

BOLSA DE MERCADORIAS & FUTUROS BM&F BRAZILIAN MERCANTILE & FUTURES EXCHANGE

By J.L. Amaral*

I Introduction

On October 26, 1917, exporters, businessmen and commodity producers founded the Sao Paulo Commodities Exchange (BMSP). This was the first Brazilian institution to offer forward transactions. With the passage of time, BMSP established a rich tradition in the trade of agricultural commodities, especially coffee, live cattle and cotton.

In July of 1985, the Mercantile & Futures Exchange (BM&F) was established. Trading sessions commenced on January 31, 1986, and within a short time it attained a position of respect among the world's major futures exchanges, by offering derivatives on varied financial assets.

On May 9, 1991, BMSP and BM&F merged. This act brought together the tradition of the former and the dynamism of the latter in the creation of The Commodities & Futures Exchange (Bolsa de Mercadorias & Futuros), which maintained BM&F as its title.

On June 30, 1997, another merger took place, this time with the Brazilian Futures Exchange (BBF) of Rio de Janeiro, which was founded in 1983. The purpose of this merger was to strengthen the domestic commodity market and consolidate BM&F as the major derivatives trading center in Mercosur.

On January 31, 2000, upon completing 14 years of activities and inaugurating new state-of-the-art headquarters, BM&F joined the GLOBEX Alliance, composed of the exchanges from Chicago (Chicago Mercantile Exchange), Paris (ParisBourse SBF SA), Singapore (Singapore Exchange-Derivatives Trading), and Montreal (Montreal Exchange). This agreement covers the North and South American, European, and Asian time zones. To implement this inter-exchange connection, BM&F acquired the NSC system, developed by the Societ e de Bourses Fran aises (SBF). Through this system, the participants of one market will have around-the-clock access to the entire range of products offered by another market, with individualized clearing systems.

II FINANCIAL SAFEGUARDS & CLEARING FEATURES

One of the requirements for the perfect functioning of the derivatives market is the belief of its participants that gains will be received in accordance with the stipulated terms and conditions. This is made possible by a system which offsets gains and losses, thus assuming the responsibility for the settlement of all trades, wherein the Exchange becomes the buyer to the seller and the seller to the buyer.

* Managing Director,
Bm&F (USA) Inc.



This system is operated by a clearing house, which may be an independent organization that renders services to one or more exchanges, a subsidiary or an in-house department of an exchange. BM&F adopted the third model, which has proven to be more adequate for the derivatives market in Brazil.

Under this model, the Clearing Members are liable to the Exchange for the settlement of all transactions.

These members must meet a series of requirements, in addition to the pledge of their memberships to the BM&F. In financial terms, they must maintain the minimum net working capital established by the Clearing Division; in operational terms, they must post collateral to fund the Clearing Fund and comply with the limits imposed to the positions under their liability in order to reduce leverage risk.

In addition to margin requirements, the Clearing Fund guarantees the settlement of transactions in the case of default by a Clearing Member. A Member's contribution to the Clearing Fund cannot be withdrawn as long as the organization remains a Clearing Member. The Exchange fixes and reevaluates periodically the amount of collateral that funds the Clearing Fund. Each Clearing Member has joint and several liabilities for the default of all other Clearing Members, limited to twice its share in the Fund.

There are two other funds: the Clearing Members' Special Liquidity Fund, which is funded by the Exchange's revenues to cover a Clearing Member's default before the liquidation of its share in the Clearing Fund and to meet occasional liquidity needs of Clearing Members and Commodities Brokerage Houses; and the Guarantee Fund, that ensures customers of Commodities Brokerage Houses of the refunding of price differences resulting from inaccurate execution of trading orders and/or misuse of amounts that were supposed to be invested in the BM&F markets.

The Guarantee System structure, which consists of safeguards that secure market integrity for participants, as well as their contractual rights, is subdivided as follows:

- settlement of trades on the business day following the trading day, that reinforces the guarantee of the system as a whole, since the trades are only at a one-day risk of default;
- daily settlement of accounts, a mechanism that allows the daily cash settlement of gains and losses of the futures market participants;
- margins, that must be posted by all customers holding risky open positions at the Exchange. These positions are monitored on a customer level or on the level of a group of customers acting in concert for each contract month and for every market managed by BM&F. If necessary, the Clearing Division may require additional margin;
- position limits, that are imposed to impede market concentration, avoid manipulations and control market and credit risks.

Finally, the Commodities Brokerage Houses, Local Traders and Non-Members Authorized to Trade are liable to the Clearing Members to which they are bonded for the transactions they execute from registration to final settlement. They must also meet the minimum requirements established by the Clearing Division in terms of operational and financial standing. The Clearing Members may also impose operational limits upon them and require additional collateral from them, independent of any notice from the BM&F.



III BM&F'S PRODUCT LINE

The main goal of BM&F is to register, clear, and settle (physical and cash) the trades performed on the trading floor or in electronic systems. It thus must develop, organize, and operate a free and transparent derivatives market that offers economic agents opportunities to hedge against movements in the price of a varied range of products -agricultural commodities, interest rates, foreign currencies, metals, indices- as well as any other instrument or macroeconomic variable that may influence the economic activity negatively if their future price is surrounded by uncertainty.

