

THE USES OF NEW CAPITAL MARKETS – ELECTRONIC COMMERCE
AND THE RULES OF THE GAME IN AN INTERNATIONAL
MARKETPLACE

by

Andrea M. Corcoran*

World Economic Development Congress
September 24, 1999
Washington, D.C.

© 1999. All rights reserved.

*Ms. Corcoran is Director of the Office of International Affairs of the United States Commodity Futures Trading Commission in Washington, D.C. The views expressed herein are solely those of the author and do not necessarily reflect the views of the Commission or any office or division of the Commission.

The Uses Of New Capital Markets -- Electronic Commerce And The Rules Of The Game In An International Marketplace

One cannot open a newspaper today without reading about the formation of a new trading consortium or market. Electronic technology makes it increasingly easy to develop both local niche and broad-based international markets. Electronic technology readily and cheaply spans geographic boundaries, cultures and time zones. Markets using such technology can -- and do -- deliver the power of immediate information and direct trading access into the hands of the people wherever located. Many functions, such as loans, insurance, and utility rates, and many property interests, such as emission, bandwidth, or air rights, have been securitized or commoditized so that they can be more efficiently priced in a central marketplace. Centering demand is easy electronically. In principle, then, most financial activity can now occur on markets. Some have called this phenomenon a capital markets revolution.¹

The premise of this paper is that as long as property and contractual rights are protected by and enforceable in the pertinent legal systems, markets in general and electronic markets in particular can be the perfect international trading vehicles. Theoretically, the contractual nature of market conventions can permit a third world system to have a first world market infrastructure. Further, technology can export a first world market around the globe in real time to wherever trading demand is located.

Why is this premise important to industries such as energy; political initiatives such as improving the quality of the global environment; brokers and dealers who want to access multiple products and jurisdictions from a single platform; and financial markets regulators coping with adapting national regulatory systems to an

¹ P. Young & T. Theys, *Capital Market Revolution The Future of Markets in an Online World*, Financial Times/Prentice Hall (London 1999). Although electronic markets have advantages with respect to spanning jurisdictions and time zones and automating trading rules and conventions, there may remain issues about how such markets provide liquidity as volume increases and how they address large orders, the security of proprietary information, and the handling of error trades. Further, whether the advent of electronic markets will lead to the organization of broad, integrated markets, or lead to fragmentation or disintermediation that is undesirable, is not addressed by this paper. This paper focuses on the capacity of electronic markets to facilitate market access across borders generally, whether to broad-based or niche markets. Moreover, international alliances established by contract to engage in trade or to provide financial services are not new. Consider, for example, the Hanseatic League and the Wendish Monetary Union. See generally, C. P. Kindleberger, *A Financial History of Western Europe*, 2nd Ed., Oxford University Press (London/New York 1993)

international marketplace? Because, while national legislatures struggle to keep pace with technological change, and international organizations of financial services regulators labor to produce cross-border minimum standards and guidance on best practices, markets, and in particular, electronic derivatives markets have the free market incentives and the wherewithal to harmonize jurisdictional differences *right now*.

This paper first will outline the structural characteristics of markets that enable them to transcend national law. Then it will discuss three examples of current initiatives seeking to use these characteristics to best advantage: the London Clearing House Limited's SwapClear program for registering and clearing certain privately negotiated over-the-counter ("OTC") derivatives transactions;² BrokerTec Global, LLC's proposal for development of a 24-hour single electronic facility or platform for execution, and potentially, related clearing of international fixed-income cash and listed futures and options products;³ and the Kyoto Protocol, which includes provisions to permit the trading of internationally-recognized greenhouse gas emission allowances.⁴ The paper concludes that, with transparent rules in a legal system that protects and enforces property and contractual rights and with fair governance (of the market⁵ and of the legal systems accessed), markets can improve on and harmonize national law by applying uniform rules to their participants. As a consequence, the development of markets that can deliver internationally efficient prices and risk shifting or management tools with legal certainty is very promising.

Let us explore this premise further. Legal certainty and the efficiency of markets are a beneficial by-product of their structure. In essence, markets sell their rules and their trading and back office systems as part of their product.⁶ Market rules ordinarily deal with:

- (1) who may trade;

² Commodity Futures Trading Commission ("CFTC") Release No. 4247-99 (23 March 1999).

³ BrokerTec Global, LLC, unpublished Statement of Objectives for Listed Derivatives (13 July 1999) which was privately circulated to various exchanges and other interested parties. BrokerTec noted in this Statement that fair governance and equitable access are necessary attributes for a market to prosper.

⁴ For further information on the Kyoto Protocol, *see* the homepage for the United Nations Framework Convention on Climate Control at <http://www.unfccc.de/>.

⁵ Organization for Economic Cooperation and Development ("OECD") *Principles of Corporate Governance* at <http://www.oecd.org/daf/governance/principles.pdf>.

⁶ A.M. Corcoran, "Developing Exchange Derivatives Markets" (20 October 1999), Securities and Exchange Commission *1999 International Institute for Securities Market Development*. The benefits derived from market rules and trading and back office systems are attributes of open-outcry markets as well as electronic markets. However, this paper focuses specifically on electronic markets.

- (2) what and how they may trade;
- (3) when and how much of the unit of trading can be traded;
- (4) how the product is delivered or settled; and
- (5) the consequences of failures to meet trading commitments or otherwise abide by the rules of the game.

