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PUBLIC ROUNDTABLE TO DISCUSS
ADDITIONAL CUSTOMER COLLATERAL PROTECTIONS
DAY 2

TRANSCRIPT OF PROCEEDINGS

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1 P R O C E E D I N G S

2 (9:37 a.m.)

3 MR. BARNETT: Okay, we're going to get
4 started. Welcome back to the second day of our
5 roundtable. And in this first session today, we
6 will look at various issues and ways of enhancing
7 customer protection, but with a focus on Part 30,
8 looking at protections of customer funds deposited
9 within FCM for trading on foreign markets.

10 Housekeeping, we're scheduled to go from
11 9:30 to noon. We'll take a 15-minute break in the
12 middle of the session and I think for those of you
13 who were here yesterday, you know where the
14 bathrooms are in the back.

15 Again, yesterday was really helpful. We
16 really appreciate the participation of the panelists
17 and let's quickly go around the table stating name
18 and company affiliation. My name is Gary Barnett,
19 CFTC.

20 MR. SMITH: Tom Smith, CFTC.

21 MR. PICCOLI: Kevin Piccoli, CFTC.

22 MR. DRISCOLL: Dan Driscoll, National
23 Futures Association.

24 MR. GILMORE: Carl Gilmore, Penson.

25 MR. WINTER: Steven Winter, State Street.

1 MR. SHORT: Jonathan Short, ICE.

2 MS. STREIT: Julie Streit, Country
3 Hedging.

4 MR. FOLEY: Kevin Foley, Katten Muchin
5 Rosenman, on behalf of FIA.

6 MR. PARKE: Ross Parke, Barclays.

7 MS. MCCARTHY: Sandy McCarthy, FC Stone.

8 MR. DeWAAL: Gary DeWaal, Newedge.

9 MS. BURKE: Maureen Burke, Bank of
10 America/Merrill Lynch, representing FIA.

11 MS. BAGAN: Anne Bagan, CME Group.

12 MR. WASSERMAN: Bob Wasserman, CFTC.

13 MR. BARNETT: Thank you. We, in our
14 disclaimer, CFTC staff cannot engage in a discussion
15 concerning matters involving MF Global in light of
16 our Division of Enforcement's ongoing investigation,
17 so we ask the participants to respect our request
18 that such specifics not be injected into the
19 discussion here today.

20 So let's begin. Very generally, just sort
21 of a -- some discussion, some beginning to get us
22 started. U.S. customers who wish to engage in
23 trading in foreign markets can deposit funds with
24 their FCM, who will facilitate the foreign trading
25 by depositing those funds, Part 30 secured funds,

1 with foreign depositories, foreign brokers which
2 affect the trades and a variety of issues arise out
3 of the basic arrangement.

4 For instance, in terms of the amount of
5 such funds that the FCM is required to hold in Part
6 30 secured accounts, Commission regulations
7 currently only require the margin plus method and
8 not the net liquidating method which is applicable
9 under 4d. Thus customer funds deposited with the
10 FCM that exceed margin plus could be at risk,
11 resulting in a potential shortfall of funds due to
12 customers -- that's due to their customers upon an
13 FCM insolvency. Also, if the foreign broker or
14 depository goes insolvent, not the FCM, funds that
15 are on deposit with the foreign broker or depository
16 would be subject to the foreign laws and foreign
17 administration applicable to the foreign broker or
18 depository.

19 In addition to foreign laws you can't
20 control, foreign laws and regs may provide for a
21 variety of options that could impact the safety of
22 customer funds, including, for instance, as noted in
23 the FIA piece -- which I've still not read
24 carefully, but I saw -- the ability in at least one
25 jurisdiction to opt out of the foreign law's seg

1 requirements.

2 Other issues arise because only customers
3 located in the U.S. are taken into account for
4 certain calculations and requirements, which has the
5 effect, as my colleague Bob Wasserman colorfully
6 describes it, and I hope he gets a chance to --
7 he'll get a chance to describe it later -- as
8 allowing real foreign customers who are also
9 involved to feed at the trough without having
10 contributed to the trough, although sometimes he
11 uses a cake or something like that, right?

12 Anyway, another consideration is that
13 these risks, like some of the others we discussed
14 yesterday, are risks that customers are expecting to
15 be backstopped by the FCM, but they are taken into
16 account in a nuanced way in the FCM's capital
17 structure or are otherwise litigated.

18 There's a capital requirement equal to 8
19 percent of the margin required on foreign futures
20 and options. There's a 5 percent foreign broker
21 charge. There's a simple requirement that a foreign
22 bank, to qualify as a depository, must have one
23 billion in reg cap, but the coverage of risks that
24 can arise from these issues don't attract a nuanced
25 capital charge or a specific mitigant and we should

1 be focusing on that, I think. But we want your
2 views on that.

3 Okay, so in that light, let's -- let me
4 ask the panelists, is there any reason not to
5 require FCMS to compute the secured amount
6 requirement under the net liquidating equity method,
7 basically the 4d method, instead of the margin plus
8 method as currently called for under reg 30.7?

9 MS. BURKE: I'll tell you the committee
10 strongly feels that there's no reason why it
11 shouldn't be done on a net liquidating value method,
12 which is a more conservative method, and for the
13 protection of all the clients.

14 MR. BARNETT: Any disagree?

15 MR. DRISCOLL: And I believe the SROs
16 would hold the same view.

17 MS. BAGAN: Anne Bagan from CME. I think
18 there's absolutely no reason why the 30.7 regs don't
19 mirror the 4d regs as well.

20 MR. BARNETT: Okay, thank you. All right,
21 so let me ask you, how can we -- and this, I guess
22 more open-ended question -- but how do we protect
23 FCMS and their customers from foreign insolvency
24 risk; what are some ways? For instance, I'll show
25 -- throw a few ideas at you.

1 Should we have a requirement that foreign
2 broker credit worthiness be posted? Should we
3 require double posting so that for every dollar
4 that's going overseas, there would be an equal
5 amount of proprietary funds held back in the U.S.?
6 Should we minimize the amount of funds that are
7 going out so that the amount of customer funds at
8 risk is minimized to limiting them to what's needed
9 to cover margin and customer positions in some
10 access, or some cushion?

11 Which ways -- in what ways can we deal
12 with the foreign insolvency risk of brokers and
13 custodians?

14 MS. BURKE: Okay, so Maureen Burke, Bank
15 of America/Merrill Lynch, representing FIA. And the
16 committee's looked at some of these options here and
17 feels strongly that the amount that -- the FCMS
18 should not have to keep funds here in the state --
19 in the States equal to the amount that's deposited
20 at the foreign broker, that there are disclosure
21 rules already in place and maybe there could be
22 enhanced disclosure rules to the clients on the
23 risks on trading on foreign boards of trade.

24 Understandably, that as the clients move
25 into different jurisdictions, there's different

1 bankruptcy regimes, there's different regulatory
2 environments as well. But we do feel that there
3 should be some level of an amount that the FCM
4 should deposit, a reasonable amount for the margin
5 obligation so it cannot leave excess funds at the
6 foreign brokers, either an affiliate or third-party
7 brokers, a reasonable amount.

8 And there are rules already in place
9 which -- I think the CFTC has looked at this
10 historically, that if the FCM has more than 150
11 percent the margin obligation, greater than 150
12 percent of the margin obligation, that you'd have to
13 take the 5 percent broker charge against that
14 amount. So those rules are in place. We support
15 the rules. There are some jurisdictions that
16 require a pre-funding in some instances that the
17 client has to pre-fund their margin, so that should
18 be taken into consideration as well.

19 MR. BARNETT: Carl?

20 MR. GILMORE: Carl Gilmore from Penson. I
21 tend to agree with Maureen's comment. Your earlier
22 comment, Gary, about should there be a -- some sort
23 of requirement for creditworthiness as a broker, or
24 the intermediary overseas, I think that's a good
25 idea. I'd be surprised if most of us are not doing

1 that now on an ad hoc basis, so we're not just
2 putting that money over there without some due
3 diligence, so formalizing that or perhaps making it
4 an audit point. Third-party risk-based audits might
5 be something that you want to do.

6 Secondly, I strongly agree with the --
7 with Maureen's position on I don't think it's a good
8 idea to require the FCM to keep an equivalent amount
9 of proprietary funds in the U.S. to secure the 30.7
10 requirements. The math just does not work out.

11 If you go back to the selected FCM data
12 reports that does -- that CFTC puts out, I think our
13 total risk-based capital requirement at the end of
14 the last reporting period was approximately 16
15 billion. The 30.7 requirement was approximately 40
16 billion.

17 So making the FCMs put in proprietary
18 funds in an amount equivalent to the 30.7, in my
19 view is -- amounts to a de facto raise in capital of
20 several magnitudes, and I'm not sure it's a
21 practical way to protect those customers.

22 Lastly, I do agree with the fact that we
23 ought to limit the exposure and limit the funds that
24 are held overseas to the margin required and some
25 buffer. And the trick will be depending on -- is

1 deciding on what the buffer is, because what's a
2 reasonable buffer now in Europe, frankly, after what
3 happened over the summer, is different than what it
4 was last summer. So it's got to be -- it's got to
5 be volatility based and it's got to have some kind
6 of trigger that will be reasonable for the margin
7 requirements.

8 MR. BARNETT: Okay, just following on from
9 -- oh, Gary, go ahead.

10 MR. DeWAAL: I was going to say, in
11 addition to agreeing with what has been said
12 previously, keep in mind that in many of the
13 jurisdictions, there already are a double option for
14 client -- U.S. clients already. So to the extent
15 that a jurisdiction is a 30. -- a Part 30
16 jurisdiction, the clients already have a option
17 either to have a direct relationship with a firm
18 located in that jurisdiction, or with a U.S. firm
19 carrying its position omnibus into that
20 jurisdiction.

21 And certainly our experience has been that
22 different clients choose different routes. Most
23 clients want to have a single route for ease of
24 administration, for ease of margining, et cetera, et
25 cetera.

1 I don't think it was among the questions
2 you asked. I've always had a bugaboo that Part 30
3 potentially allows foreign brokers to have -- carry
4 accounts for retail clients and I've always thought
5 that was something that should be corrected. I
6 don't think it's taken advantage of, but it's out
7 there. It's a loophole and I don't personally like
8 it.

9 But for institutional clients, ECP type
10 clients, you know, there already are options and I
11 just think that in general we're certainly not
12 holding ourselves out as guarantors of a client's
13 decision to trade overseas. The client itself has
14 made that decision to trade overseas and at least
15 for us, parcel of that is we have to explain
16 adequately what the risks are of trading overseas.
17 But once someone has made that decision to trade a
18 certain way overseas, there's -- there has to be an
19 assumption of risk. We can't be in the guarantee
20 business or, again, the economics will get even more
21 crazy.

22 MR. BARNETT: Let me just ask you, but is
23 there a difference maybe between a customer wanting
24 to take on a risk directly versus if doing it
25 through the FCM, not only affects the FCM and thus

1 its customers as well?

2 MR. DeWAAL: Well, keep in mind that if a
3 client goes through the U.S. entity to get abroad,
4 there is a capital requirement in addition to that.
5 The firm has to set aside additional capital,
6 whereas if that client goes directly abroad, then a
7 U.S. firm is not putting up additional capital.

8 So there is economic implications already
9 to that decision. I think the concern is, as Carl
10 has said, is the idea of putting up -- requiring us
11 to have an additional amount of capital equal to the
12 margin requirement, again, really skews the
13 economics. And obviously, that kind of charge would
14 have to be passed back into -- into the client.

15 So in effect, you're going to be
16 encouraging the client to have the direct
17 relationship, and I'm not sure as a matter of public
18 policy that's such a great idea either.

19 MS. BURKE: Just one further point. Back
20 to the reviewing the credit worthiness, and we fully
21 support that they should be reviewing that, the due
22 diligence that we had suggested for any -- anywhere
23 where a customer is segregated or secured funds are
24 held. So we do third-party and affiliated brokers
25 as well as the underlying custodial providers in

1 foreign jurisdictions.

2 But -- and also on a double seg, or
3 holding the funds here in the States, there could be
4 unintended consequences, as Gary is mentioning, that
5 if clients feel they have more protection on the
6 Foreign Boards of Trade than they have for trading
7 in the U.S., if it could -- you know, force more
8 trading overseas through the double seg arrangement.

9 MR. BARNETT: Okay, thank you. And also
10 just a reminder, and I'm not so good at reminding,
11 the housekeeping, but to say our -- your name
12 beforehand so in the transcript we can pick it up
13 right.

14 Picking up on something that was
15 mentioned, so enhanced disclosure, are we talking
16 general? Are we talking specific? Who's providing
17 it? Who's drafting it? What's -- are we just
18 talking about some general statement about going
19 offshore?

20 MS. BURKE: Well, I think there is
21 disclosure and Kevin or Gary, I'm not a lawyer, so
22 would appreciate the lawyers to step in here. But
23 there's already disclosure requirements that the
24 FCMs have. If we can -- they can be reviewed to see
25 if it's not sufficient. There's also the work that

1 has been done by the loan compliance group, where
2 they were looking at simplistically bringing it down
3 to a very simple language, which we discussed
4 yesterday as well, FAQs, that -- you know, provide
5 to the client so they truly understand the risk when
6 they're trading on foreign boards of trade, and each
7 jurisdiction -- every jurisdiction is very
8 different. The bankruptcy rules, as well as the
9 customer protection rules, are very, very different.

