The Role of Clearing Firms in Futures Markets

July 2022

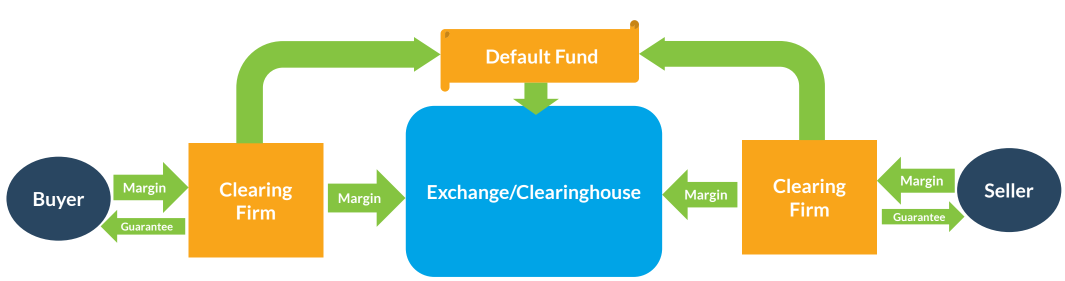
INTRODUCTION

In futures markets, as in most financial markets, there are several types of intermediaries that provide customers with access to the markets and a range of services related to their trading activity. In futures markets, however, there is one type of intermediary that is especially important. This is the clearing firm, which functions as the intermediary between the customers and the exchanges and clearinghouses.

Clearing firms, which are known as futures commission merchants in the US and general clearing members in Europe, perform several critical functions in the trading and clearing lifecycle for the futures markets.

- First, they offer customers a central point of access to futures exchanges and clearinghouses around the world.
- Second, they maintain an array of checks and controls aimed at protecting both markets and customers.
- Third, they are responsible for collecting margin from their clients and guaranteeing their clients' obligations to the markets.
- Finally, they contribute significant financial resources to the default funds maintained by clearinghouses. These default funds serve to absorb losses from defaults and protect the stability of the futures markets.

During periods of economic stress and market turmoil, futures markets take on additional importance because of their resiliency. As shown during the financial crisis of 2008, the futures markets continued to function even amid tremendous stress in the financial system. This resiliency underscores the importance of futures markets—and the clearing firms within those markets—to the stability of the entire financial system.



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INTERMEDIARIES IN THE FUTURES MARKETS

There are two main types of intermediaries: executing brokers and clearing firms. Executing brokers provide access to markets and support trading by their clients. This role includes executing trades for clients, providing market data, trading tools, portfolio analytics and automated trading software. Clearing firms process trades after execution, hold client assets, guarantee their clients' obligations, and contribute sizeable resources to the clearinghouses. Many intermediaries provide both execution and clearing services, but clients have the option to unbundle these services and use multiple firms to meet their needs.

CLEARING FIRMS AND RISK MANAGEMENT

One of the greatest risks to the clearing system is the potential for a default. Futures are highly leveraged, and a sudden market move can cause large losses.

Clearing firms play a central role in ensuring the resiliency of the clearing system and preventing losses from triggering a domino effect that can threaten the stability of the markets. They do this in several ways.

First, failures of clearing members are quite rare, and customer losses resulting from such failures are rarer still. This is due to the credit and risk due diligence of customers performed by clearing members. This diligence reduces the overall risk exposure to the system and is a critical role played by intermediaries.

Second, they guarantee the obligations of their clients. The need for this guarantee arises when a client's position suffers a loss in value. If the client is unable to meet the margin requirements on that position, the client's clearing firm will cover any losses resulting from the close-out of that position.

Third, clearing firms mutualize the risks of losses from a default by a member of a clearinghouse. At most clearinghouses, the overwhelming majority of the resources in the default fund comes from the clearing members, rather than the clearinghouse itself. In addition, most clearinghouses require members to replenish the fund if any amounts are used to cover losses from a default.