Therefore, markets -- through their rulemaking powers -- have the means to transcend or improve upon national law. In particular, they can assure:

- (1) common trading rules that are implemented without regard to the identity of the players or where they are located,
- (2) equitable cross border access to transparent prices, and
- (3) secure settlement of transactions or delivery to participants located in multiple jurisdictions.

This is true notwithstanding a diversity of, or even diminished, legal and regulatory infrastructures in some of the jurisdictions where market counterparties are located.

Regulators, although recognizing the critical importance of developing or revamping capital market legislative regimes to address the operations of an increasingly global marketplace, cannot ignore that comprehensive regulatory change takes time.⁷ For regulators, a promising feature of evolving market structures is that, pending regulatory change, an enforceable self-regulatory infrastructure can be pursued by contract.⁸ The optimistic view is

⁷ E.g., the 1989 reauthorization of the Commodity Futures Trading Commission culminated in the Futures Trading Practices Act of 1992. The European Commission noted in a recent Communication that the EU's single market in financial services has been under construction since 1973 and that it took over a decade for the EU member states to agree upon legislation to implement the philosophy of "single passport/home-country control." See *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232, 11.05.99, pp. 1, 16. See also the *CFTC Survey on the Regulation of Over-the-Counter Derivatives (1999)*, section captioned "Recent and Contemplated Changes" which gives other examples of the time frame of major legislative initiatives in the financial services field. However, notwithstanding the difficulties incident to the process of regulatory reform, international financial services regulators currently have identified as a priority developing common principles and standards regarding the operation of regulated markets.

⁸ Regarding the validity and enforceability of choice of law provisions, see H. van Houtte, *The Law of International Trade* §§ 1.24 - 1.30, Sweet & Maxwell (London 1995); Restatement [Second] of Conflict of Laws, American Law Institute §§ 187, 188 (1971), as amended. International private law rules in most jurisdictions allow the parties to a contract to choose the law that will govern their relationship, provided that the laws of the country chosen do not violate either (i) the fundamental policy, mandatory laws, or *ordre public* of the country whose law would have applied in the absence of a choice of law provision, or (ii) the fundamental policy, mandatory laws, or *ordre*

that pending change, which often gets embroiled in the political process or contentious battles among competitors, market-based solutions to international public policy problems or commercial needs can nonetheless go forward. Most importantly, their implementation can be accomplished in a manner that is consistent with the view that an appropriate infrastructure is vital to well-functioning markets.

How can this be possible? Let us look at a few examples. The first principle of markets is that they live and die by their operating rules. Regardless of who enacts the requirements, markets must have rules to function. These are often called the rules of the game. As such, exchange rules potentially can overcome uncertainties—not the least of which are non-existent, conflicting, or inadequate laws. In some ways, exchanges are mini-governments or self-governments⁹ -- so a fair governance structure is critical to their proper function.¹⁰ In this regard, commercial incentives favor fairness, especially if buttressed by some accountability to a regulator. Fairness is necessary for the market to function properly. Fairness promotes market confidence; market confidence supports liquidity; liquidity promotes efficient pricing; efficient pricing enhances market confidence and, in turn, attracts further liquidity.

One set of rules generally applies across the board to all market participants. In electronic systems, the algorithm that matches orders or trades constitutes the trading and execution rules that govern the priority and manner of trading. This leaves no room for disputes as to the applicability of the trading rules contained in

publique of the country of the court seized of the case, in either of which event the court may determine not to apply the laws of the country chosen in the contract. See also note 17.

⁹ At least in certain countries, self-regulation for markets (such as internal controls and risk management for firms) has been a required element of the regulatory structure. See e.g., with respect to the U.S. CFTC, 17 CFR §§ 1.51, 1.52. Indeed, international standard-setters such as the Council of Securities Regulators of the Americas (“COSRA”) and the International Organization of Securities Commissions (“IOSCO”) have endorsed the concept of self-regulation subject to appropriate oversight. Principles 3 and 4, *Resolution Concerning Principles of Effective Market Oversight*, COSRA (29-30 May 1995); see also Principles 6 and 7, *Objectives and Principles of Securities Regulation*, IOSCO Technical Committee Report (1998). . Even though the movement to for-profit markets is testing the limits of the self-regulatory model, it is still an expected feature of market regulation and of required risk management practices that exchanges will enforce their rules in an equitable manner and it is still a feature of best practice that these compliance activities of markets would be subject to oversight or scrutiny by a regulatory authority. Exchanges have demutualized and become for-profit enterprises in the Netherlands, Germany, Sweden, Italy, and Australia. Hong Kong Exchanges and Clearing Limited, The Stock Exchange of Hong Kong Limited, and the Hong Kong Futures Exchange Limited issued a Joint Press Release on July 30, 1999 regarding the conclusion of negotiations for a merger of the exchanges, with the surviving exchange to be a for-profit company. The New York Stock Exchange also has recently announced that it proposes to demutualize and to convert to a for-profit exchange. In the case of for-profit markets, it may be that certain aspects of enforcement will be (or will be required to be) outsourced or unbundled from the marketplace itself or overseen by independent auditors to limit the potential for conflicts of interest. Nevertheless, the market will still have operating rules and remain in some ways accountable to the regulator for the enforcement of the operating rules. IOSCO’s Consultative Committee has an ongoing project looking into this precise issue—New Models for Effective Self-Regulation. Final Communiqué of the 23rd Annual Conference of the International Organization of Securities Commissions (1997) at <http://www.iosco.org/iosco.html>.