10 MR. DeWAAL: I'm sorry. One thing that's
11 been very, very helpful, Asco, in March of last year
12 published a survey of the customer protection views
13 of all the -- all the principal jurisdictions around
14 the world and certainly post the company whose name
15 we cannot name, we have made that link readily
16 available because that's something that people want
17 to know about.

18 So FIA obviously has proposed an
19 additional disclosure document that will enhance the
20 already robust disclosure. And I think letting more
21 folks know about this survey, you know, will help
22 the disclosure that's out there as to what are the
23 various protections.

24 I think -- I think that what surprised
25 clients most in the recent episode was actually not

1 the customer protection, necessarily regimes. I
2 think customers were aware, certainly institutional
3 clients were aware that there were different levels
4 of protection in different jurisdictions.

5 I think that what surprised clients was
6 the steps they have to actually go through to get
7 the money repatriated back to the jurisdiction where
8 their account began. And that's not unique to the
9 U.S. Their account began in London. Same issues.
10 If they were trading in Singapore, they might have
11 to go through Hong Kong before it gets back to
12 London.

13 I think that was the biggest surprise.
14 But I think that the enhanced disclosure that FIA is
15 proposing will help make some of this stuff clear.

16 MR. BARNETT: Kevin, can you add color to
17 the disclosure?

18 MR. FOLEY: Well, I think the -- from
19 CFTC's viewpoint in the past, and I think from the
20 firm's viewpoint in the past, you -- there is a line
21 to be drawn in terms of how much do you tell a
22 client. Do you hand the client upfront to tell them
23 to read and run the book, or do you say here is --
24 here are some risks and if you're going to trade
25 overseas you ought to ask your broker about some of

1 these risks to make sure you understand what those
2 risks are?

3 I think one of the issues that firms find
4 is the documents, even now with all the disclosures
5 can be 40 pages long, 50 pages long. And I think I
6 would be very surprised that except for the larger
7 clients that hire someone else to read these
8 documents for them, that a client is going to sit
9 down and read all this and understand it.

10 And they say, all right, now I -- now I
11 know. I mean, I think there really is -- you can't
12 downplay what those risks are certainly and
13 hopefully the risk disclosure that's out there --
14 the prescribers' disclosure that's out there now
15 doesn't; I don't think it does.

16 And certainly we should look to see what
17 else more we should say. But I think we need to be
18 -- to be careful not to pile so much information on
19 our clients that it actually causes them not to
20 bother reading something; they're actually reading
21 it and then that doesn't help anybody.

22 I think now that we have things like these
23 links where you can say you want to know about this
24 and you should know about this, here's the link, you
25 read it, make sure you understand it, ask questions,

1 but it's -- you know, I think there's -- there is
2 that balance to be drawn on that.

3 MR. BARNETT: In the -- and again, I
4 apologize for only having -- I mean, I didn't -- but
5 in your FIA piece, there is a footnote that talks
6 about the ability in the U.K. to opt out of seg. So
7 what would you do with that one -- you pick one
8 jurisdiction and one issue, what would you do with
9 that with disclosure? Would you have a
10 jurisdictional specific disclosure? Would you pick
11 one and ignore others?

12 MR. FOLEY: No. Our recommendation, the
13 ability for U.S. ECPs who open accounts directly
14 with a U.K., a 3.10 firm, to opt out of the client
15 -- client money rules is pursuant to a CFTC order.
16 I think it was in 2002. And our recommendation --
17 the FIA recommendation is that that order -- part of
18 that order ought to be rescinded. And my
19 understanding is -- and this is anecdotal -- but
20 that FSA is looking at changing that rule.

21 MR. BARNETT: But use that as an example.
22 Would you take something similar but maybe not as --
23 you know, where you're not as strongly advocating
24 it, if you change -- or something that's in the
25 process of being changed? What do you do with it as

1 a disclosure matter pending a change, or if it's
2 assuming -- I mean, you picked one out of one
3 jurisdiction.

4 MR. FOLEY: Right. That's the only one
5 that I'm aware of, so I can't -- I can't say there
6 are others. There may in fact be. But I'm just --
7 I don't -- I think if an ECP client opens -- well --

8 MR. BARNETT: But again, it doesn't have
9 to be an election out of SAG or something. Just use
10 that as one example.

11 MR. FOLEY: Oh, okay, certainly.

12 MR. BARNETT: I just noted that in your
13 fact you picked one example to highlight. The rest
14 is very high level kind of general. I'm just trying
15 to understand where -- kind of how would you -- and
16 I understand the difficulties, but trying to find
17 the right balance.

18 But using that an example, it kind of
19 drives you -- does it drive you towards
20 jurisdictional specific disclosure, or do you stay
21 at a very high level? Where do you think it needs
22 to go?

23 MR. FOLEY: Well, I think on a account
24 opening basis, it's high level. I don't think you
25 can do that, because I think the Asco document that

1 Gary referenced is 100-plus pages. I'm sure it's at
2 least that, right? I think they -- the CFTC -- no?
3 I'm happy to be told wrong. I mean, I thought --

4 MR. DRISCOLL: It's a convenient summary
5 table. That's probably -- it's 20 pages actually.

6 MR. FOLEY: Okay.

7 MR. DRISCOLL: It hits most of the main
8 jurisdictions. The one -- the one matter that I do
9 have to point out is that I'm aware this was
10 provided, information, from the different regulators
11 overseas. I am already aware that at least one
12 regulator's information may not be correct.

13 So I think the regulators should also use
14 this opportunity to go back and check what was
15 posted on this because clients are relying on this
16 now. And as I said, I'm aware of at least one
17 jurisdiction that information may not be correct.

18 MR. WASSERMAN: So two things first.
19 Yeah, that was -- I have some small familiarity with
20 that survey and it was at a particular point in time
21 and it was indeed based on what the regulators did
22 submit at that time. But perhaps there might be
23 some updating done out -- but to be sure, it's
24 difficult to unfortunately unless you're CCH or the
25 --

1 MR. DeWAAL: Welcome to our world.

2 MR. WASSERMAN: But Kevin, I just wanted
3 to clarify one point. The point you were making on
4 that was with respect to a 30.10 order. That was
5 not, I believe, with respect to 30.7 accounts?

6 MR. FOLEY: I believe that's right.

7 MR. WASSERMAN: Thank you.

8 MR. BARNETT: Okay, well, let me move
9 forward. So there was a -- what about -- yeah?

10 MR. PICCOLI: Before we do, just one
11 follow-up on disclosures. Yesterday we talked about
12 disclosing the investments, the character of what
13 the funds are invested in. I assume we would
14 probably carry the same to the Part 30 pick if it
15 was in the U.S., and if the funds were there, we
16 would want the same level of disclosure on the
17 underlying assets that they're invested in as well.

18 MR. WINTER: Steven Winter. The only
19 other thing I would suggest, or that we should
20 consider as it relates to disclosure is the fact
21 that when clients open up an account, they open up
22 an account, they sign the documentation, they get
23 the disclosure, all the disclosures that they're
24 required to. You either sign, review or whatever.

25 But a lot of clients have signed those

1 documents years ago and they're living off that
2 one-time disclosure. I think it would be worthwhile
3 that the industry be required to send out updated
4 disclosures at least on an annual basis.

5 MR. BARNETT: Thanks. Okay, so -- all
6 right, so let me -- go ahead.

7 MR. PARKE: Just to add on the
8 disclosures, I think one of the best practices we've
9 talked about, which I think a lot of the firms are
10 doing today, the brokers, is providing their
11 underlying customers information about who they're
12 actually facing or who they're using when they trade
13 on certain markets.

14 Because although they sign up with an FCM
15 in the U.S., once they trade potentially on Eurex or
16 on the OAC or a different market in foreign
17 jurisdiction, the clearing member may be a different
18 firm. And I think it's important to provide that
19 information to customers so they understand here's
20 the underlying clearing member that my trading
21 activity will be going through, so they can
22 determine if they're uncomfortable with that
23 clearing member because they originally signed up
24 with a certain FCM, that they have the option to
25 direct that trading activity through a different

1 broker.

2 MR. SMITH: Gary, I wanted to follow-up on
3 something you mentioned, get a sense of your firm
4 and how it operates and then something like Country
5 Hedging and FC Stone. Because I think you mentioned
6 something that's very interesting to me.

7 The FCM who's going to have customers who
8 want to trade on foreign markets will go through
9 your organization and then as you mentioned, they
10 may end up with an omnibus account in London that
11 will move on to Japan, wherever.

12 How does that normally work in the sense
13 of does the U.S. FCM have the one account with a
14 particular foreign broker that it uses, or does it
15 go directly to -- in an organization like yours,
16 that's multi-national?

17 And then -- and then I'll follow-up. Then
18 I was just going to ask the general profile of a
19 Part 30 customer relative to a 4d customer and
20 particularly like an FC Stone and Country Hedging,
21 what do you see there? I mean, my general sense is
22 I always understood they're more institutional type
23 of customers, but I just wanted to get your sense
24 from two or three very different type of
25 organizations.

1 MR. DeWAAL: Let me do the second question
2 first, only because as much as the competitive
3 reasons, I actually agree with Ross' views that you
4 should disclose the affiliates, because when most
5 people come to Newedge, they want to trade with
6 Newedge.

7 In fact, I see anti-competitive reasons
8 why you probably wouldn't want to require the
9 disclosure of the ultimate foreign brokers, and
10 that's because if a client of a lot of smaller firms
11 were aware that they were clearing their -- that the
12 smaller firms were clearing their accounts
13 internationally with a Barclays or a Newedge, they'd
14 probably say hmm, why don't we just deal with
15 Newedge directly?

16 I think just disclosing the fact that
17 there may be a non-affiliated or affiliated overseas
18 entities and on a request basis, I think that's a
19 good idea. I think to mandate automatically --
20 again, I'm very fearful of increasing the
21 concentration in this business. I just think it
22 could be anti-competitive.

23 You know, from our perspective, we don't
24 see a big difference between the clients that come
25 to us to trade 4d and overseas, but that's our

1 client base. We're exclusively institutional, you
2 know, and there are clients who come to us by the
3 way who may want -- they just -- they trade their
4 needs. We're not telling them what to trade.
5 They're the ones who have decided what they need to
6 hedge, what they want to trade, et cetera, et
7 cetera.

8 So part of the reasons why clients come to
9 us is they know we have an international footprint
10 and they want to deal with us because they know
11 we're physically present. They see -- they're
12 willing to take the group risk, so to speak, even up
13 to our ultimate parents, and so they just figure
14 that everything's in the family and they look in
15 fact to the ultimate credit ratings, even though the
16 ultimate parents have no guaranteed relationship
17 with the subsidiaries.

18 And I'm not -- I think that's pretty
19 typical in group organizations, that even though
20 they're dealing with one entity, the clients tend to
21 look at it as a group relationship. They obviously
22 are looking at the specific entity. They want the
23 specific balance sheet. They want the specific
24 financial statements. But they're looking it as a
25 group relationship.

1 And now, of course, because I answered
2 your second question, I forgot your first question.
3 Remind me again.

4 MR. SMITH: The first question would be in
5 your situation with the one-stop shopping --

6 MR. DeWAAL: Oh, yes.

7 MR. SMITH: -- for the FCM, just go to one
8 foreign broker no matter what market it is.

9 MR. DeWAAL: Again, we're organized around
10 three clearing centers, the U.S., the U.K. and Hong
11 Kong. That's just the way we're structured. And
12 typically we flow our Hong Kong account through our
13 London account into the United States. So someone
14 who's trading Asia will bounce twice. Someone who's
15 trading Europe will come into London and then go
16 through.

17 So potentially, I'm trying to think, you
18 could have as many as four stops. You're trading
19 Singapore, you start at Singapore, you go to Hong
20 Kong, you go to London, you come to the United
21 States. But every firm is structured differently.
22 It depends on how you're set up operationally.

23 And as I said, there are clients that want
24 direct relationships. There are things you can do
25 in different jurisdictions that dictate where you

1 want your account.

2 You know, most of -- we find that there's
3 a great preference to house accounts in London,
4 because I think London's considered to be a
5 particularly flexible environment internationally to
6 do a lot of transactions. There's not a distinction
7 between the securities environment and the futures
8 environment. Financing within the organization is
9 easier in London. There's many, many reasons why we
10 find that clients more often than not choose London
11 as a domiciled account.

12 But again, you know, every firm works out
13 their own operations to figure out what flows
14 through. And regrettably, in many firms' case, it's
15 a condition of history, so it may not be the most
16 efficient. It's just sort of there. You know, many
17 firms use different systems in different locations,
18 and that drives it too. But I think that's a
19 description of sort of how we do things.

20 MR. SHORT: Jonathan Short, ICE. I just
21 wanted to add one thought on the FIA proposal,
22 amounts that were not needed for margining purposes
23 on foreign markets be kept in the U.S. I think it's
24 a good idea. I think it's probably something that
25 should be mandated as an option for a customer, but

1 in the event that a customer has been given
2 appropriate disclosure about the risks, I'm not sure
3 it's something that should be a mandate that all
4 firms be held in the United States.