For this purpose, it maintains the following markets:

- Futures, where two parties buy and sell for settlement (physical and/or cash) on a future date. The main characteristic of the futures market is the system that manages positions, which comprises the daily settlement of accounts (variation margin) and the margin requirements;

- Options on physicals, where one party acquires the right to buy (a call option) the underlying commodity from another party or to sell (a put option) the underlying commodity to another party, up to or on a certain date, at a specified price;

- Options on futures, where one party acquires the right to buy (a call option) the underlying futures contract from another party or to sell (a put option) the underlying futures contract to another party, up to or on a certain date, at a specified price;

- Flexible options, where, unlike floor-traded options, the parties define certain specifications, such as strike price, expiration, and size, as well as whether the contract (call or put) will or will not have the guarantee of BM&F's Clearing Division. Flexible options are registered via an electronic system;

- Forward, where, like the futures market, the parties buy and sell for settlement on a future date. However, in the forward market there is neither the variation margin nor the interchangeability of positions, binding the parties to each other up to the contract's settlement date;

- Swaps, like flexible options, are traded via an electronic system. In the case of swaps, the parties exchange one profitability index for another with the purpose of hedging, matching asset and liability, equalizing prices, arbitrating markets, and even leveraging positions. For such, they must choose the variable combination that is most adequate to their operations and define price, maturity, and size, as well as the guarantee or non-guarantee of BM&F's Clearing Division;

- Cash or spot, where trading is made for immediate settlement and delivery. This market is reserved only for certain commodities in order to create a price discovery mechanism necessary to promote the development of options and futures markets.

BM&F seeks to collaborate in the development of the physical or cash markets of the products underlying its contracts. Furthermore, it promotes a series of activities to maintain free, equitable, and transparent markets. Among the most important are:



- Trading facilities and/or electronic systems with state-of-the-art technology adequate for the execution of transactions;
- The regulation of the markets it manages;
- The surveillance of the transactions carried out on the trading floor and via electronic systems, as well as those regulated by BM&F;
- The regulation of its members' activities and their compliance;
- The prompt and broad reporting of the transactions executed on the trading floor and via electronic systems;
- The application of penalties to the violators of legal, regulating, and operating procedures;
- The concession of operational credit to its members, in accordance with its programs and objectives;
- The protection of its interests, as well as its members', before competent authorities;
- The dissemination of the derivatives market culture throughout the country by means of training and educational events and publications.

IV Contracts

1 GOLD

Gold Spot Contract
Gold Futures Contract
Call Options on Gold Spot Contract
Put Options on Gold Spot Contract
Gold Forward Contract

2 INDEX

Ibovespa Futures Contract
Call Options on Ibovespa Futures Contract American Style
Put Options on Ibovespa Futures Contract American Style
Call Options on Ibovespa Futures Contract European Style
Put Options on Ibovespa Futures Contract European Style

3 INTEREST RATES

One-Day Interbank Deposits Futures Contract
Call Options on Average One-Day Interbank Deposit Rate Index
Put Options on Average One-Day Interbank Deposit Rate Index
Spread on the Average Rate of One-Day Interbank Deposits Against Exchange Rate of Brazilian Reals per U.S. Dollar Futures
Long-Term Interbank Deposits Futures - Long ID
Floor-Traded Interbank Deposit Forward Contract With Reset
Floor-Traded Interbank Deposit Forward Contract Without Reset



4 EXCHANGE RATES

U.S. Dollar Futures Contract
Call Options on Cash U.S. Dollar Contract
Put Options on Cash U.S. Dollar Contract
Call Options on U.S. Dollar Futures Contract
Put Options on U.S. Dollar Futures Contract
Mini U.S. Dollar Futures Contract

5 SOVEREIGN DEBT INSTRUMENTS

Front-Loaded Reduction with Capitalization Bond Futures Contract
Eligible Interest Bond Futures Contract

6 SWAPS

Swap Contract

7 FLEXIBLE OPTIONS

Flexible Call Options on Cash U.S. Dollar
Flexible Put Options on Cash U.S. Dollar
Flexible Call Options on Cash Ibovespa
Flexible Put Options on Cash Ibovespa

8 AGRICULTURAL COMMODITIES

Anhydrous Fuel Alcohol Futures Contract
Arabica Coffee Spot Contract
Arabica Coffee Futures Contract
Call Option on Arabica Coffee Futures Contract
Put Option on Arabica Coffee Futures Contract
Corn Futures Contract
Call Option on Corn Futures Contract
Put Option on Corn Futures Contract
Cotton Futures Contract
Call Option on Cotton Futures Contract
Put Option on Cotton Futures Contract
Live Cattle Futures Contract
Call Option on Live Cattle Futures Contract
Put Option on Live Cattle Futures Contract
Soybean Futures Contract
Call Option on Soybean Futures Contract
Put Option on Soybean Futures Contract
Crystal Sugar Futures Contract
Call Option on Crystal Sugar Futures Contract
Put Option on Crystal Sugar Futures Contract