¹⁰ See OECD *Principles of Corporate Governance* at <http://www.oecd.org/daf/governance/principles.pdf>.

the system. The rules also standardize the interest traded. This leaves no room for disputes about the validity of, or uncertainty as to the legality of, that interest.¹¹

As the algorithm enforces the trading rules, assuming the algorithm cannot be gamed or compromised, the system will itself assure uniform treatment in accordance with its matching and priority rules to all participants and provide a complete audit trail that cannot be circumvented.¹² All trading on the system can be made visible in real time to compliance personnel; therefore, ongoing surveillance and reconstruction of trading is possible. Similarly, such trading potentially can be made transparent to the public in real time wherever located. Most systems include their own dispute resolution, disciplinary and emergency rules, error resolution procedures, and liability limitations, which each participant using the system subscribes or consents to by entering into an access arrangement or by becoming a member. These rules govern the execution of trades.¹³

Exchange rules also govern the integrity of the transaction. Membership, eligibility or access criteria are set to limit who can use or have direct access to the market (that is, to filter out the unfit, the under-capitalized, or the improvident and to restrain trading within appropriate limits). Derivatives exchanges tend to collect obligations owed to them up front. Typically, they are pay-as-you go systems that are intended to remove credit risk from the market or reduce it to the bare minimum on a daily basis.¹⁴ (Real-time gross settlement of obligations is the ideal -- and an achievable ideal by the use of electronic systems -- reducing the time exposure or credit risk of unsettled obligations to the legal risk of disparate national laws.) Back-office and settlement functions also are effectively built into the individual interests traded, the market's rules and the system whether actually integrated into the market itself or linked to it through separate clearing facilities. As a consequence, multilateral netting of obligations can be made automatic and part of market rules by using the market itself or its clearing counterparty. Typically, the market becomes the buyer to every seller and the seller to every

¹¹ A. M. Corcoran, "Prudential Regulation of OTC Derivatives: Lessons from the Exchange-traded Sector," in *Prudential Regulation of Banks and Securities Firms*, G. Ferrarini, Ed., Kluwer (London 1995).

¹² A. M. Corcoran & J. Lawton, "Regulatory Oversight and Automated Trading Design: Elements of Consideration," 13 *The Journal of Futures Markets* 213 (1993).

¹³ *Compare Principles for the Oversight of Screen-Based Trading Systems*, Report of the IOSCO Technical Committee, June 1990 (the principles themselves are attached as Appendix I); *Issues in the Regulation of Cross-Border Proprietary Screen-Based Trading Systems*, Report of the IOSCO Technical Committee, October 1994; See also Principles 25-30 and Section 13, *Objectives and Principles of Securities Regulation*, Report of the IOSCO Technical Committee, September 1998. See <http://www.iosco.org/iosco.html>.

¹⁴ A. M. Corcoran, "Developing financial and operational performance standards for exchange derivatives markets: a modest proposal for an international dialogue," 4 *European Financial Services Law* 145, Institute of Advanced Legal Studies (May/June 1997).

buyer.¹⁵ This feature is intended to leave no room for speculation as to what is valid or invalid netting or what is valid or invalid collateral for purposes of determining individual market participant's exposures to the market. This system also means that there is no need to return to the original actual counterparty to a transaction to reverse or offset that transaction and, as a consequence, reduces asset liquidity risk and transaction costs.¹⁶ OTC derivatives counterparties, and associations of OTC derivatives dealers, attempt to obtain the same result by standardizing master agreements and by choosing the law of, or advocating the choice of the law of, a particular jurisdiction to govern their contracts.¹⁷

An exchange's rules also address market failures and the failure of market participants to perform. Exchange rules permit open interest to be liquidated immediately, and subject margin and other collateral or security to the payment of claims against a defaulting party.¹⁸ The national law of some jurisdictions explicitly permits disposition of such property in accordance with exchange rules and exchange rules may include the value of a defaulting member's memberships or access arrangements in the property available to satisfy the claims of other exchange members against the defaulting member. Such rules should be enforceable by the market notwithstanding the bankruptcy of the clearing member.¹⁹ Therefore, the property value of open interest, collateral, exchange memberships, or access arrangements may be accessible by the exchange to satisfy specified claims of its members (or contracting participants) and, in the event of a

¹⁵ Generally, for a futures exchange's clearing organization, trading is a zero-sum game; the buyers' obligations that it undertakes equal the sellers' obligations that it undertakes and the obligations match and cancel each other out. As well as efficiently netting cash flows, the clearing organization's taking on the opposite side of each trade and becoming the common counterparty for all traders results in another advantage. Such a counterparty relieves traders of the necessity to assess the financial condition of their counterparties in the market and thereby permits and facilitates anonymous transacting. Market counterparties handling customer business must still assess their credit risk vis à vis their customers. It is possible to unbundle the trade execution and clearing functions of an exchange and to clear transactions that are consummated over-the-counter or at another exchange through a clearing account. Clearing organizations, like markets, operate by rules agreed to on a multilateral basis by their members or participants. But, this paper does not explicitly address issues relevant to clearing organizations that seek to cross borders independent of markets.