5 MR. BARNETT: Other -- other views in
6 response?

7 MS. STREIT: Julie from Country Hedging.
8 I agree with Jonathan. Back to Tom's question
9 regarding clients. For Country Hedging, we might
10 have farmer producers who live in northern North
11 Dakota, northern Minnesota, Montana, who want to
12 hedge their canola in Canada. I mean, that would --
13 all the way up to an energy company who wants to use
14 an ICE contract to hedge their energy. So we have a
15 wide variety of clientele and the disclosures we're
16 talking about would -- you know, that would
17 definitely affect them as far as what they were able
18 to read and understand, and frankly, their
19 willingness to want to do that.

20 But I mean, the disclosures are a great
21 idea. I just think different levels of clientele
22 and different levels of sophistication will play
23 into it.

24 MR. BARNETT: Thank you. In this
25 discussion about affiliates raises the affiliates

1 question. The use of FCMs, they're using affiliate
2 foreign depositories or affiliate foreign brokers,
3 so should there be a concern that an FCM won't
4 objectively analyze -- doesn't need to analyze the
5 credit risk of its own foreign affiliate? Should we
6 -- how do you deal with the fact that if one goes
7 down maybe they both go down? What are some
8 mitigants about that? Are we concerned about the
9 use of affiliates? Are there ways to mitigate the
10 risk of them both going at the same time?

11 MS. BURKE: We looked at this as well.
12 Maureen Burke, Bank of America/Merrill Lynch,
13 representing FIA. And one of the recommendations,
14 once again, that we recommended was that the FCMs
15 should have procedures, due diligence procedures for
16 monitoring any depository, custodial account,
17 affiliate and third-party broker, and the
18 depository, custodial accounts should be monitored
19 in a comparable manner to third-parties.

20 Regarding -- to prohibit an FCM from using
21 an affiliated broker overseas would complicate
22 things. Many clients want to come in, as Gary
23 mentioned, and deal with one -- one counter-party.
24 We do -- you know, from a Bank of America/Merrill
25 Lynch perspective, we have clearing -- we have

1 memberships all around the globe where a client
2 comes in, comes into Pirus and then we face all
3 those affiliates.

4 We have much more information available to
5 us about our affiliates, internal controls, policies
6 and procedures. We can look at that on a broad base
7 and see that there's equivalent policies and
8 procedures in place with our affiliates. We're
9 going through a third-party broker. We're not privy
10 to that information.

11 So there's things that we know by dealing
12 through an affiliate that we do not know by dealing
13 through a third party.

14 MR. BARNETT: Anne.

15 MS. BAGAN: Anne Bagan, CME. So to your
16 point, Maureen, and I just throw this question out.
17 Yes, you have a lot more information for your own
18 affiliates, but what's the likelihood that you're
19 not going to actually use one of your affiliates,
20 and I -- that you go to an affiliate -- unaffiliated
21 third-party foreign broker, what's the likelihood of
22 that? And I don't know, so I'm just asking.

23 MR. DeWAAL: Let me say it the other way.
24 We set up the affiliate because in fact the clients
25 have wanted to deal with our footprint globally.

1 MS. BAGAN: Right.

2 MR. DeWAAL: So it's not that we choose to
3 -- it's not like we have a random choice of
4 affiliates. We've set up the affiliate structure in
5 the first place in response to client demand. They
6 want the convenience of being able to process all
7 their trades through a single entity. And there's
8 lots of flow-through information, the operational
9 information.

10 And frankly, in these days of PTG trading,
11 you get more real time information as a result of
12 dealing with your affiliate than you would possibly
13 get through dealing with a non-affiliate. So
14 there's no doubt that there are some clients that
15 prefer this. There's some clients that don't prefer
16 this and in this world, the good thing is they have
17 their choice.

18 But it's not that we choose our affiliate.
19 It's more that we're pushed to set up an operation
20 in that location.

21 MR. BARNETT: A quick question, Maureen,
22 follow-on. And I don't remember, but is the policy
23 that you call for in your write-up, is that publicly
24 avail -- that's available to customers when they
25 come in? Is that -- or is that just internal

1 policy?

2 MS. BURKE: The policy of review of the
3 due diligence?

4 MR. BARNETT: Well, how you'll choose your
5 counter-parties. For instance, if say we'll
6 consider custodians and affiliate counter-parties or
7 have -- meet a certain criteria, is that --

8 MS. BURKE: The recommendation, as it
9 stands right now, is on that we would -- it would be
10 written policies and procedures that would be
11 available to the SROs and the CFTC. We did not get
12 to the point of putting it out for public disclosure
13 to the clients.

14 As mentioned yesterday, this is a work in
15 progress. It's a living document. We're working,
16 you know with the industry as a whole. There are
17 some concerns on making our -- you know, for the
18 FCMs to have all your due diligence policies and
19 procedures public and then having a client rely upon
20 that. And there's also Chinese walls within the
21 firms, that there's things that are done by our
22 credit department that may not be able to be
23 disclosed with Chinese walls.

24 So there's some concerns there and I don't
25 think it's been fully formulated at this point in

1 time. It is a living document. I don't know if
2 anyone else --

3 MR. WASSERMAN: Let us assume, for the
4 sake of this discussion, that firms, in looking that
5 are -- looking at their affiliates will do so with
6 the utmost in due diligence and objectivity in both
7 items. Let's take that as a given for this sake.
8 In the event that there is a failure, for whatever
9 reason, lightening strikes at say the U.S. firm,
10 what is the likelihood that those affiliates will
11 not themselves also fail within a period of days?

12 MR. DeWAAL: Realistically, I think it's
13 low.

14 MR. WASSERMAN: And Gary, you were talking
15 about -- and forgive me for picking on you -- but --

16 MR. DeWAAL: Not the first time.

17 MR. WASSERMAN: Well, beyond there's a
18 reason, I think. But you mentioned that there would
19 be -- earlier you talked about people just seeing
20 the complications in particular incidences, which I
21 shall not name, of how things go in terms of having
22 to get money back.

23 And you also mentioned that you folks are
24 -- I'm sure there are very -- very important
25 efficiency reasons organized so that if it's going

1 through various places, they might be intervening
2 one, two, three entities. If heaven forbid, and I'm
3 sure this is not, you know, in any way likely, but
4 just hypothetically a firm so organized failed, in
5 order to get that money back, you'd have to be going
6 through at least two and in some cases maybe even
7 three or four insolvency proceedings. Is that --
8 what's the impact there?

9 MR. DeWAAL: Well, first of all, that has
10 nothing to do potentially with doing business with
11 affiliates or non-affiliates, because you don't know
12 how those non-affiliates are organized and they may
13 be organized the exact same way.

14 I mean, firms choose to organize how they
15 process what I call -- there's the remote markets,
16 there's the central markets, and then there's the
17 two big markets. There are a lot of remote markets
18 that clients want access to and to have a direct
19 omnibus account, I mean, part of -- part of what
20 drives the way we're organized, frankly, is the
21 large trading reporting requirements of the U.S.,
22 because we're trying to set up the flow-through in a
23 way that we can actually get the information the
24 most timely and efficiently.

25 And one of the reasons we've set up our

1 operations -- and we've done a lot of re-programming
2 in the last couple of months, or last year or so --
3 is to make sure the information flows through in a
4 way that we can get it to you guys as efficiently
5 and as accurately as possible.

6 So part of what's driving our flow-through
7 process is in fact an effort to comply with other
8 regulatory requirements. But the specific issues
9 that you are raising are -- just go with the
10 territory. Even a non-affiliate that -- I mean, we
11 have two issues. For example, let's suppose you
12 want to access the markets in Vietnam. I'm not even
13 sure they trade futures right now, but let's -- I
14 know they trade securities and that's why it's on my
15 mind. I probably don't want to have a direct
16 relationship with a Vietnamese company. I have a
17 hard time doing a credit analysis at this point.
18 Maybe I'm concerned.

19 I would much rather do business, because
20 it fits my internal credit policies, with a Hong
21 Kong entity that itself brings in Vietnam and is
22 willing to stand behind its Vietnamese subsidiary.
23 So in that case, right off the bat now, I'm going to
24 have a double, if not a triple potential bankruptcy
25 situation, because it's the Vietnam company and

1 Vietnam law. It's Hong Kong. It's the U.S.,
2 whether I use an affiliate or not.

3 By granting access through the U.S.
4 portal, you're bringing in inevitably different
5 bankruptcy regimes. That's just one of -- you know,
6 you've got -- the clients have to weigh the pros and
7 cons of doing business in certain ways. I mean,
8 obviously, there's efficiency, there's margin,
9 there's single margins, there's potential financing.
10 There's all sorts of benefits to having the single
11 account.

12 But there's, obviously, as we recognize,
13 certain detriments. You can alternatively find a
14 Part 30 jurisdiction and open up your account
15 directly there, but that's not as convenient.
16 You're dealing with different time zones, et cetera.
17 I mean, there's pros and cons for each alternative,
18 and that's why at least for the institutional
19 clients, and certainly it's the case in the last
20 four months, I find that certainly the legal
21 compliance teams are becoming much more involved in
22 the discussions with potential clients as to how
23 things work out there.

24 MR. PICCOLI: Gary, just following up on
25 that then. If we do -- you go forward with we're

1 going to trade with affiliates and use affiliated
2 broker-dealers, which from my past time I totally
3 get why that would be appropriate. But would then
4 there be reason to look at the 17-H filing and maybe
5 we need more disclosure there so that we at least
6 have the opportunity to look at what are the
7 inter-company funding and financing relationships,
8 where are the inter-company receivable/payable --
9 and look at it from that perspective and maybe that
10 way we can get better insight into it?

11 MR. DeWAAL: As Maureen said, I think -- I
12 think these type of issues are certainly important
13 to discuss and I think as regulators it seems fair
14 to me you'd want to know more about how groups work.
15 Certainly there are other regulators that we are
16 subject to that certainly want to know that kind of
17 information, so I don't see a big objection.

18 Obviously, it's the level of detail that
19 we go down. But yes, I mean, I think there are
20 certainly regulators around the world that want to
21 know about where we're getting liquidity from, where
22 we're getting capital from, what's our commitments,
23 things like that. They want to know that structure.

24 Again, there is a fine line though,
25 because I do think there's an anti-competitive

1 aspect of this. I mean, the disclosure that's made
2 to you versus the public, I think -- and it's not --
3 it's not that we wouldn't make it on a selective
4 basis, but general disclosures I think could be
5 somewhat embarrassing. You know, if a big -- if
6 clients see the big firm is clearing through another
7 big firm, that's embarrassing. If a smaller firm is
8 clearing through a big firm, then the clients are
9 wondering why they're not dealing with the big firm
10 directly, but the big firm may not want to deal with
11 them.

12 I mean, it's -- it gets a little
13 complicated and that's where I get nervous and I
14 just -- I just don't know the answers.

15 MR. BARNETT: Thank you. Other thoughts?

16 MR. GILMORE: Carl Gilmore from Penson.
17 Just one quick follow-up. I think Kevin makes a
18 very good point. Just sort of going on Bob's
19 original question, my view would be that it's
20 doubtful that using an affiliate just for clearing
21 at settlement, you know, same way that you would use
22 a third-party, it's doubtful that that activity in
23 and of itself would increase Bob's domino effect.

24 And so -- but I think it's really
25 important to point out, as Kevin says, if you move

1 out of clearing and settlement traditional
2 activities into funding and financing, that's the
3 touch point in my view where you may increase the
4 risk where one affiliate goes down and then the
5 others go down one after another. So essentially I
6 think you got two different questions there.

7 MR. BARNETT: Okay. Let's move back to
8 slightly -- because of the FIA point, slightly
9 different question. But to the extent that a
10 foreign jurisdiction's regulations provide for
11 different degrees of protection for customer funds,
12 should FCMS be required to elect the most stringent
13 regime offered? Should FCMS be prohibited from
14 opting out of protection, going to that point? And
15 if not, how should the related risk to the FCM be
16 mitigated?

17 MS. BURKE: To the extent that the foreign
18 jurisdiction offers a more stringent regulatory
19 regime for customer protection, we strongly feel
20 that the -- the FCM should take the most stringent
21 protection to be offered to the -- coming into the
22 U.S. FCM. And to the point of the opt-out, the U.S.
23 FCM should not be able to opt out their client base
24 trading through 30.7 accounts. They should take the
25 -- and the FCM should review jurisdictions,

1 understand the rules.

2 I think the CFTC should perform a thorough
3 review of each jurisdiction and understand the
4 related rules, as well as the SROs, and that should
5 be part of the disclosure going out to the clients.
6 But it should be the most stringent approach.

7 MR. BARNETT: I see general agreement. No
8 disagreement?

9 MR. DRISCOLL: Dan Driscoll, NFA. I would
10 agree with that completely.

11 MR. BARNETT: Let me ask, what additional
12 reporting should be required from FCMS who deposit
13 customer Part 30 funds with foreign brokers, what
14 kind of reporting? We've talked about disclosure.
15 We've talked about limitations and how much goes.
16 What kind of -- are we talking categories generally?
17 Is it kind of the same thing as yesterday? But what
18 specifically, what kind of reporting should be
19 available, I guess either to the SRO, the
20 Commission, and to the -- available to the customer
21 base?

22 MR. DRISCOLL: Dan Driscoll, NFA. My
23 opinion on that is that I think any sort of
24 reporting that we think is appropriate for U.S.
25 business should be adopted per the Part 30 as well,

1 and basically in the same format in the same level
2 of detail, unless there is some specific reason that
3 it can't be done or it's not practicable.

4 But I think anything -- and I think we all
5 agree that more information should be submitted to
6 the SROs and much of that should actually be made
7 available to the public.

