted in an interview that when the currency crisis swept through Asia last year, it became virtually impossible to hedge exposure in the over-the-counter markets there. "Banks were asking a significant premium for OTC hedging," he said. "When things started to go wrong, there was really nowhere to hedge."

To fill that gap, he said the SFE plans to begin offering non-Australian debt instruments, such as futures on various forms of Japanese debt. "People are nervous about clearing and settlement in Asia. They want to do everything they can to reduce risk," he said. "There is a genuine need for more cleared, exchange-traded instruments in Asian debt."

And the London Clearing House, which last summer said it plans to offer centralized clearing of the OTC interest-rate swaps that the world's largest banks trade among themselves, was commended time and again at the conference for what's now seen as foresight in offering one OTC market a measure of steadiness. LCH plans to begin test-trading on SwapClear, as the initiative is known, in December with three unnamed participating banks.

David Hardy, LCH's chief executive, said in an interview that because LTCM's trades weren't "inter-bank," a system like SwapClear, had it been in operation when the hedge fund began having problems, it wouldn't directly have indicated the fund's problems to the big firms who are its counterparties. "But," he added, "they would have been laying off [the risk they accepted by trading with LTCM] in the inter-bank market. So because we would have been margining their inter-bank trades every day and marking them to market, they may have had an early warning bell, through our third-party view, of the risk on their traders' books."

Officials at the big firms, meanwhile, believe centralized clearing for some types of OTC markets could fill the need some see for regulation of hedge funds and the derivatives they trade.

"I'm not calling for more [government] regulation," said John Davidson, managing director at Morgan Stanley & Co. "But there are certain types of [OTC] markets where a centralized third-party body with the trust of the marketplace as a whole could add value. One of the most important lessons [of LTCM] is that transparency is important in all types of markets."

Mr. Davidson excoriated the Chicago futures exchanges, particularly the CBOT, for their inability to merge their clearing operations, something that had been pushed by the cost-conscious Wall Street firms who bring most of the exchanges' business. "Clearing has the most potential to change the exchange landscape," he said. "That is one of the opportunities the Chicago exchanges lost when the CBOT backed out of common clearing."

He said in the wake of that deal's death, firms like his now are looking for other ways to bring centralized clearing to U.S. derivatives markets. The firms' options, he said, include building a new clearinghouse from scratch or turning to existing clearinghouses like those of other U.S. exchanges or like LCH, which appeals, he said, because it isn't linked to one exchange but clears several and is majorityowned by large firms. Mr. Davidson declined to comment on specific discussions in process but said "there have been lots of meetings with lots of parties."
In other commodity news:
REGULATORS: Sen. Richard Lugar said at the FIA conference that he wants to start reauthorization hearings in December for the Commodity Futures Trading Commission, moving up a debate that was expected in the second quarter of 1999. Sen. Lugar (R., Ind.), who chairs the Senate Agriculture Committee, which has oversight over the CFTC, said his intent is to assure confidence in world markets. His remarks also came in light of the CFTC's efforts to insert itself as a regulator of OTC derivatives, a role that Sen. Lugar opposes. He indicated one reason for speeding up the hearings is to respond to CFTC Chairwoman Brooksley Born, who recently said she might push to make the CFTC a permanent body, rather than one that needs periodic reauthorization. Sen. Lugar, along with Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan, has expressed concern over recent CFTC statements that swaps might fall under CFTC jurisdiction. "The CFTC isn't determining the laws of the land. We still are," Sen. Lugar said.
COPPER: Futures rose at the Comex division of the New York Mercantile Exchange in response to Thursday's U.S. rate cuts. Analysts said the market hopes the easing of monetary policy will bolster the world economy and keep the dollar weaker so that copper, which is denominated in dollars, will be cheaper for Asian buyers to import. The December contract rallied 1.95 cents to 74.55 cents a pound.