¹⁶ A. M. Corcoran, "Prudential Regulation of OTC Derivatives: Lessons from the Exchange-traded Sector," in *Prudential Regulation of Banks and Securities Firms*, G. Ferrarini, Ed., Kluwer (London 1995). See also note 40, *infra*.

¹⁷ See e.g., a description of the International Swaps and Derivatives Association's ("ISDA") standardized documentation, netting opinion, and collateral enforcement projects at <http://www.isda.org/>.

¹⁸ A. M. Corcoran and S. C. Ervin, "Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers from Troubled Firms" 44 *Wash. Lee L. Rev.* 849 (1987).

¹⁹ See e.g., 17 CFR Part 190; *In re Drexel Burham Lambert Group Inc.*, 120 B.R. 724 (S.D. N.Y. 1990). See also *Board of Trade of the City of Chicago, et al. v. Johnson*, 264 U.S. 1 (1923). See also Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems ("Settlement Finality Directive"), O.J. L 166, 11/6/1998, p. 45-50.

default, may be disbursed, liquidated or transferred in accordance with exchange rules with the minimum of delay and interference from the courts.²⁰

The consent of members (trading rights holders and/or market participants) to the rule structure of the market permits the exchange or clearing structure to enforce multilateral commitments of such participants to support the financial conclusion of transactions conducted on the market.²¹ Such consent also can overcome issues related to:

- (1) what information has to be provided to the exchange by market participants,
- (2) the use of information in the system by system supervisors or operators,
- (3) the sharing of appropriate information with regulators or authorities in other jurisdictions, and
- (4) the resolution of disputes about executions, the handling of errors, and the liability for system failures.²²

In the case of electronic systems, the system itself can document this contract to abide by the rules of the game by making it part of the instruction with respect to any trading activity, that is, the assumed pre-condition of any trade. In many jurisdictions, the terms and conditions of standardized exchange contracts are themselves part of the exchange's operating rules thereby reinforcing that the terms of the contracts are legal and enforceable.²³

²⁰ For examples in specific countries (e.g., France, Germany, Italy, Spain, and the United Kingdom), see *The Regulation of Over-The-Counter Derivatives Transactions Survey 1999*, United States Commodity Futures Trading Commission, pp. 69-70, at [http://www.cftc.gov/oia/interpro.htm#International Publications](http://www.cftc.gov/oia/interpro.htm#International%20Publications). In some jurisdictions, these rules also apply to documented OTC transactions.

²¹ Such commitments also may be supported by disapplication of local anti-trust laws. See e.g., Section 15 of the United States Commodity Exchange Act, codified at 7 USC § 19.

²² E.g., Directive 95/46/EC of 24 October 1995 on the protection of individuals with regard to the processing of personal data and the free movement of such data ("Privacy Directive"). Pursuant to the Privacy Directive, an individual must be given notice when personal data is proposed to be processed by another party, including processing resulting in a dissemination of the data to another party. The Privacy Directive allows the individual to control the use of personal data by giving him the right to object to and prevent the processing or dissemination of his personal data. However, the Privacy Directive also contemplates that an individual may be able to foresee the dissemination of data and that he may desire the dissemination of data. In such circumstances, the Privacy Directive allows the individual to consent to such processing or dissemination in advance.

²³ *Futures Exchange And Contract Authorization - Standards And Procedures In Selected Countries*, CFTC Office of International Affairs (3 August 1999) at [http://www.cftc.gov/oia/interpro.htm#International Publications](http://www.cftc.gov/oia/interpro.htm#International%20Publications).

In sum, these features of exchanges facilitate asset liquidity and the reduction and isolation of credit risk, usually are self-executing by the market, and minimize conflicts of interest and issues of interpretation that may develop when bilateral contracts go awry.

An exchange must ordinarily be authorized in the jurisdiction in which it is domiciled,²⁴ but may also need approvals in other jurisdictions in which it, or its members or participants, conduct business.²⁵ To the extent that domestic law or the law of an exchange's "home" jurisdiction gives markets their legal identity and shapes how they can operate, concessions to or reinforcement of market rules is an important element of a mature jurisdiction's capital markets law. Such reinforcement can increase the attractiveness of an exchange-type vehicle domiciled in that location for harmonizing jurisdictional differences by making it more likely to be recognized by other jurisdictions. Market operators can choose the most hospitable jurisdiction from the perspective of its enabling law and infrastructure in which to domicile or organize an electronic market and tailor market rules to meet (or not be inconsistent with) the requirements of jurisdictions from which they wish to be accessed.²⁶ Theoretically, this would *not* be the jurisdiction with the least infrastructure or rules. Why? Again, because the rules and the manner in which the rules control risk are part of the product being sold over the system and choosing a jurisdiction with too low a regulatory level within which to frame the rules could compromise their enforceability, unduly limit the class of participants that would be able to trade on the system, or reduce the geographic scope of the market's business. Of course, other factors would be taken into account in choosing a domicile, such as where is the likely bulk of the customer base, time zone coverage, the nature of the contract traded, where banking or delivery arrangements, if any, are likely to be located, the nature of the products on which reference prices are based and whether physical delivery rather than a cash settlement of the trade is contemplated.

Interestingly, some jurisdictions have proactively adopted legislation or given judicial comfort that market rules will supersede certain contravening local laws.