8 MR. BARNETT: What about country-specific,
9 anything dealing with specific -- things going on in
10 the country?

11 MR. DeWAAL: Maybe you can explain what
12 you mean by country specific.

13 MR. BARNETT: Sovereign risks, sovereign
14 occurrences, anything that needs to be maintained,
15 or is it just kind of a sort of a transactional kind
16 of notice, your FAAC or whatever and periodic
17 information about what's going on on a transactional
18 basis. Go ahead, Gary.

19 MR. DeWAAL: Again, I think that, you
20 know, it depends on the way -- it depends on the
21 nature of your basis. I think if you're directing
22 your clients into a foreign jurisdiction for trading
23 purposes, then you probably have some kind of
24 additional obligations to affirmatively disclose
25 events in that jurisdiction.

1 But the clients who are themselves
2 choosing to be in that jurisdiction, it seems to me
3 that they are generally aware, or should be aware,
4 of what's going on in that location, so I'm not sure
5 what kind of disclosure.

6 I mean, obviously, you know, if there's
7 something material that the domiciled FCM needs to
8 disclose, I think we disclose that in the ordinary
9 course. But I don't think we should go beyond the
10 walls or require the same type of disclosure perhaps
11 we are required to make in the local jurisdiction by
12 the local affiliate to different jurisdictions.

13 I mean, I think it's -- you may do that,
14 but I think to require that probably just becomes
15 information overload.

16 MR. BARNETT: Carl?

17 MR. GILMORE: I'm sorry, Carl Gilmore,
18 Penson. Gary, was your question disclosure to the
19 public, or was it -- or was it disclosing additional
20 information to you the Commission? I'm sorry, I
21 didn't understand the question.

22 MR. BARNETT: It could be either one.

23 MR. GILMORE: I think the problem with --
24 the problem with a disclosure requirement is that to
25 do it, you either got to do it wholesale or you have

1 to do it not at all. And the problem is that if you
2 -- if you -- you don't want to get into a situation
3 where each of your participants is making its own
4 sort of analysis as to what the risks are, sovereign
5 risks, what the risks are in that country, the
6 political situation, et cetera, et cetera.

7 What I would urge the Commission to do in
8 that -- in that point is to make -- is to make
9 sovereign risk or country risk or activity in each
10 company -- or country a point in your risk-based
11 analysis of all the registrants. So I think it
12 might work better to come from you based on your
13 view as to what's happening out there in the world,
14 to ask the registrants what their -- what their
15 activities are in that country rather than some sort
16 of wholesale disclosure. Because I don't know -- I
17 don't know what it really gets.

18 I'm going to have a website with 200
19 countries and my analysis of each. It probably
20 works better to come from you out to the registrants
21 rather than require some sort of overall risk
22 disclosure on a country by country basis. I think
23 it becomes too unwieldy.

24 MR. DRISCOLL: Dan Driscoll, NFA. On the
25 -- on the reporting issue country by country, when

1 the -- when the Part 30 rules were first adopted,
2 there was -- there was a provision in there that
3 said that all FCMs had to report on a quarterly
4 basis their positions on all of these markets to
5 NFA. And we got a lot of documents over the years,
6 but in about 10 years that that rule was effective,
7 there was one economist from the U.S. Department of
8 Commerce that once a year would call and ask for
9 information about those reports, but nobody else
10 ever did anything with them, including really NFA,
11 except to receive them and make sure we stored them.
12 And ultimately that rule was repealed because it --
13 nobody could think of a use of it.

14 So my view on that would be on country
15 specific things, not to require ongoing regular
16 reporting of that information. But if there's
17 something going on in a particular jurisdiction or a
18 particular exchange, that the regulators ought to
19 have the ability to call for that information to
20 review it. Because I think if it's regularly filed
21 it will just add costs and paper and I'm not sure
22 anyone will really use it on an ongoing basis.

23 MR. BARNETT: Going back to some
24 specifics, and again, I think another issue covered
25 in the FIA thing, so maybe it's quick -- a quick

1 discussion. Should FCMs be required to include the
2 foreign futures and option positions of both U.S.
3 domiciled and foreign domiciled customers in Part 30
4 secured amount requirement?

5 MS. BURKE: Maureen Burke, Bank of
6 America/Merrill Lynch, representing FIA. Yes, we
7 strongly believe all kinds should be included in
8 30.7 on a net liquidating value basis.

9 MR. BARNETT: Okay, and maintain -- sorry.

10 MR. PARKE: Gary, I would just add that I
11 think most firms do this today and that to not do it
12 would actually increase operational risks to try to
13 peel away the non-U.S. persons, non-U.S. firms and
14 hold them into a different calculation. That would
15 actually make it more complicated to do these
16 calculations.

17 MR. BARNETT: And do I get a similar
18 answer to something like maintain all funds received
19 from U.S. and non-U.S. domiciled customers as margin
20 for foreign futures and options in a Part 30 secured
21 account? Same. Okay.

22 Do you want to ask about this? Should
23 Part 30 secured accounts contain only foreign
24 futures and options positions and what transactions
25 other than foreign futures and options positions are

1 carried in Part 30 secured accounts?

2 MS. BURKE: Yes, we feel that they should
3 only include foreign futures and options positions.
4 The cleared swap positions are now mandated to be
5 out, I think effective November 8th. And it's up to
6 -- for the regulators, the FCMS to clearly be able
7 to identify the accounts that should be within the
8 30.7 account. We thought it should be -- you know,
9 some of the rules should be changed. In some
10 instances we made recommendations. The SROs can
11 make some of these rule changes by a matter of best
12 practices, but we do feel some -- the rules should
13 be changed to make it explicit.

14 MR. BARNETT: Anne?

15 MS. BAGAN: Anne Bagan. CME rules
16 actually do require that any of our cleared OTC
17 products be held in a separate origin -- the
18 sequestered origins, so we're already not allowing
19 them in 30.7.

20 MR. WASSERMAN: And to be very clear,
21 while I know there were some issues before April or
22 May of 2010, as to where -- what one could do with
23 cleared swaps, the effect of that point, we -- and
24 this was even pre-Dodd-Frank -- did establish a rule
25 permitting the -- putting the cleared swaps into a

1 cleared swaps customer account. But because at that
2 point we did not have the power to require this, we
3 said it would only work in the event it was there
4 pursuant to a DCO rule. And so that is something
5 that could happen today for any DCO clearing swaps.
6 That does not need to wait on November 8th.

7 MR. BARNETT: Dan?

8 MR. DRISCOLL: In terms of other types of
9 positions that -- and accounts that might be held in
10 a Part 30, it's my understanding that one or more of
11 the firms that are both registered as FCMs and
12 RFEDs, you know, have put some of their OTC retail
13 FX positions and accounts in part -- in Part 30 to
14 -- because of the fact that there is no -- you know,
15 no segregation or Part 30 treatment under the part
16 190 rules with bankruptcy code. And that gives them
17 some solace, they think, that there is some -- that
18 there may be some protection there.

19 So I think go -- I agree that it should
20 only be Part 30 accounts that go in.

21 MR. WASSERMAN: And to be very clear,
22 whatever solace anyone's drawing, it's a bit of a
23 false comfort. Indeed, what they're doing is
24 enhancing protection of the Part 30 customers.

25 MR. DRISCOLL: I don't disagree with you,

1 Bob.

2 MR. BARNETT: Okay, thank you. Okay, so
3 turn it over to Gary for a minute. He wanted to
4 talk to us, wanted to talk about -- I'll let you
5 introduce the China system.

6 MR. DeWAAL: Yeah, I was just -- you know,
7 as some folks know -- Gary DeWaal from Newedge -- we
8 maintain a -- we're one of the few authorized FCMS
9 that's authorized to maintain a joint venture in the
10 futures world in China through our entity CITIC
11 Newedge Futures Co., Ltd. And as a result of that,
12 we have come across a regime that has interested me
13 for some time and certainly in light of current
14 events has interested me regarding how they oversee
15 funds protection in China.

16 It's fun -- it's interesting to
17 overlook -- to look that way for information, but
18 I'd sort of like to get information anywhere. China
19 has had its own problems with FCMS pre-2006. They
20 had a number of insolvencies that caused them to
21 institute regulations and additional protections.
22 And they basically have a customer protection regime
23 that maintains three core elements, one of which I
24 think is worth just noting for the record and we
25 will submit something into the public file later

1 today or early next week.

2 China is a pre-trade margin jurisdiction,
3 which means that clients can only trade if they have
4 the money upfront. That's not something that we
5 think necessarily should be exported. China has an
6 investment protection fund sort of like CITIC. It's
7 something that might want to be studied. From my
8 own knowledge, I don't think it's easily exportable,
9 but it is a regime that has an insurance protection
10 system for the futures markets.

11 But the element that I do think is worth
12 studying is something called the China Futures
13 Margin Monetary Center and this was established in
14 March of 2006 in response to what I said were a
15 number of insolvencies in China. And effectively
16 it's a company that is overseen by the CSRC, which
17 is their equivalent of the CFTC and the general
18 office of the State Council, and it's owned by the
19 four principal commodity exchanges in China, Dalian,
20 Zhengzhou, China Financial Futures Exchange and the
21 Shanghai Futures Exchange.

22 And effectively what this organization
23 does is each day they receive feeds, electronic
24 feeds from both sides of the market. They receive
25 feeds from the Futures Commission Merchants, so, for

1 example, my organization in China, and they receive
2 feeds from the depositories of customer funds, the
3 exchanges and obviously the custodial banks, and
4 effectively through software that they have, they do
5 a daily reconciliation between the two.

6 China's an interesting jurisdiction,
7 because in fact, it's this entity that also issues
8 customer statements officially on behalf of the
9 FCMs, and that's an element that I don't think is
10 readily exportable. But what's interesting though
11 is they do get information that effectively allows
12 them also to do a reconciliation between what the --
13 what the FCM is saying should be in segregation
14 versus what the underlying records say should be in
15 segregation.

16 So there's a reconciliation between the
17 segregation calculation and underlying information
18 and then there's a reconciliation between that
19 amount that's required to be segregated versus what
20 the depositories are independently reporting as in
21 segregation.

22 So if you go back to how this could have
23 been useful -- and China's a no top-up jurisdiction,
24 so you can't top up the amount in segregation, so
25 there should be an exact match. And they recognize,

1 of course, that there will be some variation because
2 of the various issues that we discussed yesterday.

3 But if you think about this, applied to
4 our circumstances, and you think about the trustees
5 report and the firm who -- that we can't name,
6 obviously there would be an early warning that maybe
7 the excess is declining, that there's a potential
8 violation of segregation. I mean, there are
9 elements of the law that are odd, because again,
10 once CFMMC sees a problem, it's supposed to refer it
11 to the local office of CSRC where the FCM is
12 located, as well as the headquarters in Beijing.
13 And CSRC then has five days to respond, which I'm
14 not sure is probably the right time frame.

15 But again, this to me is a very, very
16 interesting regime and I might mention that CSRC is
17 funded 100 percent by the four participating
18 exchanges. But it's something that they believe has
19 prevented them from having a repeat of their FCM
20 default situation because of invasions of customer
21 funds. And I do think it's something that is well
22 worth the SROs in the United States, as well as the
23 CFTC, to look at.

24 Again, I don't think everything of the
25 system works, but there are certainly core elements

1 of the system that are very, very interesting, and
2 from an operational perspective, I don't think would
3 impose a lot of operational burdens on folks,
4 because electronic feeds are things that we make
5 available or use already for other purposes.

6 MR. BARNETT: Thank you. Any reactions?

7 MS. BAGAN: Anne Bagan. I got a couple
8 questions for you on that, because I knew you were
9 going to talk about this. First is, is this a real
10 time system or it's as of appointed time? It's real
11 time?

12 MR. DeWAAL: No, it's as of appointed
13 time. All the firms are required to provide this
14 information. I believe it's by 5 p.m. each business
15 day. By the way, I forgot to mention that one of
16 the interesting -- why this is becoming very
17 topical, because as many may be aware, three pilot
18 FCMS in China have been authorized to, in theory, to
19 trade outbound and these will be the first FCMS in
20 China that will be authorized to trade outbound and
21 they'll be authorized to trade on LME, ICE and CME.

22 And the firms that are competing to get
23 the business will have to sign up to the system.
24 They will have to provide information. They're
25 trying to -- CFMMC right now is trying to figure out

1 how to get information from the non-U.S. brokers --
2 I'm sorry, the non-China brokers to feed into the
3 system so that they can extend the protection of
4 CFMMC to the overseas business.

5 MS. BAGAN: Okay, my other questions are,
6 Sandy made a point yesterday that a lot of your
7 customers deposit checks and that you have a lot of
8 very small banks out in the farmlands or wherever.
9 And I don't know if that's the same structure that
10 they have in China, but there's going to be a lot
11 of, I would assume, reconciling items or things in
12 -- you know, in transit.

13 How does the system handle those?

14 MR. DeWAAL: Again, it's a pre- --
15 remember, China is a pre-margin trade system, so the
16 money isn't housed in events. As I said, not
17 everything can be exported. It's not a -- the
18 systems are different. As I said, officially, it's
19 a no top-up jurisdiction. But to me, I don't know
20 how you have a no top-up jurisdiction frankly. But
21 it is a no top-up jurisdiction, so there are
22 parameters.