From a structural perspective, the clearing system has the effect of compartmentalizing risk. Rather than having a single point of failure, the clearing system mutualizes risk across the membership of the clearinghouses and reduces the risk that the clearinghouse might fail. In effect, the financial strength of the

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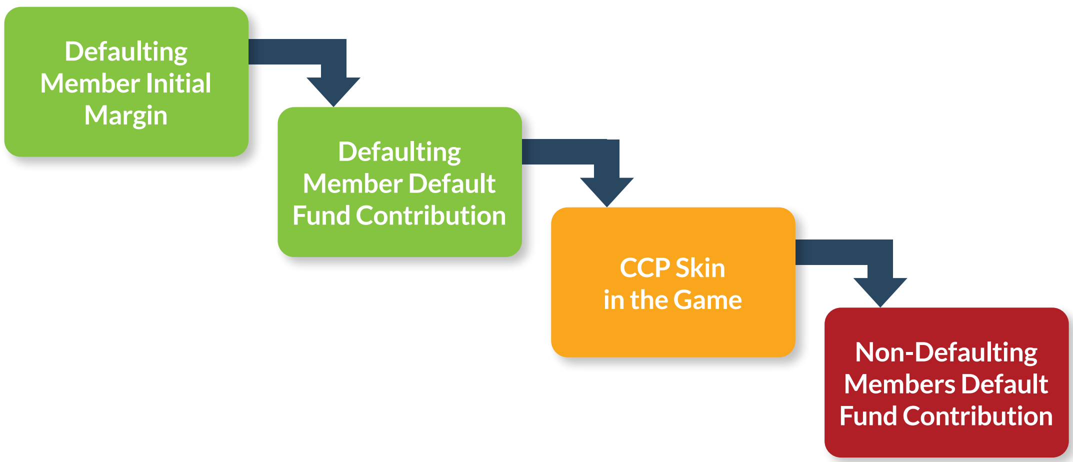
clearinghouse membership is the foundation for confidence in the clearinghouse itself. This is one of the main reasons why central clearing has proven to be so resilient during periods of market stress.

Waterfall of financial resources that absorb losses from a default.



PROTECTIONS PROVIDED BY INTERMEDIARIES

During the trading and clearing lifecycle, executing brokers and clearing firms offer the following types of protections and functions:

Customer Protection – Intermediaries provide risk disclosures and ensure that customers understand the risks of trading futures and options. They also evaluate the creditworthiness of clients to lessen the likelihood of default.

See the following:
FIA FAQs for Protection of Customer Funds
FIA Risk Disclosure Template for Negative Contract Prices
FIA Regulatory Disclosures

Policing Illicit Activity – Intermediaries perform various regulatory requirements designed to prevent the financial system from being used for illegal purposes. These requirements include anti-money laundering controls and know-your-customer rules.

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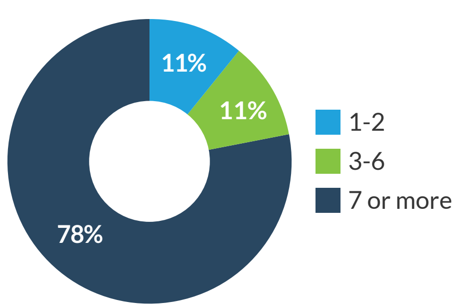
Market Access – Intermediaries offer centralized connectivity to multiple markets. Some examples of clients that benefit from this access include:

- A food company that uses futures contracts listed on multiple exchanges to hedge its risks – the Chicago Board of Trade and the Minneapolis Grain Exchange for wheat, ICE Futures US for canola, the CBOT for soy meal.
- A commodity trading firm that buys, sells and transports various types of fuel and uses futures contracts listed on multiple exchanges to hedge its risks – the New York Mercantile Exchange for gasoline and heating oil, ICE Futures Europe for gasoil.
- A fund manager that uses equity index futures to manage exposure to global stock markets – CME for the S&P 500 futures, the Osaka Securities Exchange for Nikkei 225 futures, the Singapore Exchange for the China A50 futures, and Eurex for the Eurostoxx 50 futures.