²⁴ *Id.*

²⁵ See e.g., regarding French law, Article 18 of Law of 28 March 1885, as amended, together with Decree 90-948, dated 25 October 1990 pursuant to which such Law is enforced. Compare Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, O.J. L 141, 11/6/1993, p. 27-46, as amended at O.J. L 168, 18/7/1995, p. 7-13.

²⁶ A regulatory authority in a jurisdiction from which financial intermediaries are accessing an electronic market in another jurisdiction must make its own determination whether the electronic market must be authorized in its jurisdiction to provide services there. But, in making this determination, such regulatory authority is likely to take into account the quality of the regulatory system of the jurisdiction in which the electronic market is located and regulated and of the internal operating rules of the electronic market.

For example, the EU has adopted a directive which requires the Member States to transpose into their national law provisions that will cause the rules of a settlement system to govern transactions on the system in lieu of or with precedence over conflicting national bankruptcy law provisions.²⁷

Given that a major benefit of electronic markets is their ability to link users located in multiple dispersed jurisdictions, is assurance that the home or domicile of the market is conducive to enforcement of the market's rules enough to reliably bridge international differences? Or, is there anything more than just the applicability of the rules of the market that one could rely on to assure the precise functioning of the market for remote or offshore users? Well, in fact, market regulators -- like markets -- also have developed some innovative approaches to surmounting the lack of international protocols or rules to resolve jurisdictional differences. They too have found that, although a clear international set of parameters would be desirable, the evolutionary state of international law need not be an obstacle to regulatory arrangements intended (i) to enhance the enforcement of exchange rules, and (ii) to facilitate cross-border access to markets.²⁸

First, similarly to all other sophisticated participants in financial markets, regulators follow the money. The money (margin) can be located (and electronic means may further facilitate this) where enforcement of the market rules relating to the money's disposition are most likely assured. Indeed, systems can be designed where the system itself debits or credits a trading account based on linkages to banking facilities, thereby limiting, if not eliminating entirely, the time between conclusion of a trade and payment or settlement and the incumbent credit risk.²⁹

Second, just as markets can form alliances, so can regulators. Regulators may be able to further harmonize or assure the effectiveness of the rules of the market in remote jurisdictions by promoting joint ventures, alliances, or memoranda of understanding that function in a manner similar to a type of contract among the

²⁷ Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems ("Settlement Finality Directive"), O.J. L 166, 11/6/1998, p. 45-50.

²⁸ See *Objectives and Principles of Securities Regulation*, IOSCO Technical Committee Report (September 1998); Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations (March 1996) (Boca Declaration) at <http://www.cftc.gov/oia/bocadec0398.htm>. Such arrangements may be further supported by practitioner agreement or best practices. See e.g., the IOSCO Consultative Committee's Companion Report on the Tokyo Communiqué on *Supervision of Commodity Markets* (October 1997).

²⁹ For example, U.S. exchanges clearing delivery rules involve arrangements with banks in the jurisdiction of currency. But, conceptually, a fund of customer accounts used for settlement could permit currency settlement within the account, subject to a mechanism for handling imbalances.

affected regulatory authorities.³⁰ As a matter of international law, in order for such arrangements to be binding they may have to be negotiated among the relevant governmental authorities, and would be subject to what could be a cumbersome foreign policy or treaty process. However, regulators are free to adopt a statement of intention that is further supported by the operating rules of the market.³¹ For example, regulatory authorities can indicate that there is an understanding among them to share oversight, supervisory information, and compliance responsibility without invoking procedures relevant to concluding legal assistance treaties.³² To date, this type of arrangement by regulators has been the vehicle of choice to address regulatory concerns arising from the increasing international scope of the markets they oversee. The very fact that such smart strategies for overcoming a gap in international law can be, and are in fact, effective suggest that the practicability of these arrangements should be further explored by market developers and market regulators.

A third possibility would be to encourage the relevant regional or international organization of market regulators, such as, the International Organization of Securities Commissions or IOSCO, to develop some very basic, high level ground-rules to which all participating countries would generally subscribe. The IOSCO Principles for the Oversight of Screen-Based Trading Systems,³³ adopted in 1990 were developed for just this reason. IOSCO is the premier organization of securities and derivatives regulators, that is, of market regulators. It has 92 ordinary members and total membership of 164 which includes the international financial institutions, self-regulatory associations and trade associations as well as additional national governmental authorities with an interest in development of appropriate infrastructure for the financial markets.

³⁰ See, the CFTC Backgrounder on information sharing through Memoranda of Understanding, entitled *The CFTC: An Active Partner in Global Cooperation Through Information-Sharing with Other Financial Regulators*, at <http://www.cftc.gov/opa/backgrounder/mou.html>; see also a discussion of the information sharing arrangements in connection with the CME/LIFFE/MATIF links at <http://www.cme.com/news/emulink.html>.

³¹ See e.g., §12 (g) U.S. Commodity Exchange Act, codified at 7 USC § 16 (g).

