Issues to Consider for Hedge Funds and Proprietary Traders Contemplating Self-Clearing

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In the wake of the financial crisis of 2008 to 2009, trading firms having been taking a closer look at a variety of risks to their well-being. The collapse and near collapse of large brokers/futures commission merchants has highlighted that these risks arise not only from a trading strategy or the markets in general, but also from operational issues and from various counterparties. Traditionally, traders thought of counterparty risk only in bilateral transactions. Lehman Brothers' failure has caused these parties to reassess systemic risk and recognize that the end-user trading firm also bears "counterparty risk" when trading on exchanges arising from their clearing broker, custodian and even the clearing house itself. Some end-users, with the financial resources to do so, may be considering, or have already undertaken, to "self-clear" their transactions by becoming members of the clearing house as a way to mitigate counterparty risk, or for the other benefits of membership.

Given the likely legislative directive that will require more transactions, such as over-the-counter derivatives, to go through centralized clearing, this article examines some of the issues to be considered by hedge funds or proprietary traders seeking clearing house membership.