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Via email - theodore.lubke@ny.frb.org

Mr. Theodore J. Lubke
Vice President, Operational Risk
Federal Reserve Bank of New York
33 Liberty St
New York, NY 10045

Re: Credit Default Derivatives

Dear Mr. Lubke:

I am writing in connection with recent reports in the media about the application process being led by the Federal Reserve Bank of New York for firms to propose clearing and settlement solutions applicable to the over the counter (OTC) credit default derivative marketplace.

I was recently appointed Chief Executive of ELX Futures, L.P. (“Electronic Liquidity Exchange” or “ELX”) following positions as Chairman and CEO at the American Stock Exchange and as COO at the NYMEX. ELX was formed in December, 2007 by eight dealers; three trading firms; and a major electronic and voice broker and technology provider, and is now in the process of applying for designation with the Commodity Futures Trading Commission (“CFTC”) as a Board of Trade and Contract Market for exchange trading in, among other products, U.S. Treasury futures. ELX is also studying its possible role as an execution facility, as opposed to a clearing and settlement venue, for the trading in credit default futures contracts, and it is in connection with your consideration of that product class in the OTC market that I write today.

ELX is in the process of obtaining clearing services from a third party clearing organization for the futures contracts that we intend to offer for trading through our designated contract markets. Unlike two of the leading applicants who are reportedly before you to provide clearing and settlement services for OTC credit default derivatives, ELX does not own its own clearinghouse, but instead will operate on an open model as an exchange which only provides execution services. We are, therefore, not proposing a clearing solution in this matter.

The concern that ELX seeks to raise, however, is that any clearing organization that is awarded the right to provide clearing and settlement services for OTC credit default derivatives can use that award to suppress or deter competition in the subsequent development of a trading market in regulated futures related to such cleared products. An actual or de facto clearing monopoly can be used to undercut rates in a trading market, and can be the source of other anticompetitive conduct to favor the clearer's own trading market, and frustrate efforts by others to compete for transactions. A quick comparison of the equities marketplace, where clearing is strictly separated from exchange trading, shows the benefits to competition, and ultimately to the investor, that an arrangement brings where clearing and execution are separated. Futures exchanges, on the other hand, have a weak record of allowing competition, and have been allowed to maintain a model where the exchange and clearing facility are vertically tied so as to limit or exclude competitors from entering the space.

In a Department of Justice comment letter dated January 31, 2008 addressed to the Department of the Treasury (TREAS-DO-2007 0018) DOJ commented on this very issue as follows:

In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. This lack of control appears to have facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads, and high trading volume. Equities and options execution systems are also very sophisticated and feature-rich, more so than futures contract execution systems.

Although characteristics of the equities and options markets differ from those of financial futures markets, the clearing processes and related regulatory framework in equities and options markets appear to provide useful lessons in the futures arena. In light of the potential competitive benefits that could flow from regulatory changes that would facilitate competition in financial futures exchange markets, the Department recommends that Treasury propose a thorough review of futures clearing and its alternatives.

<http://www.usdoj.gov/atr/public/comments/229911.htm>

The recommended review has not yet taken place. However, the logic of DOJ's observations is clear and applicable to the instant situation. At some point, and it may be soon, the credit default derivatives market could benefit from a transparent execution marketplace in addition to a clearing and settlement system. The market will decide when, if ever.

We ask simply that the "winner" of the clearing prize for OTC credit default derivatives be strictly prohibited from participating as an execution venue, directly or indirectly, i.e. itself or through an affiliated entity, for the trading of credit default futures if and when they become regulated products.

In addition, we ask that the appointed clearinghouse be required to be “open access” and clear all execution facilities that transact such futures contracts on a common carrier basis for the same cost, on the same terms, and with access facilitated on a first come, first served basis. We would not want to see the award of clearing rights in the credit default market used by the chosen clearinghouse to gain a competitive advantage in the clearer’s affiliated execution business by rewarding some exchanges and punishing others that compete for trade executions in futures products unrelated to the credit default market in which the clearer also acts as an exchange.

As you can see, even when the clearing and trading functions for credit default OTC and futures products are separated, there is still a need to regulate the competitive practices of the selected clearing organization if it also maintains affiliated execution facilities in other futures markets.

With the risk of abuse so clear when the functions of clearing and trading credit default OTC and futures contracts, respectively, are separated, given the likely affiliation of the chosen clearinghouse with a futures exchange, it is not feasible to think that policing could properly regulate a structure if the clearer of credit default derivatives were permitted to execute trades in credit default futures and offer clearing services to others for trade executions in credit default futures.

The users of the clearing facility will be best served by allowing centralized, common clearing where the selected facility clears and only clears.

As a final point in favor of requiring the chosen facility to accept traded futures contracts from all execution venues, there are a number of benefits that accrue from having OTC credit default derivatives and futures contracts cleared under the same roof: the chosen clearinghouse can net exposures across OTC and futures markets; reduce capital demands for users; and process trades on and off exchange most efficiently. Preserving operational and cost efficiency, however, does not require a sacrifice of competition and investor and consumer interests.

Thank you for your consideration. I would be pleased to answer any questions you may have.

Sincerely,