³² See, the CFTC Backgrounder on information sharing through Memoranda of Understanding, entitled *The CFTC: An Active Partner in Global Cooperation Through Information-Sharing with Other Financial Regulators*, at <http://www.cftc.gov/opa/backgrounder/mou.html>; *Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations* (March 1996) (Boca Declaration at <http://www.cftc.gov/oia/bocadec0398.htm>); for information regarding CME/LIFFE/MATIF links see <http://www.cme.com/news/emulink.html>; and for information regarding the CME / SIMEX Mutual Offset System, see <http://www.cme.com/market/interest/mos.html>. See also A. M. Corcoran, "Developing financial and operational performance standards for exchange derivatives markets: a modest proposal for an international dialogue," 4 *European Financial Services Law* 145, Institute of Advanced Legal Studies (May/June 1997). See also generally 22 CFR Part 181 and the Department of State procedures set out in Volume 11, Foreign Affairs Manual, Chapter 700 (Circular 175 procedure).

³³ *Principles for the Oversight of Screen-Based Trading Systems*, Report of the IOSCO Technical Committee, June 1990.

Developers of Globex, a planned round-the-clock, round-the-globe trading system designed by the Chicago Mercantile Exchange and Reuters in the 1980's, wanted international guidance in-advance on what types of requirements might be applied to the screens or what would be the likely regulatory interest in the major market jurisdictions in which they hoped to enter trading alliances and place computer screens. At the same time, other jurisdictions wanted comfort in this area, then on the cutting edge of innovation, where there were in fact very few if any actual rules, that there was some international agreement that a level of national scrutiny to such systems was not protectionist or inappropriate. The development of the Swedish electronic system OM, which intended to sell franchises globally, further spurred the debate on screen access to markets.

The EU, in the Investment Services Directive (“ISD”), treated this issue in the context of an economically integrating, supranational community of nation-states -- a *sui generis* type of regional federation -- where services may be provided freely across borders. The EU balanced competing regulatory and other interests in favor of letting screen-based markets provide screen access to financial intermediaries operating anywhere within the EU under the basic home/host framework for allocating jurisdiction over the provision of financial services within the community. The ISD provides a solid regulatory foundation for such an approach because it harmonizes certain major concepts relating to financial services regulation.³⁴ In the US, both the Securities and Exchange Commission and the Commodity Futures Trading Commission (“CFTC”) are looking at issues related to screen-based markets. In the negotiation of the Agreement on the World Trade Organization and the General Agreement on Trade in Services, the contracting states favored open access regarding financial services, subject only to prudential and comparability carve outs.³⁵

Fourth, as a practical matter, it appears much more difficult for a court to set aside a multilateral agreement among many users than a contract negotiated between two parties. This is especially true in cases where exchange operating rules and contracts are agreements or sets of rules that have the imprimatur of the relevant regulator in the home jurisdiction and meet certain parameters in the host

³⁴ Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, O.J. L 141, 11/6/1993, p. 27-46, as amended at O.J. L 168, 18/7/1995, p. 7-13. See Article 15 of Directive 93/22 regarding membership in or access to regulated markets and their corresponding clearing systems in a “host” EU Member State by investment firms authorized in another “home” EU Member State.

³⁵ Sections 2-3, Annex on Financial Services to the General Agreement on Trade in Services. See generally the World Trade Organization home page at <http://www.wto.org/>.

jurisdiction as well.³⁶ It is not so easy for a judicial authority to determine to disregard, to set aside or to reinterpret the contract of all the parties in such a case. Additionally, the symmetry of information access and the identity of trading rules incorporated in the trading system design prevents arguments as to asymmetry of information that could be the basis for setting aside bilateral agreements on grounds of unequal access to information or unequal bargaining power if due to unforeseen market or other circumstances such agreements prove to be unduly onerous.³⁷

But perhaps you think that these are merely theoretical musings of a representative of one regulator as to what is possible using a market format without any evidence that practitioners or other regulators believe that “marketization” of financial instruments can have distinct advantages in this age of electronic globalization. Therefore, I would like to offer a few examples of current or projected initiatives that seek to exploit the synthetic governmental elements of exchanges.

The three examples which lend themselves to using the market framework to resolve international differences are: The London Clearing House’s SwapClear program (“SwapClear”); BrokerTec Global, LLC (“BrokerTec”), a proposal to link various cash fixed income and derivatives markets across borders through a common trading platform, and the Kyoto Protocol proposal for emissions trading.

SwapClear is a program for clearing OTC transactions together with exchange-traded contracts through London in accordance with applicable clearing rules and procedures intended to permit a broader netting between types of products than otherwise would be achievable in most jurisdictions. The program is being touted as a means to improve risk management of such contracts and to reduce legal uncertainty. The clearing program would be based in London although clearing members would not necessarily have to be London-based. The rules of the

³⁶ The CFTC Division of Trading and Markets has issued no-action letters regarding the placement of terminals in the United States to access foreign screen-based trading systems to LIFFE (by letter dated 23 July 1999) and Eurex Deutschland, Parisbourse SBF SA, and Sydney Futures Exchange Limited/New Zealand Futures and Options Exchange Limited (“SFE/NZFOE”) (by letters dated 10 August 1999, respectively). In issuing such no-action letters, the Division noted, among other things, that such exchanges are authorized under the laws of another country; the market members are subject to oversight in the other country by a legitimate regulatory authority that is responsible for ensuring their compliance with an extensive regulatory regime; the market adheres to the IOSCO Objectives and Principles of Securities Regulation; and the U.S. and foreign regulatory authority are parties to information-sharing arrangements applicable to the activities of the market. For historical background, *see also* CFTC proposed rules on Access to Automated Boards of Trade, 64 *Fed. Reg.* 14159 (24 March 1999), and the Commission Order withdrawing such proposed rules dated 2 June 1999, published at 64 *Fed. Reg.* 32829 (18 June 1999). *See also* the CFTC Backgrounder on *The CFTC: An Active Partner in Global Cooperation Through Information-Sharing with Other Financial Regulators* (April 1999) at <http://www.cftc.gov/opa/backgrounder.html>.