23 But, you know, again, you have to look at
24 it and take the elements. Unfortunately, and I do
25 think the folks at CFMMC, they actually did prepare

1 something which they've authorized me to submit into
2 the record. It is in Chinese unfortunately. My
3 staff in China was kind enough overnight to do a
4 literal translation, which probably needs to be a
5 bit refined more to ordinary English. But I think
6 for purposes of starting a discussion, it's a good
7 document we'll get into public record.

8 MS. BAGAN: I just worry. I mean, I think
9 the system sounds really interesting and certainly
10 people have brought it -- this idea to us over the
11 past few months. I just worry about, given the way
12 our industry is structured here in the U.S. with all
13 these small banks and checks and that kind of thing,
14 if the system can really work for us. But it's an
15 interesting concept.

16 MR. DRISCOLL: If I could --

17 MR. BARNETT: Dan.

18 MR. DRISCOLL: -- just put my two cents on
19 this. Dan Driscoll, NFA. So certainly at NFA we
20 believe that at a minimal it would be good if we had
21 sort of standing -- standing instructions where FCMS
22 have to give standing instructions to depositories
23 to give us information at least on requests so we
24 don't have to go to the firm and give a second
25 confirm every time we want to do that. And it's --

1 we've talked about and it's intriguing about the
2 idea of getting regular electronic feeds or
3 electronic access.

4 I do think though then, if we have that,
5 you -- or we could have it, you need to worry about
6 security, obviously, because this is very sensitive
7 information. You need to have systems to do
8 something with this. If you have constant
9 electronic access, you can't afford to just
10 occasionally look at it, because I think there's
11 concern that if you have the information available
12 to you, you're supposed to be doing something with
13 it.

14 So we would have to figure out what we
15 would do with it, how often we would analyze it and
16 create systems to coordinate with that. But it's a
17 very intriguing sort of process and I think it's
18 just a question of how far you go down that line.

19 MR. BARNETT: Gary.

20 MR. DeWAAL: Again, without repeating my
21 general speech from yesterday, I do think at the end
22 of the day clients in our business deserve
23 additional comfort and additional assurances that
24 their money is safe. And obviously there are a
25 number of alternatives that will come out of this

1 debate.

2 And I think as we look at all of the
3 alternatives, it's critical that we consider the
4 fundamentals of the business, of which one of the
5 most important aspect is maintaining the viability
6 of the FCM model.

7 So yes, I agree that there is an invasive
8 element to this and yes, my own colleagues in my own
9 organization are probably going to get ready to
10 lynch me when I walk back. But I do think that
11 we're going to have to make -- not only are we going
12 to have to evaluate each of the alternatives for
13 their benefits, but we do have to consider the cost
14 on the system. And at least intuitively to me, you
15 get a lot of protection with this relying on a lot
16 of the already available infrastructure.

17 And so to me, that's one that doesn't
18 really upset the economics dramatically. I mean,
19 obviously everything has an impact, but given some
20 of the other alternatives, which fundamentally
21 change how things are working -- and I'm not even
22 sure hearing all the legal debates yesterday you
23 actually get as much protection as people are
24 bargaining for -- this isn't a good alternative to
25 be looking at perhaps adapting to the U.S. model.

1 MS. BURKE: Maureen Burke. So on the
2 point that Gary's making here, as we've stated, the
3 committee has gone through initial review and
4 recommendations. This should be reviewed, as well
5 as other alternatives. If we can enhance the
6 customer protection model in any manner, it should
7 be reviewed and we'll look to review this.

8 The feasibility of it, we know that it
9 couldn't happen overnight and understandably, there
10 would have to be some sort of system set up in order
11 to take the information in to analyze the
12 information. If there's disparities, changes, it
13 could not be done overnight.

14 But even with the changes that were made
15 on the LSOC model and the reinstatement that
16 third-party custodial accounts are permitted, it's
17 something that should be used there as well so that
18 there's online systems, electronic feeds so we know
19 that there isn't any unauthorized -- the flip side
20 of that, unauthorized withdrawal of funds by the
21 custodian back to the clients, which introduces risk
22 to the FCM and the system as a whole.

23 So in the day and age that we're in, we do
24 need to look at technology enhancements to provide
25 the transparency and enhancements to the customer

1 protection regime.

2 MR. WASSERMAN: Can I ask one question? I
3 know Dan raised some important security issues. Is
4 it -- assuming that one has appropriate password and
5 protection, is it practicable to give some
6 third-party, say a regulator or self-regulator,
7 essentially view access to what the balance is in
8 the account that would be say, in this case, held by
9 an FCM for its customers?

10 MR. WINTER: I think the question becomes
11 more related to what's the level of detail that's
12 being provided. If it's summary level detail at a
13 customer's seg account at a bank, that's fine, but I
14 think if you're getting into more detailed
15 information as to who might be behind that client,
16 things of that nature, that would be problematic.

17 MR. WASSERMAN: I'm sorry, so balance
18 then, yes. Transactions?

19 MR. WINTER: Again, what would be the
20 benefit of the transactions being there? But I
21 think it gets back to bank secrecy rules and
22 protection of customer intimation. And so as long
23 as it's summary that doesn't allow somebody to take
24 advantage or get accessed information at a customer
25 level, I don't see that as being a major issue, but

1 it would have to be reviewed by the banking
2 regulators.

3 MS. BAGAN: Anne Bagan. My issue is just
4 knowing what the balances are in a seg account is
5 only one half of the pot, right? You got to look at
6 what the actual liabilities are to the customer,
7 because without both sides, how much is in a seg
8 account is totally irrelevant. It doesn't give you
9 any comfort or any solid information unless you know
10 that it's enough to meet the obligations to the
11 customer.

12 MR. DeWAAL: Also, as a matter of
13 practicality, when you guys do inspections or the
14 regulators come in to do their inspections, they
15 look at our segregation computation. They're going
16 below just the segregation computation. They look
17 at the trial balances. You're in fact looking at
18 the ins and outs.

19 So to a certain extent, you're getting
20 that information upon request to begin with. The
21 only issue is in what form do you want it? But
22 certainly when our third-party auditors at the end
23 of each year confirm stuff, they're not asking us to
24 give them the information. They're going directly
25 to the source to get that information.

1 So that practice is sort of out there. So
2 technically, can it be done? Of course, it can be
3 done technically. The issue is what kind of
4 protections you want to put around it and how
5 frequently do you want to have that information?
6 But again, it's technically a lot can be done these
7 days.

8 MR. BARNETT: Okay, so why don't we take a
9 15 -- oh, other -- where? Where? Go ahead. Sorry.

10 MS. STREIT: That's okay. Julie from
11 Country Hedging. Speaking on the technology, I
12 guess as a smaller FCM, we have concerns what kind
13 of burdens this additional technology would put on a
14 firm our size, but where a larger firm might be able
15 to bear that burden more easily than a firm our size
16 would as we have less customers, to help us try to
17 recoup those -- those expenses.

18 MR. BARNETT: Okay, understood. Anyone
19 else?

20 MS. McCARTHY: Sandy McCarthy with FC
21 Stone. I just want to make a comment that I don't
22 know how comfortable -- I think we would have to
23 disclose to our customers that we were granting
24 access to the government so that they could see the
25 wires. And I don't know how comfortable some of our

1 customers would feel about that.

2 MR. BARNETT: Okay, let's take a 15-minute
3 break. Let's come back at five after 11.

4 (A recess was taken.)

5 MR. BARNETT: Okay, so one thing that's
6 obvious is a lot has happened since the mid-eighties
7 when the Part 30 rules were adopted. Change is
8 needed. There's agreement on what many of the
9 issues are and we'll be working with you all towards
10 changes that address those issues.

11 So the FIA paper is very helpful on the
12 Part 30 part. Not sure that we're there on all the
13 recommendations and I know you're not all the way
14 there either, but it does surface many of the issues
15 in this space, so that's great. It shortens our
16 conversation.

17 So we're going to -- unless there's other
18 issues in this space that panelists want to raise,
19 we'll end this session and then pick up the 1:00
20 session on the dually registered FCMs and BDs. So
21 are there other issues people want to raise right
22 now in the Part 30 space?

23 No? Okay. All right, well thank you all
24 for your help and your participation. Thank you so
25 much.

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(Whereupon, at 11:28 a.m., a luncheon
recess was taken.)

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A F T E R N O O N S E S S I O N

(1:11 p.m.)

MR. BARNETT: Okay, let's get started.

Welcome back to the roundtable, second session today, as we continue to look at various issues and ways of enhancing customer protection. In this session we're going to look at issues that are particular to dually registered FCMs and BDs. And in case you don't know it, the top 10 FCMS, 18 of the top 25 FCMs based on customer seg held are dually registered entities registered with CFTC as FCMs and the SEC as BDs.

So to help us explore these issues today, of course, all of you, but I wanted to point out that we have John Ramsey from the SEC and Grace Vogel from FINRA. Thank you for joining us.

So let's quickly go around the table, again, each panelist telling us their name and company affiliation. Gary Barnett, CFTC.

MR. SMITH: Tom Smith, CFTC.

MR. PICCOLI: Kevin Piccoli, CFTC.

MR. RAMSEY: John Ramsey with the Securities and Exchange Commission.

MR. DRISCOLL: Dan Driscoll, NFA.

MR. GILMORE: Carl Gilmore, Penson.

1 MR. WINTER: Steven Winter, State Street.
2 MR. NICHOLAS: John Nicholas, Newedge.
3 MS. VOGEL: Grace Vogel, FINRA.
4 MS. TRKLA: Katie Trkla, Foley & Lardner.
5 MR. TIRRELL: Bill Tirrell, Bank of
6 America/Merrill Lynch.
7 MR. LEE: Robert Lee, Deutsche Bank, for
8 SIFMA.
9 MR. HOLLOWAY: Mark Holloway, Goldman
10 Sachs, chairman of the SIFMA Capital Committee.
11 MS. COCHRAN: Christine Cochran of the
12 Commodity Markets Council.
13 MR. DeLEON: Bill DeLeon, PIMCO.
14 MS. BAGAN: Anne Bagan, CME Group.
15 MR. BARNETT: Great, thank you. And then
16 Bob Wasserman is going to return later on in the
17 session.
18 So FCMS and BD -- FCM BDs are in the
19 business of handling customer funds, and as we
20 discussed yesterday, and Bob will touch again a bit
21 upon it today, futures customers' funds are handled
22 under one part of the bankruptcy code while
23 securities customer funds are handled under another
24 part, and we'll hear -- you've been talking about
25 that yesterday. There will be more today.

1 But while the entity in bankruptcy faces
2 different parts of the code, which separately
3 address its futures and securities customer funds,
4 the entity is still nonetheless a single individual
5 company, single legal person that faces an overall
6 insolvency risk. Thus, risks to the enterprise
7 which might compel insolvency could come from the
8 future side, the security side or for some other
9 risks, perhaps risks which arise from other
10 activities of the entity or even risks created by
11 affiliates of the entity from a parent or other
12 entity that in one way or another puts the
13 registered entity at risk.

14 So in that light, let me ask the
15 panelists, are customers currently getting
16 sufficient disclosure to understand that overall
17 bankruptcy risk, the various business lines of a
18 dually registered FCM BD are creating for that
19 entity?

20 Do you understand my question? Is that --
21 so people just getting information on the futures
22 line, but they're not hearing about the security
23 side or vice versa, what kind of information are
24 they getting? Are they getting the disclosures they
25 need to understand the risks to the entity? Who can

1 I -- Carl, you want to give me -- a try at that?

2 MR. GILMORE: Thanks Gary. Carl Gilmore
3 from Penson. As a general premise, I think that
4 what has happened in the practice in the -- in both
5 the securities and the futures industry is for
6 bankruptcy disclosures to be activity specific. So
7 a futures customer gets information on part 190. A
8 securities customer will get information in SIPC and
9 what happens in the case of a broker-dealer
10 bankruptcy.

11 But I don't think currently that there is
12 a lot of overlap for multiply registered
13 broker-dealers and FCMS and probably I think there
14 ought to be. It's a great question.

15 MR. BARNETT: So let me back it up. So
16 pre-bankruptcy -- I should make it clearer. So
17 pre-bankruptcy, when I'm facing a company that may
18 or may not be stressed at the time, but let's say
19 it's a company that's under stress, but it may not
20 be -- let's say a futures customer entity is under
21 stress from some other part of the business, are
22 there -- is there enough information about other
23 parts of the business getting to it or are we just
24 focusing information from one part of the business
25 to the people who are being served by that part of

1 the business?

2 MR. GILMORE: I think traditionally that
3 the way most of the firms have organized themselves
4 is that the -- that the bankruptcy information is
5 again, it's specific to the type of activity. So if
6 the question is is there enough information about
7 what the implications are for a futures customer if
8 they are in a SIPC bankruptcy? Or what is the
9 implication for a broker-dealer customer if
10 something on the futures side causes the firm to
11 become insolvent?

12 I think probably not. So one of the
13 things that we ought to think about, and this is why
14 I think it's such a great question, is for firms
15 that are multiply registered, there probably ought
16 to be more crossover bankruptcy information
17 available out there, frankly, in plain English,
18 which is why I like FIA -- FIA's FAQ touches on that
19 a little bit. I think that's a great first start.