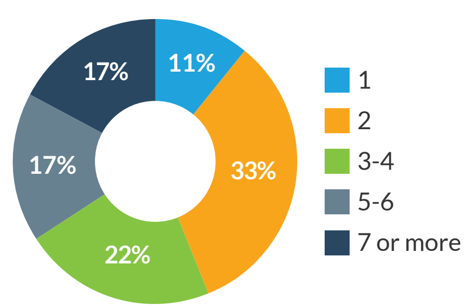
Execution Services – Intermediaries help their customers execute trades more efficiently by providing algorithmic trading tools. Intermediaries also help their customers reduce the market impact of large trades through off-exchange mechanisms such as block trades.

Institutional investors active in futures markets typically use multiple intermediaries for trading and clearing. A survey conducted by Greenwich Associates in 2021 showed that most asset managers used more than half a dozen brokers to execute their trades, and more than half used three or more firms to clear their trades.

Number of Executing Brokers



Number of Clearing Firms



Source: FIA-Greenwich survey

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Orderly Markets – Intermediaries help preserve orderly markets by maintaining risk controls to prevent erroneous trades, market manipulation, and deceptive conduct from passing through their systems.

See the following:
FIA Exchange Risk Controls
FIA Order Handling Risk Management Recommendations
FIA Guide to the Development and Operation of Automated Trading Systems

Trade Allocations – Clearing firms support the needs of asset managers by implementing their instructions to allocate positions to the ultimate clients. They also process give-up trades where a client has chosen to execute with one broker and clear with another.

Segregation – Clearing firms are required to segregate client assets from their own assets and protect client assets in case the firm fails. This is a foundation of the current customer protection regime for the futures markets.

Margin Processing – After trades are executed, the resulting positions are submitted to the clearinghouse for clearing. Clearing firms are responsible for collecting collateral necessary to meet the margin requirements on their clients' positions. In addition, clearing firms assess the credit risk of each client and may require additional margin above the minimum requirements set by the clearinghouse. Examples of these requirements could include:

- Collateral transformation – clearing firm collects margin in one currency, posts margin in another.
- Consolidated margin call – fund manager receives one margin call from clearing firm, clearing firm takes responsibility for posting collateral to multiple clearing houses.

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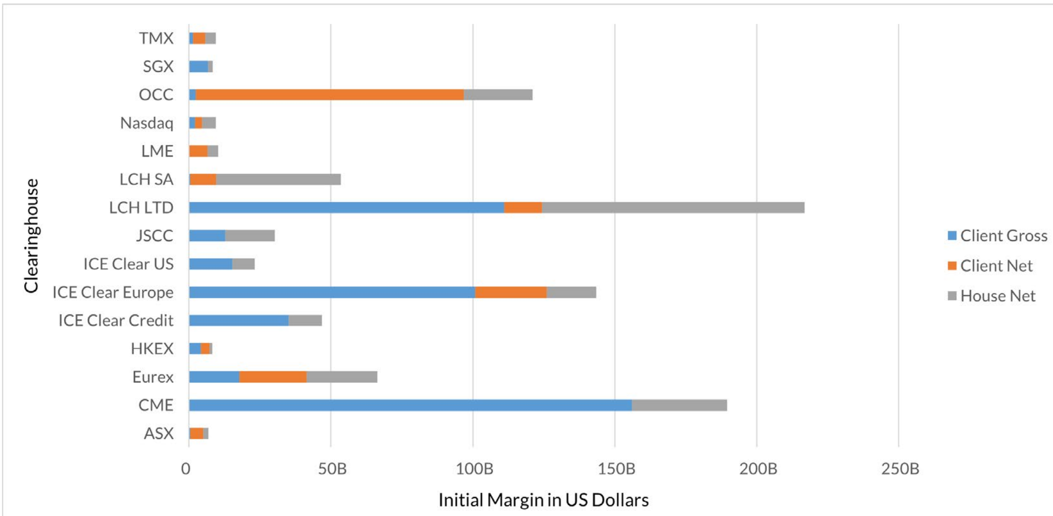
Initial Margin