³⁷ *See e.g., Procter & Gamble Co. V. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996).

clearing arrangements would permit registered OTC contracts meeting certain specifications to be offset against exchange business and cash flows within the clearing system.³⁸ These arrangements are supported by national and EU legislation intended to assure the desired treatment, as well as legal opinions relating to counterparties based in various jurisdictions.³⁹ Contracts meeting the specifications should be capable of being cleared providing that they do not infringe relevant local law. The CFTC facilitated the use of these clearing arrangements by US persons by removing any ambiguity as to the likelihood that the Commission would seek to take the position that US counterparties using the system to clear OTC business would lose the protection of exemptions from the Commodity Exchange Act.⁴⁰ The LCH program takes advantage of applicable law (and also various legal opinions) that clearing business combined and cleared through SwapClear is protected from certain uncertainties and limitations that may afflict the use of master netting agreements because of variations in international solvency law.⁴¹

BrokerTec is a proposal that was recently circulated to a number of brokers and markets by a group of co-venturers from the cash and derivatives foreign-exchange industry. That proposal sets out global clearing and execution objectives that the proponents believe can be met through establishing a single platform to access listed derivatives in multiple markets. This proposal would add to an inter-dealer cash brokerage arrangement the ability to cross-collateralize and potentially net cash flows with respect to futures related products. The proposal contemplates a fully international facility. The basic elements of the desired arrangements were circulated this summer to a number of exchanges and dealers who could be

³⁸ See CFTC Release No. 4247-99 (23 March 1999) regarding SwapClear and *Regulation of Over-The-Counter Derivatives Transactions Survey 1999*, United States Commodity Futures Trading Commission, section captioned "Clearing Facilities for OTC Derivatives Transactions," p. 39-41, at <http://www.cftc.gov/oia/interpro.htm#> International Publications.

³⁹ Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems ("Settlement Directive"), O.J. L 166, 11/6/1998, p. 45-50. See also The CFTC's *Regulation of Over-The-Counter Derivatives Transactions Survey 1999*, at <http://www.cftc.gov/oia/interpro.htm#> International Publications, at p. 69-70 regarding insolvency law with respect to OTC transactions and, specifically, the extension of market insolvency protections to cleared OTC derivative transactions in the United Kingdom.

⁴⁰ See CFTC Release No. 4247-99 (23 March 1999). See also 17 CFR Part 35, regarding the exemption of swap agreements from certain provisions of the United States Commodity Exchange Act and related *Federal Register* releases.

⁴¹ See note 38, *supra*. For information regarding ISDA documentation and legislation projects regarding the enforceability of netting and collateral arrangements, see <http://www.isda.org/>. See also Directive 96/10/EC of 21 March 1996 as regards recognition of contractual netting by the competent authorities ("Netting Directive"), O.J. L 085, 3/4/1996, p. 17-21, which permits the calculation of own funds (capital) by credit institutions on the basis of a net rather than a gross amount with respect to contracts which are subject to an enforceable bilateral netting arrangement. The Netting Directive requires that, to take advantage of the directive, the credit institution must have available to it an opinion of counsel that the operative netting arrangements are enforceable in the pertinent jurisdictions.

potential co-venturers and who could have input into the design of the structure and governance of the project. The visionary theme of the project is to develop an electronic pan-global marketplace and improve the security, transparency and integrity of transactions using a market format. Several combinations of exchanges within the EU are proposing similar plans for common pan-European platforms for trading and/or clearing.⁴²

The Kyoto Protocol memorializes the international objective of reducing greenhouse gasses (global carbon emissions) in the interest of promoting protection of climatic conditions and corresponding or related environmental benefits.⁴³ The Protocol anticipates the design of an emission trading program that would permit trading of surpluses or deficits in overall caps or limits across borders either by sovereign jurisdictions directly or domestically in the first instance and then internationally. The Protocol's expectation of using trading as a means of reduction to the agreed country goals is modeled on the highly successful SO₂ (acid rain) trading program in the US, the cash market auction for which is handled by the CBOT and which has contributed to implementation of current reduced levels at substantially reduced economic costs (about 50%) to those originally estimated. To develop a trading program, a unit of trading would have to be identified; standardized tradable units which can legally convey the interest would have to be created; and verification, tracking and enforcement of subsequent use (expenditure or banking) of the interest would be required.⁴⁴ Assuming the

⁴² For example, eight of the principal European exchanges (those in Amsterdam, Brussels, Frankfurt, London, Madrid, Milan, Paris and Zürich) recently signed an accord to form a European alliance with the long-term objective of creating a single common electronic platform with common rules. The ultimate objective of this accord is to build a unified pan-European market. Additionally, the regulated French markets SBF, Matif S.A., Monep S.A. and Societe de Nouveau Marche recently merged to form ParisBourse SBF SA, bringing together all trading in equities, derivative products, and commodities, with each market maintaining its own regulations, identity and members. (Clearing for these markets takes place through a separate entity, the Banque Centrale de Compensation, or Clearnet SBF SA, which ultimately purposes to provide pan-European clearing similar to that provided by the National Securities Clearing Corporation/Government Securities Clearing Corporation in the United States.) The OM Stockholm Exchange and the Copenhagen Stock Exchange also recently commenced equity trading via a single electronic system using common trading rules. Seventy percent (70%) of the total equity market of the Nordic countries is now accessible from this single system. (The clearing of transactions consummated through this system takes place locally.)