20 MR. BARNETT: Other views? Please.

21 MS. TRKLA: Yes.

22 MR. BARNETT: Katie.

23 MS. TRKLA: I'd like to touch on what we
24 mean by disclosure, as well and how it's
25 communicated, because we've got -- I think there

1 could be improvements to it and I agree with Carl
2 that it's something we need to address. We've got
3 -- you know, when you open up your futures account
4 relationship, you're handed this set of disclosure
5 documents, all of which if any customer actually
6 read it, they'd probably say my God, am I crazy for
7 even opening up a futures trading account? And that
8 says to me that most customers don't read it or
9 glance at it. It doesn't sink in.

10 Yes, I think there is still a benefit to
11 providing it. There are some who will. I think
12 it's also protective into the benefit of the FCM BD
13 to have provided that even if the customer doesn't
14 review it. But do we need to be thinking of how we
15 get the disclosure out there on sort of an ongoing
16 basis? Is it available? Should it be available on
17 a website, the company's website, or the clearing
18 house website or the CFTC website, but something
19 that's sort of available on an ongoing basis?

20 And part of what I factor into sort of how
21 I'm now thinking of this, I think there was a lot of
22 confusion in a recent bankruptcy matter where a lot
23 of customers were under the impression, an incorrect
24 one if they actually read the bankruptcy disclosure
25 statement that they're given, that the clearing

1 system also protects and makes whole the customers
2 of a defaulting FCM. And that seems to have gotten
3 a fairly common misconception.

4 Now in some instances it may be sort of
5 wilful ignorance, but I think with others that there
6 really was this impression, and part of it may have
7 been based on some of the rhetoric that maybe
8 historically we've used that may oversell credit
9 clearing.

10 MR. BARNETT: Let me -- I hear what you're
11 saying. Thank you. Let me -- two things. First,
12 housekeeping, because I fail to make the -- and you
13 were very good about it. Thank you. So the
14 disclaimer of the unnamable.

15 So in light of our Division of
16 Enforcement's ongoing investigation, the staff
17 cannot -- we cannot engage in a discussion
18 concerning matters involving MF Global. So we ask
19 each of you to respect this necessary rule that we
20 not inject MF Global or specifics about MF Global
21 into the discussion here today.

22 Second thing is just remember for the
23 court reporter and the transcription and all to
24 state your name and your affiliation -- or state
25 your name when you go to speak.

1 And then let me just go back, wind back
2 again for just -- to make it clear. So heard today
3 in the -- in the earlier sessions the need for more
4 information to customers, more information, so
5 whether it's reporting or notices. And so I fall
6 under the term disclosure, but I should call it
7 information, whether it's reports and notices of
8 various types.

9 So what I heard from FIA in certain
10 respects today was that certain things should be
11 mitigated by more information. We can't -- you
12 know, certain things we should bullet proof in some
13 ways, to some extent, and other ways it should be
14 handled by giving more information to customers.

15 So I guess the question is, in that vain,
16 even before you get into the music's stopped and
17 you're in an insolvency proceeding, just in terms of
18 the normal operating business, but businesses come
19 upon stresses, and these enlarged notices of reports
20 that are being made available, are we thinking that
21 the futures folks are going to see the futures
22 notices and reports? Are they going to be on a, as
23 Katie is suggesting, some website?

24 So there's more of a picture about the
25 company. Is that happening or is it still kind of

1 bifurcated so that one side sees one thing and they
2 are blind to what's going on elsewhere in the
3 company? Or to the extent things are already being
4 reported, not in large reports, but the futures
5 people don't see what the securities side of the
6 business is providing.

7 Grace?

8 MS. VOGEL: Are you assuming that the
9 customers are professional or institutional
10 customers as opposed to retail customers --

11 MR. BARNETT: No.

12 MS. VOGEL: -- when you ask the question?

13 MR. BARNETT: No, can't assume that, but
14 it's a good point. Go ahead.

15 MS. VOGEL: Because I think that it would
16 be very difficult to have a disclosure describing
17 the bankruptcy regimes that a retail customer could
18 understand. I think there are so many complicating
19 factors here and so many unknowns that I can't
20 imagine how you would ever draft something that a
21 retail customer would be able to understand.

22 MR. NICHOLAS: I think in my experience
23 with our company I agree with this gentleman that
24 the disclosures tend to be divided primarily along
25 product lines. So if you have a customer that opens

1 up a futures account, they're going to get futures
2 disclosures and securities disclosures, because a
3 lot of the disclosures are product specific. They
4 just wouldn't make sense otherwise.

5 But that being said, I will say that
6 before 2008, we had very few inquiries at all from
7 inquiries about bankruptcy issues and customer
8 protection. After 2008, we certainly had more and
9 then in the last four months we've had quite a few
10 and I think that's probably very reflective of the
11 industry generally.

12 I think customers want to know the
13 differences, want to know about customer seg, want
14 to know about bankruptcy protection. And I think
15 there's a significant appetite out there for that
16 type of disclosure. And we went ahead and drafted a
17 sort of a comparison document, you know, this is
18 what happens on the security side, this is what
19 happens on the futures side, and it's been fairly
20 well received, but obviously not mandated.

21 But maybe something like that would be --
22 would be worth doing. We're a -- you know, it's
23 just simply a chart, this is what happens on the
24 securities regime, futures regime, all in one piece
25 of paper.

1 MR. BARNETT: Yes.

2 MR. DeLEON: Hi. Bill DeLeon, PIMCO. I
3 think that as Grace pointed out, you can't have full
4 disclosure on what it means for bankruptcy. It's
5 just too complicated and I think the amount of
6 disclosures you would have on that, because it would
7 be a firm's interpretation, would be -- it would
8 just make it a lot of paper and not a whole lot of
9 value.

10 I understand the concept that you want to
11 protect the individual versus not being aware as
12 well as the institutional investor. What I think is
13 important though is, as John pointed out, you want
14 to have certain information available that's easy to
15 obtain and I think that in our experience certain
16 questions we've asked have been less easy to get the
17 information than you would hope.

18 So, for example, you may say how do you
19 invest funds, excess funds or how do you manage your
20 funds? And the answer to that, it's compliant with
21 1.25. While it's legally correct, doesn't give you
22 a whole lot of information. And I think that there
23 are multiple -- or what controls do you have in
24 terms of processing things? And we're fully
25 compliant with SRO rules. Doesn't give you a lot of

1 information.

2 So I think that while those are truthful
3 answers and they're not meant to be bad, I think
4 that especially given the new framework we're in
5 with more collateral being posted, more questions
6 than what we've seen in the last four months, and
7 then again three odd years ago, I think that there's
8 more focus.

9 So I think what would be helpful is sort
10 of more guidance or force in terms of what needs to
11 be disclosed as opposed to well, we've answered
12 that. Thank you. If you don't like it, you can
13 take your business elsewhere. So I think that there
14 is somewhere in between. And just in terms of
15 negotiating with people we've seen that, and that
16 being one of my concerns is sort of the bar for what
17 needs to be disclosed more than just broad strokes
18 of we meet this requirement.

19 For example, to use internal repos or not.
20 Well, if you wanted to find that out six months ago,
21 not everyone would have told you the answer, or
22 would have given you a meaningful answer. So things
23 like that are where I think people are very
24 concerned and focused on what and how are people
25 doing things.

1 And while you don't want to necessarily
2 see how the sausage is made, you do want to know
3 some of the ingredients as opposed to it meets the
4 standards.

5 MR. BARNETT: Thank you. Thank you.
6 Yeah, John.

7 MR. RAMSEY: Before I say anything, I
8 should -- I'll get the disclaimer out of the way.
9 It just occurred to me. If I say anything
10 interesting or noteworthy, it represents my own
11 views and not those of the Commission or my
12 colleagues on the staff.

13 The reaction that I had was that it's hard
14 coming from the SEC to argue against more and better
15 disclosure and maybe there should be more and some
16 thought about that as to the application of sort of
17 bankruptcy laws generally, sort of on either side of
18 the aisle.

19 But with respect to how those things work
20 with respect to a dually registered firm, the points
21 of confusion that people particularly are somewhat
22 focused on today as to how the bankruptcy regimes
23 operate along side each other in the case of a
24 dually registered firm, and how claims of customers
25 on one side or the other sort of are resolved,

1 vis-a-vis each other, those things are confusing,
2 not -- I think just because they're difficult to
3 understand, but they just may not have clear
4 answers. So I don't think you're probably going --
5 or at least in some respects, may not have a clear
6 answer.

7 So I think with respect to those kinds of
8 questions, you may not make that much headway by
9 trying to draft a disclosure that will sort of get
10 people better information which -- to sort of make a
11 decision about whether to go into a jointly
12 registered firm or not. That may be more a question
13 of sort of all the stakeholders working together to
14 sort of resolve those things in advance to the
15 extent we can.

16 MR. BARNETT: How about in terms of the
17 kinds of information we were talking about
18 yesterday, Dan, the 4d topic, and talking about the
19 amount in seg, the amount required for customers,
20 the access? I mean, should we see -- should the
21 securities customers see that? Should futures
22 customers see more on the security side? Should
23 there be issues regarding the failure to -- under
24 seg or under cap?

25 MR. DRISCOLL: Dan Driscoll, NFA. In a

1 lot of those things that we talked about yesterday,
2 I think in the final analysis might very well be
3 posted on NFA's website. So they're available to
4 anyone that comes to our website and I suppose you
5 could have some sort of notice to securities
6 customers by broker-dealers that that information is
7 available there.

8 But my idea would be if you have
9 information that's publicly available and posted, it
10 ought to be publicly available to anyone that finds
11 it helpful.

12 MR. BARNETT: Let me shift directions
13 then, totally shifting directions for a second here.
14 Currently, BD FCMs are permitted to compute the
15 required capital under each stand-alone business and
16 then are only required to maintain the larger of the
17 two, not the sum of the two.

18 Does this approach, should this make
19 sense? Should it change? Should the Commission
20 amend the capital rule to require a dually
21 registered FCM broker-dealer to maintain a minimal
22 level of regulatory capital equal to the sum? What
23 do people think about the way the capital rule works
24 for dually registered entities?

25 MR. DeLEON: I'm Bill DeLeon, PIMCO. I

1 think that you need something in between, that the
2 current method is probably low because there is
3 correlated risk between the two and having
4 sufficient capital for one entity or the other is
5 not enough. Taking the sum, I think, is too extreme
6 because that assumes that there's no offset between
7 the two. So I think that would be too high.

8 However, there is that intersection. So I
9 think you should view it as the higher of the two
10 entities themselves and then whatever the cross
11 product would be, if it was a combined entity. And
12 that would be the right way to look at it because to
13 the extent that you need a minimum, you could have a
14 situation where I imagine there's only one position
15 and one entity and one position in another. They
16 could be going the opposite direction, so you wind
17 up with zero.

18 And I would argue that's the wrong number.
19 If you took the sum of the two, that's clearly the
20 wrong number because there is an offset. So I think
21 you need to sort of think about something in
22 between.

23 MR. BARNETT: Great. Thank you. Okay,
24 other thoughts on it? Dan?

25 MR. DRISCOLL: Dan Driscoll. You know, my

1 thought on this is that the CFTC computation and the
2 SEC computation, while they're, I think, both
3 designed to -- tend to increase as a firm's business
4 increases, they're measuring very different things
5 and I think ideally, if you would like to have
6 something that measures the risk of the entity, it
7 would require probably some more harmonization
8 between those two computations.

9 It's simple to just add two numbers that
10 people already compute, but it doesn't necessarily
11 get you the right number.

12 MR. BARNETT: Grace?

13 MS. VOGEL: Yeah, Grace Vogel from FINRA.
14 I think that we -- on the securities side we've
15 looked at the minimum capital requirement as a
16 leverage limitation, whereas we use -- with respect
17 to the customer business and we use the haircuts and
18 other charges to limit the firm's proprietary
19 business.

20 So there's a bit of a mixing of apples and
21 oranges here. I think that what we need to do is
22 really start with a clean sheet of paper and revisit
23 what the capital requirements should be for
24 broker-dealer FCMs. We need to factor in leverage
25 and we also need to factor in liquidity.

1 If we look back at the problems that we've
2 had in the industry, they haven't been caused by not
3 insufficient capital at firms. They've been caused
4 by a run on the firm, which is caused by their
5 inability to liquify positions or to obtain funding.
6 So I think a fresh look at the rules is appropriate.

7 MR. BARNETT: Thank you. Katie?

8 MS. TRKLA: Yeah. I would agree with that
9 and with the need for harmonization and quite apart
10 from measuring different things, even in the areas
11 where the same things are being measured, they are
12 very different conceptual approaches being taken.
13 For example, cleared swaps would be an example where
14 if I correctly understand the SEC's position,
15 they're treated effectively as back-to-back swaps by
16 the broker-dealer.

17 And so if it's under-margined more than
18 one day, you may have to take proprietary capital
19 charge, whereas in the CFTC capital rule, it
20 increases your risk capital requirements when you're
21 clearing on behalf of either a customer or an
22 affiliate, which is a very different approach and
23 you don't have a proprietary haircut.

24 You may have an under-margined haircut at
25 a later point in time, but just very different

1 conceptual approaches for dealing with what seems to
2 be the same risks.

3 MR. BARNETT: Yes?

4 MR. HOLLOWAY: Hi. Mark Holloway from
5 Goldman Sachs. I'm chairman of the SIFMA Capital
6 Committee. I'd like to pick up on the comments that
7 Dan made and that Grace made. Many of the firms on
8 your list are what we would describe as full-service
9 FCMs and broker-dealers and as a result, these
10 entities conduct many, many product lines.