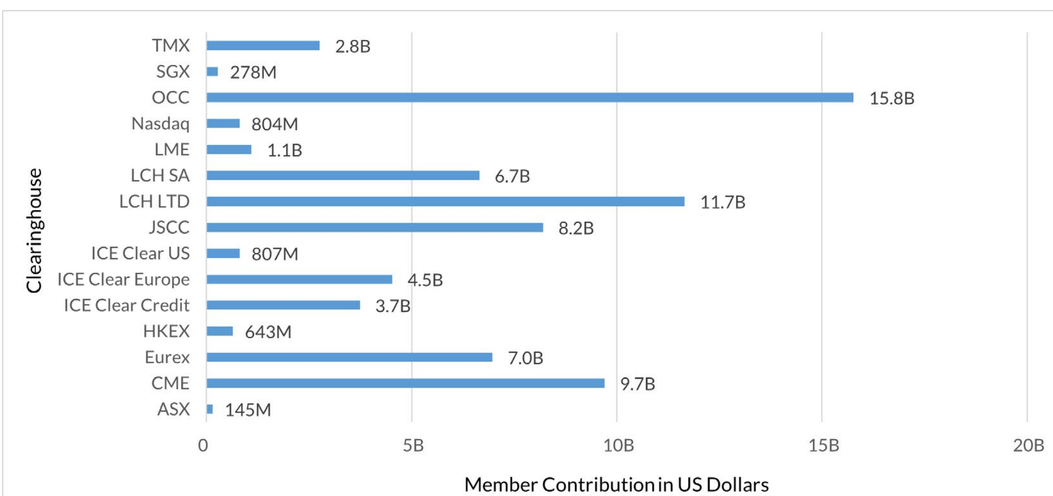
This chart shows the total amount of initial margin clearinghouses were holding for all customer positions outstanding at the end of 2021. Initial margin functions as the first line of defense against losses from a default. The amount is generally equivalent to the CCP's estimate for the potential loss on a position over a short time horizon, based on the current level of price volatility and historical data on extreme price movements.



Source: FIA CCP Tracker

Default Fund Member Contributions

This chart shows the amounts contributed by clearinghouse members to the default funds maintained by these clearinghouses. A default fund serves as a backstop in case losses from a member default cannot be covered by that member's initial margin and default fund contribution.



Source: FIA CCP Tracker

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VALUE OF INTERMEDIARIES TO THE MARKET ECOSYSTEM

In addition to the functional aspects described above, intermediaries also provide value to the exchange-traded derivatives markets in other ways.

For example, the presence of intermediaries strengthens market discipline by providing an independent check on both the market infrastructures and the customers. Having intermediaries as an independent layer in the ecosystem avoids conflicts of interest that can arise when the functions of intermediaries are combined with the functions of exchanges and clearinghouses in a single entity.

Intermediaries also bring human judgment into the risk evaluation process. They have the ability to tailor their risk evaluations to different types of customers and different types of financial strength. In a sense, they function as an extra set of eyes on every customer, complementing the risk management processes of clearinghouses.

CONCLUSION

Intermediaries offer a wide range of services to customers interested in trading futures. These services cover every stage of the trading lifecycle, from the initial entry of orders all the way through to the collection of margin days, weeks, and even months after the initial trade. Intermediaries also are the financial backbone of the clearing system, providing the capital that absorbs losses in case of a default and protects the clearinghouses from collapse. This market structure has stood the test of time, preserving the stability and resiliency of the global exchange traded derivatives markets for decades, even during periods of extreme volatility and financial crisis.

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BRUSSELS
Office 621
Square de Meeûs 37
1000 Brussels, Belgium
+32 2.791.7572

LONDON
Level 28, One Canada Square
Canary Wharf
London E14 5AB
Tel +44 (0)20.7929.0081

SINGAPORE
One Raffles Quay North Tower
Level 49
Singapore 048583
Tel +65 6950.0691

WASHINGTON
2001 K Street, NW
Suite 725, North Tower
Washington, DC 20006
Tel +1 202.466.5460

FIA.org