⁴³ For further information on the Kyoto Protocol, see the homepage for the United Nations Framework Convention on Climate Control at <http://www.unfccc.de/>. See also *The Kyoto Protocol and the President's Policies to Address Climate Change* at http://www.epa.gov/globalwarming/reports/pubs/wh_econ/wh_full_rpt.pdf. *The Kyoto Protocol on Climate Change Fact Sheet* released by the Department of State Bureau of Oceans and International Environmental and Scientific Affairs, January 15, 1998, http://www.epa.gov/globalwarming/actions/global/us/kyoto_dosfs_011598.html. The text of the Kyoto Protocol is also available at <http://www.epa.gov/globalwarming/actions/global/international/cop3.pdf>.

⁴⁴ See R.L. Sandor and J.R. Skees, *Creating a Market for Carbon Emissions -- Opportunities for U.S. Farmers*, at <http://www.envifi.com/Internal/Choices.htm> in which Sandor "postulates a simple seven-stage process for market development: 1. a structural economic change that creates a demand for new services; 2. the creation of uniform standards for a commodity or security; 3. the development of a legal instrument which provides evidence of

cash instrument can be created and the monitoring and the scientific measurement issues resolved, developing a market that can operate internationally should be possible using the force of contract law consistent with the principles and examples set forth above. In this case, any international/supranational entity created to facilitate trading may receive other support from or in participating countries.

Private regulation of markets through rules puts a premium on enforceability of the contract evidenced by market rules, especially the contract related to the creation of tradable interests and the protection under the exchange rules of enforcement of the financial settlements embedded in the traded instrument. Therefore, such markets cannot flourish in environments where rules are disparately applied, where the governance of the market or of the jurisdiction where the market is located is suspect, or where money paid to the market could be diverted.⁴⁵ To the extent an electronic system makes trading systems rules self-enforcing or embedded in the system and related settlement systems collect the money to secure market risk upfront, the potential for rule infractions or failures is reduced.

With the foregoing caveats, markets potentially can harmonize requirements across borders where legislatures have failed (or have yet) to do so and can provide internationally ruled trading facilities notwithstanding the national nature of financial services law.

ownership; 4. the development of informal spot markets (for immediate delivery) and forward markets (non-standardized agreements for future delivery) in commodities and securities where "receipts" of ownership are traded; 5. the emergence of securities and commodities exchanges; 6. the creation of organized futures markets (standardized contracts for future delivery on organized exchanges) and options markets (rights but not guarantees for future delivery) in commodities and securities; and 7. the proliferation of over-the-counter markets."

⁴⁵See A.M. Corcoran, "Developing Exchange Derivatives Markets" (20 October 1999), Securities and Exchange Commission *1999 International Institute for Securities Market Development* discussing uncertainty about equitable application of laws, clearing arrangements, ability to repatriate funds, enforceability of obligations, and prices of underlying reference products as major impediments to successful market structures.

Appendix I

IOSCO Principles for the Oversight of Screen-based Trading Systems for Derivative Products

1. The system sponsor should be able to demonstrate to the relevant regulatory authorities that the system meets and continues to meet applicable legal standards, regulatory policies, and/or market custom or practice where relevant.
2. The system should be designed to ensure the equitable availability of accurate and timely trade and quotation information to all system participants and the system sponsor should be able to describe to the relevant regulatory authorities the processing, prioritization, and display of quotations within the system.
3. The system sponsor should be able to describe to the relevant regulatory authorities the order execution algorithm used by the system, i.e., the set rules of governing the processing, including prioritization, and execution of orders.
4. From a technical perspective, the system should be designed to operate in a manner which is equitable to all market participants and any differences in treatment among classes of participants should be identified.
5. Before implementation, and on a periodic basis thereafter, the system and system interfaces should be subject to an objective risk assessment to identify vulnerabilities (e.g., the risk of unauthorized access, internal failures, human errors, attacks, and natural catastrophes) which may exist in the system design, development, or implementation.
6. Procedures should be established to ensure the competence, integrity, and authority of system users, to ensure that system users are adequately supervised, and that access to the system is not arbitrarily or discriminatorily denied.
7. The relevant regulatory authorities and the system sponsor should consider any additional risk management exposures pertinent to the system, including those arising from interaction with related financial systems.
8. Mechanisms should be in place to ensure that the information necessary to conduct adequate surveillance of the system for supervisory and enforcement purposes is available to the system sponsor and the relevant regulatory authorities on a timely basis.

9. The relevant regulatory authorities and/or the system sponsor should ensure that the system users and system customers are adequately informed of the significant risks particular to trading through the system. The liability of the system sponsor, and/or the system providers to system users and system customers should be described, especially any agreements that seek to vary allocation of losses that otherwise would result by operation of law.
10. Procedures should be developed to ensure that the system sponsor, system providers, and system users are aware of and will be responsive to the directives and concerns of the relevant regulatory authorities.