11 And if you were to look at our capital
12 computations, picking up on what Grace said, the
13 overwhelming majority of our capital requirements
14 relate to penalties for liquid assets, haircuts on
15 our securities positions and other penalties
16 associated with our operations.

17 The either/or or greater of situation
18 pertains just to the minimum capital requirement and
19 I think for a lot of the firms represented here, if
20 you were to look at the totality of our capital
21 requirements, the minimum is a small part. And so I
22 would just again, to come back to what Dan said, if
23 you were to look -- and again, I'm thinking of the
24 larger multi-product firms -- at the risks that we
25 face, I think one could believe that neither the

1 CFTC minimum, nor the SEC minimum really addresses
2 or is a reflection, if you will, of those risks.
3 And clean sheet of paper approach is probably a good
4 idea.

5 MR. BARNETT: Thank you.

6 MS. BAGAN: Anne Bagan, CME. This
7 certainly is a topic that has been under discussion
8 for many, many years and I suppose you could say --
9 it's kind of a tough argument to say that you
10 shouldn't have enough capital to cover both sides of
11 your business.

12 With that being said, it has been in place
13 for a long time and if we were to do a combination,
14 we are probably stripping our firms with some of the
15 capital efficiencies that they have in place by
16 being a combo firm. I actually looked at a number
17 of our broker-dealers to see if they could withstand
18 this type of aggregate, and probably most could.
19 But again, that's going to really affect their
20 business model and business activities.

21 MR. BARNETT: Thanks, Anne. Other
22 thoughts? Yeah, John.

23 MR. RAMSEY: Yeah. Excuse me, I guess I
24 would echo what Mark and Grace both said in terms of
25 focusing on liquidity. Not that I think minimum

1 capital standards may not be an appropriate to talk
2 about. It's just I think in terms of investors'
3 interest and our interest as regulators in making
4 sure that firms don't fail because of a
5 run-on-the-bank scenario, liquidity really is the
6 key measure and certainly for the largest firms, for
7 our alternative net capital firms, we require those
8 firms to -- or we expect them to have sufficient
9 liquid reserves so that the broker-dealer can
10 sustain -- sustain a fairly significant stress event
11 over a 30-day period. And there are certain
12 parameters around how it is one defines that.

13 And I think the largest firms in general
14 maintain that plus some amount. There may be other
15 classes of firms or types of firms where some sort
16 of specific liquidity standard or requirement we
17 ought to think about because I think you want at
18 least to make sure that the firm stays alive, even
19 if it ultimately fails long enough that you have the
20 ability to take steps to transfer customer funds or
21 assets or do something else remedial while you have
22 the chance.

23 MR. BARNETT: Thanks, John. Other
24 thoughts on capital? You should --

25 MR. WINTER: Kind of reiterate some of

1 what's already been said, but as I said yesterday, I
2 think liquidity and capital are really the key
3 issues and I think at the end of the day, the idea
4 of going with a clean slate is the right approach.

5 You need to look at it from a perspective
6 again of what is the business model of that entity
7 in total and what's the liquidity needs of that. I
8 would make the analogy that's what we do today in
9 the futures world when you come to an argument. One
10 of the factors in determining how much margin you
11 put up is liquidity of the underlying product, and
12 so why wouldn't you consider that as part of the
13 capital computation as well?

14 MR. BARNETT: Thank you. All right, I'm
15 going to move to another topic here, okay? Grace,
16 can I -- and Kevin, could we just talk quickly about
17 what information is currently shared between the SRO
18 and your analog regarding the examination of dual
19 registrants?

20 MS. VOGEL: Okay, I'll start. It's Grace
21 Vogel. We make available through a report center
22 that we built at FINRA all of the examination
23 reports of our dual member firms and the responses
24 to those examination reports. That's routine, so
25 the DSRsOs can pull that information out at any time.

1 We also coordinate through the IFSG, which
2 is the Inter-market Financial Surveillance Group.
3 We meet either once or twice a year to discuss
4 general topics of interest, more on the policy side
5 as opposed to about specific firms.

6 When there is an event or a concern about
7 firms, there is then an active dialogue and routine
8 sharing of information. So if there's something in
9 the news that's concerning, we'll give a call and
10 get -- you know, pay -- collect information on any
11 given day information about operational issues.

12 I think it's -- you know, it's hard to
13 generalize, but it's -- we do have a memorandum of
14 understanding that allows us to share all
15 information that's available to us.

16 MS. BAGAN: Anne Bagan again --

17 MR. BARNETT: Yeah.

18 MS. BAGAN: -- from CME. So I agree with
19 everything that Grace just said. We do try to
20 coordinate and have joint reviews, but that's --
21 it's a lot harder than it sounds because we do have
22 schedules that are going out.

23 That being said though, from our side, and
24 I'm sure FINRA does the same thing, is we do review
25 those reports that are coming out of FINRA on the

1 broker-dealer side to see if there are any ongoing
2 concerns that we perhaps should follow-up on during
3 our reviews. And then as Grace said, we do have a
4 lot of discussions and information sharing regarding
5 joint numbers.

6 MR. BARNETT: Yeah, are there things that
7 are obvious to you or occur to you that would allow
8 you to enhance the coordination or information
9 sharing that goes on that's fairly informal right
10 now?

11 MS. BAGAN: I don't think I'd say it's
12 informal, because we do have this IFSG agreement.
13 There's not routine sharing. As Grace said, it
14 comes about when either we're about to launch an
15 audit or there's a situation in the news. And
16 perhaps that's one way that we could enhance, is to
17 have more routine discussions.

18 But I can always call Grace and get her in
19 -- we get the information we need.

20 MR. BARNETT: All right, let me jump back
21 into a more difficult question, and John, you might
22 have some thoughts on this. BD FCM gets into a
23 stress situation, no technical violation. This is a
24 positive hypothetical. So BD FCM gets into a stress
25 situation, no technical violation of SEC or CFTC

1 rules are occurring.

2 Given the fact that these regulated
3 entities are holding customer funds, should the
4 regulators publish advisories, have greater power to
5 say game over, require the transfer of assets, or
6 what do we do in a situation where we've got no
7 technical violation, but we are in a -- you know, on
8 the edge situation; how does a regulator handle
9 that?

10 MR. RAMSEY: Well, I mean, I guess my
11 off-the-cuff response is there may be other things
12 that we ought to think about doing, but I think the
13 -- but the first thing I would think about doing is
14 once we're aware that there is a problem or that
15 customer funds or securities could be in jeopardy is
16 to make sure that we are on-site at the firm in
17 force and are able to make sure that all of the
18 controls around the protection of customer assets
19 are there and are working.

20 Because, after all, that is the way the
21 customer protection regime is supposed to work, is
22 to give some assurance that even upon the failure of
23 the firm, to be able to either transfer assets out
24 in advance of the fact or pay customers off
25 relatively quickly and easily. But I certainly --

1 so I don't know how much one could do publicly, but
2 certainly joint efforts onsite in appropriate
3 circumstances always makes sense, identifying firms
4 that we think may be at risk even before a point
5 where it's obvious to the world that it could be a
6 problem, but at least where there may be metrics
7 suggesting that a firm is vulnerable, making sure
8 that we share that information whenever we have it
9 and deal with those situations jointly. And when I
10 say we, I mean not sort of a SRO DR, as well as the
11 primary federal regulators.

12 MR. BARNETT: In connection with the SRO,
13 yeah, so what powers does FINRA and CME -- does an
14 SRO have, vis-a-vis its members, in that sort of a
15 situation?

16 MS. VOGEL: It's Grace Vogel. We have
17 rules that allow us to restrict a firm's business
18 and we have rules that allow us to force a firm to
19 reduce their business. Restrictions could take the
20 form of not increasing their inventory, not taking
21 on new correspondence, not hiring anymore registered
22 reps, not opening anymore branch offices. And
23 reduction of business takes the form of asking firms
24 to bring -- reduce their inventory to reduce
25 haircuts and increase capital, or to reduce the

1 number of customer accounts they're holding.

2 We have used this rule in selected
3 instances. We don't use it routinely, which is
4 good. But we have it and we do use it when we need
5 to use it. I think that it would be helpful to be
6 able to have a stronger regime in place that would
7 allow us to force a firm to move the customers out
8 of the broker-dealer while the firm is still in
9 compliance with the rules without going through a
10 bankruptcy proceeding.

11 MR. BARNETT: Anne?

12 MS. BAGAN: We have similar rules on our
13 books and I agree, you want to take whatever actions
14 you can pre-bankruptcy so that your hands aren't
15 quite so tied. But we have required firms in the
16 past either to not withdraw any capital while
17 they're going through a stress situation or not to
18 reduce seg funds, again, stress situations, without
19 our approval first.

20 And we have used that power from time to
21 time and in concert with the CFTC we've done that
22 with some firms. But yeah, we can make them reduce
23 their prop business, move customers -- you know,
24 restrict some of their activities if we deem it
25 necessary.

1 MR. BARNETT: Bill, you had your hand up
2 before.

3 MR. DeLEON: Yes. Thank you. I think
4 it's important that while there are certainly
5 controls in place -- and I know you can't talk about
6 what happened four months ago -- the things we lose
7 sleep over and are concerned about is what controls
8 and how real time are they and how do you identify
9 stuff? Because we've had questions with many FCMS
10 and BDs on what they're doing, how they control
11 things, how they audit things, and to the extent
12 that we -- well, we understand there are a huge
13 number of movements and wires and it's a non-trivial
14 aspect. We're very concerned, how do you self-audit
15 in a timely manner?

16 And a full audit of three months is not
17 really a very warm and fuzzy thing when you saw what
18 happened four months ago, when we saw what happened
19 in '08. And given additional concerns, that's where
20 we're concerned and most nervous is how do you
21 ensure that you have controls in place to prevent
22 sort of the fraud or negligence events and how do
23 you flag them and how do you reverse them? And
24 obviously there was an interesting article in a
25 widely read paper this morning about something that

1 happened.

2 So seeing that and going okay, that's
3 great, the money was in the right place and then all
4 of a sudden it magically isn't, how do you prevent
5 and control that and how do you stop it? And that's
6 in terms of what we're most concerned about to have
7 a prevention of a repeat. We want to see more
8 expanded powers or more improved reporting
9 requirements to help identify this.

10 Because clearly the model works in terms
11 of the box until it breaks. So how do you make sure
12 that the records are clean and you can track things
13 down? And that's something we're very concerned
14 about and I think it differentiates one firm versus
15 another. And to the extent that firms take it upon
16 themselves to do it, it's great. However, if we're
17 really trying to come up with a systemic fix here,
18 we need it to come from above to have higher minimum
19 standards and to give the SROs the ability to say
20 you do this or else.

21 MS. BAGAN: Anne Bagan again. I just
22 wanted to back up on one thing. To your question of
23 should they -- should somebody put out warnings, if
24 you will, publicly for a firm that's in stress or
25 crisis whatever, I think we have to be extremely

1 careful in that situation because we don't want to
2 cause a run on the bank, right? We don't want to be
3 the cause for suddenly customers wanting to flee a
4 firm when potentially these are rumors and the firm
5 is stronger than what the press perhaps is saying.

6 So I think you have to be very, very
7 careful about being the one to say hey, everybody
8 watch out for this firm.

9 MR. BARNETT: Yes, sir.

10 MR. TIRRELL: Hi. Bill Tirrell with SIFMA
11 Capital Committee. I would suggest to you that most
12 of the larger firms are subject to various stress
13 tests. We need to -- I'm sorry. Most of the firms
14 are subject to various stress tests. They need to
15 have plans in place to be able to react to various
16 conditions.

17 And to answer your question about what the
18 regulators could do, I guess I would question is,
19 what exactly are the plans that you have in place to
20 act very quickly in order to stifle any run on the
21 bank or get in there before it gets to the point
22 where it's overwhelming? And what coordinate effort
23 is there among the various regulators to have an
24 immediate reaction that's going to be beneficial to
25 the industry?

1 So I would suggest, if anything, that
2 there should be a similar type of stress test, if
3 you will, among the regulators identifying various
4 firms and go through some scenarios, what if? What
5 if this firm goes down; what are we going to do?
6 Who are the firms we're going to reach out to to
7 transfer the clients and how quickly can we
8 accommodate that?

9 And to Bill's point on controls and so on,
10 I would agree. I think most of the exams that are
11 being conducted today are very strict, the
12 regulations that are out there on the books. And
13 although the SEC has a process of going around and
14 doing with the ANC firms a process of evaluating and
15 giving feedback, I think it would be very helpful
16 also to do something along the lines of what is the
17 best practice? Where -- where can we improve some
18 of those things without having the penalties of the
19 examination and enforcing them and so on?

20 It would be more of an encouragement to
21 the firms to try to get their standards up to a
22 level playing field and will as oppose to always
23 trying to dodge regulations and figure out how to
24 comply with the minimum standards, because sometimes
25 they're overwhelming. You don't have enough time to

1 figure out what's the best practice.

2 MR. BARNETT: John.

3 MR. LOTHIAN: John Lothian. So when
4 things are going wrong, there's a tremendous amount
5 of uncertainty. And to your point earlier about
6 disclosure and all, something that could be helpful
7 in the field of uncertainty when something bad is
8 about to happen would be knowledge of the path that
9 the firm is going to take should it be in
10 bankruptcy.

11 So it's almost like a DSRO type of a
12 question. Am I going to go SIPA or am I going to go
13 through chapter 7? So for example, the firm that
14 shall not be named, it's a lot of -- a lot of people
15 out there that are saying, you know, this is a
16 commodity firm, not a stock firm. It had 400
17 commodity accounts and 38,000 futures accounts.
18 It's a futures firm.

19 And there was a tremendous amount of
20 uncertainty. It was a big curve ball when it went
21 the way that it went. And so maybe one of the
22 things that firms need to disclose, even before they
23 get into trouble, is which is the regime that they
24 would pursue? You know, maybe it's their decision
25 as opposed to the regulators.

1 MS. TRKLA: It's --

2 MR. BARNETT: Yeah. Bob, and I think you
3 have some thoughts Katie, too. But --

4 MR. WASSERMAN: And so speaking, of
5 course, purely in the -- as to the statute rather
6 than any particular hypothetical or historical
7 situation, SIPA, the Securities Investor Protection
8 Act, is fairly specific on these issues. And so
9 they have -- essentially, if you have a member of
10 SIPA which has a customer who can be satisfied by
11 SIPA advances, then you are, for reasons which I can
12 go into over the next few minutes, going to be going
13 into a SIPA proceeding.

14 Essentially the way it works, section 5 of
15 SIPA, if either the SEC or one of the securities
16 SROs is aware of facts which lead it to believe that
17 the firm is in or approaching financial difficulty,
18 it shall immediately notify SIPA. So financial
19 difficulty. At that point, SIPA may file a notice,
20 an application for a protective decree, and they
21 would basically do that if they believe that the
22 member has failed or is in danger of failing to meet
23 its obligations and one of a number of conditions is
24 met.

25 And those conditions are that the firm is

1 insolvent, is the subject of a proceeding in any
2 court in which a receiver, trustee or liquidation
3 for such debtor has been appointed. And so, in
4 other words, that would cover, for instance, a
5 bankruptcy of that firm or some other receivership
6 proceeding, is not in compliance with the applicable
7 requirements under the 34 act, with respect to
8 financial responsibility or hypothecation of
9 customer securities, or is unable to make such
10 computations as may be necessary to establish
11 compliance with financial responsibility or
12 hypothecation rules.

13 So under those circumstances, essentially
14 SIPA would go into the District Court and the
15 District Court, upon receipt of that application,
16 shall forthwith issue a protective decree if the
17 debtor consents or if they find out one of those
18 circumstances is the case.

19 And upon filing of the application, or
20 pending the issuance, the Court shall stay any
21 pending bankruptcy or various other proceedings upon
22 -- and the Court shall have exclusive jurisdiction.
23 And so moreover, there is another provision which I
24 don't have as handy, basically a firm -- a member of
25 SIPC before filing a bankruptcy must obtain the

1 permission of SIPC.

2 And so what you have is based on SIPA,
3 that statute, any joint broker-dealer FCM, and it's
4 not a dominance test, it's is there a securities
5 customer? Is there one -- I mean, as I read the
6 statute, if there is one, and no matter that there
7 be a million commodity customers, if there be one
8 securities customer, then you're likely going down
9 this path.

10 Now it's possible, I suppose, that SIPC
11 could decide not to invoke this, I guess. I don't
12 want to speak for them, but it strikes me they may
13 feel well, look we have a duty to that one or 400 or
14 whatever, security customers.

15 MR. LOTHIAN: What happened in the
16 Sentinel case, how was that different?

17 MR. WASSERMAN: Sentinel was not, to my
18 knowledge, a member of SIPC.

19 MS. TRKLA: I can confirm that. This is
20 Katie Trkla. They are not -- they were not a
21 registered broker-dealer, not a member of SIPC and
22 not even treated under the subchapter 3 stockbroker
23 liquidation provisions. But the stockbroker
24 liquidation provisions in the bankruptcy code at the
25 end of the day have a very limited application.

1 Any broker-dealer that's -- basically has
2 public customers and is required to be a member of
3 SIPC, you're in all likelihood facing a SIPA
4 liquidation proceeding and effectively you're
5 limited to broker-dealers that may be intra-state
6 where they're not registered as broker-dealers with
7 the SEC or where they may be offshore, which was an
8 issue that came up in Revco, where one of the
9 offshore entities, not a registered broker-dealer,
10 was nonetheless deemed a broker-dealer for
11 subchapter 3 liquidation purposes.

12 MR. WASSERMAN: So the short of it is, for
13 instance, in any hypothetical case, the CFTC does
14 not have the power to say look, this is mainly a
15 commodity firm, it really should be going into a
16 subchapter 4 proceeding. The statute basically puts
17 all of this in the hand of SIPC.

18 Now, the statute also says that a SIPC
19 trustee has the duties of a trustee in Chapter 7 and
20 in particular if it's a commodity broker subject to
21 subchapter 4, the commodity broker provisions, to
22 the extent this is not in conflict with SIPA.

23 I am not aware of any such conflicts that
24 have come up in recent history.

25 MR. RAMSEY: Yeah, I was just going to --

1 Bob, your recitation, description sounds right to me
2 and I was just going to sort of try to boil it down
3 in terms of my understanding of the Commission's
4 responsibility, the SEC's responsibility in the case
5 of a failing broker-dealer entity, to say that under
6 -- that SIPA is the means, the one means that
7 Congress has prescribed to try to rescue customers'
8 funds and secure the positions of customers and
9 entities that are -- that hold broker-dealers --
10 that hold customer funds for them in a situation in
11 which a firm has failed or is failing can't
12 calculate -- provide reliable calculations and there
13 is reason to think that customer funds are in
14 jeopardy.

15 The Commission is in fact duty bound in
16 those circumstances to notify SIPC. SIPC, if it
17 determines that those are in fact -- is the case,
18 it's duty bound to go into court. And the
19 Commission, in fact, if it does not -- subject of
20 another controversial case is -- may be obligated to
21 go to court to force SIPC to do so. So that's the
22 -- that's the scheme that we have.

23 It occurs to me as well that regardless of
24 what regime the -- a trustee is operating under
25 where you have potentially two separate customer

1 estates, that trustee is always going to have the
2 challenge of sort of how you manage those to provide
3 equity on both sides, and that's -- that would be
4 the case regardless of which specific title you're
5 going into court under.

6 MR. WASSERMAN: And I should note that in
7 meeting that challenge, because it is, balancing to
8 the extent there's any tension between those
9 estates, I mean, certainly we would be participating
10 in such proceedings and we have the right to appear
11 and be heard and would be -- and would be definitely
12 doing so to ensure that that tension is resolved in
13 a way that is appropriate for the protection of the
14 commodity customers.

15 MR. LOTHIAN: Yeah, I would just say that
16 this was a greatly misunderstood specific area where
17 more clarification from the Commission would have
18 been very useful. As long as we're taking shots at
19 the press, you know, it's been mis-portrayed in the
20 press then. Because it's -- it was as if the CFTC
21 had a choice in the matter and that they declined,
22 which has portrayed them as the red-headed stepchild
23 of the securities side.

24 And so I don't like to see my regulators
25 portrayed that way, so you guys, some clarification

1 would have been helpful.

2 MR. BARNETT: Thank you. Katie?

3 MS. TRKLA: I may be moving sort of a
4 segue to another topic we may be covering, but in --
5 following-up on John's comments, I do find myself
6 wondering are there things -- and I fully appreciate
7 the bandwidth constraints all around -- but are
8 there things that can be done across the CFTC, the
9 SEC and I think SIPC itself needs to have a place at
10 the table to have a better sort of agreed upon
11 understanding of how the different pieces work
12 together, a better understanding or communication of
13 how the commodity broker provisions are intended to
14 work.

15 I think almost a memo of understanding
16 type approach so that prior to the next bankruptcy
17 situation where the last time you really want to be
18 sorting out these issues for the first time is when
19 you're trying to deal with the crisis. Are there
20 things we can do to sort of improve the
21 communications?

22 I fully understand that there are
23 differences in the statutes. There are always going
24 to be ambiguities, issues that are going to come up,
25 disagreements, but to the extent that it's possible

1 to try and foster a common understanding across the
2 CFTC, the SEC, SIPC, on how this should work when
3 you've got a dually registered FCM BD and could
4 perhaps even address issues of how do you deal with
5 the myriad relationships that a firm will have with
6 customers where they may have a prime brokerage
7 account, they may also have a cleared futures
8 account, they may also now have a cleared swaps
9 account.

10 They may have a variety of other
11 relationships either directly or through affiliates
12 that I think need to be recognized and can
13 complicate or pose challenges when you're dealing
14 then with the bankruptcy and managing that kind of
15 situation.

16 MR. WASSERMAN: And so I guess you raised
17 two points. The first one, which I will seize upon,
18 there are indeed bandwidth constraints in the sense
19 that we have a limited budget and a lot of work to
20 do with very little money comparatively, and yes,
21 that would be nice, but there we are.

22 Having said that, this is critical and it
23 is something that there was some work that was done
24 in the aftermath of Lehman, which was the first
25 broker-dealer FCM insolvency, and there was indeed

1 work with the SEC and with SIPC in terms of
2 understanding how things should work, and then, for
3 instance, first day order, which is very, very
4 important. I wish I could say it was done perfectly
5 and completely, but that would not be the case.

6 We have more work to do. It is work that
7 we are doing both continuously, as I would say there
8 are certain issues that have us in consultation
9 currently as well as planning for the future and --
10 as well and to tack back to issue that came up
11 yesterday in our discussion on the bankruptcy code,
12 as well with, for instance, colleagues at the FDIC.

13 And so there's a lot more to be done and
14 we are attentive to it and we'll do as best we can.

15 MR. BARNETT: Okay.

16 MR. RAMSEY: Yeah, I would just say for
17 our part that we certainly welcome the chance and
18 opportunity to talk about, anticipate these issues
19 as much as we can. There are various forms that
20 could be appropriate. I know there's -- you know,
21 we have -- there's a Joint Advisory Committee that
22 has been used as venue before for issues of sort of
23 joint mutual interest to the two agencies involving
24 matters like this. That may be one possibility, but
25 I certainly repeat the point about a

1 limited bandwidth, because I'm feeling that at the
2 moment too.

3 MR. BARNETT: Thank you. So maybe a
4 follow-on question. Given some of the risks we've
5 discussed, so we got bankruptcy issues, we got
6 capital, we got issues about information. So here's
7 -- so given the various risks we've discussed,
8 should FCM and BDs be separate legal entities?

9 MR. NICHOLAS: Sorry, I didn't hear --

10 MR. BARNETT: Should they -- should FCMS
11 and BDs be -- should they continue to exist in the
12 one business or should they be separated?

13 MR. NICHOLAS: John Nicholas from Newedge.
14 I mean, I think there's some good arguments that
15 they should continue to be the same entity. I think
16 customers like -- seem to like the fact that they
17 can do securities and futures in the same legal
18 entity. I think that it paves the way for portfolio
19 margining, which I think would be something that
20 would be terrific in this market, something that's
21 available overseas.

22 And I think that dividing the business
23 would make life less efficient and more complicated
24 for customers and probably result in perhaps more
25 risk taking in terms of customer positions. You're

1 dealing with two counter parties. They may be less
2 inclined to put on a hedge, for example, that they
3 -- that they would do if they only had to face one
4 counter-party.

5 So I think there's a lot of good arguments
6 for keeping them together.

7 MR. BARNETT: Others? Carl?

8 MR. GILMORE: Carl Gilmore, Penson. I
9 echo John's comments. It's the 21st Century. These
10 markets are intertwined. Like it or not, the
11 futures markets affect the securities markets. The
12 securities market affect the futures markets. The
13 OTC markets affect all of them and so my view would
14 be the small benefit that you might get from
15 separating a broker dealer from an FCM in terms of
16 potentially ring fencing any problem is far
17 outweighed by the cost and the inefficiencies in the
18 marketplace based on how these markets in this
19 country have evolved.

20 So I think that would -- I don't see any
21 real good reason to separate them out.

22 MR. BARNETT: Grace.

23 MS. VOGEL: Grace Vogel. I would venture
24 to say that most of the large firms have customers
25 who are both futures customers and securities

1 customers and having both products in the same legal
2 entity actually serves to reduce the risk of the
3 combined BD FCM as opposed to increasing the risk.

4 MR. BARNETT: Katie.

5 MS. TRKLA: I would add, I think I would
6 question the premise that it may actually simplify
7 things in a bankruptcy context or in addressing some
8 of the other issues, because if you do separate
9 them, you're going to have to begin with issues on
10 an intra-affiliate basis, because it's not going to
11 stop the practice of wanting to transfer excess
12 funds out of your prime brokerage account over to
13 the futures account at a separate entity. So I
14 think you introduce another set of issues that can
15 complicate things.

16 What also -- I, just from a legal
17 perspective -- and thank you for mentioning the
18 portfolio margining. You know, Dodd-Frank did add
19 specific provisions to both the Exchange Act and the
20 Commodity Exchange Act finally to accommodate
21 portfolio margining for futures and securities,
22 which presupposes that it's a dually registered
23 firm.

24 MR. BARNETT: Thank you. John?

25 MR. LOTHIAN: John Lothian. Looking at it

1 from the customer perspective, what we've seen in
2 recent years is the entrance to the retail side of
3 the business, are people that have come out of the
4 securities side of the business. So it's some of
5 the retail stock brokers or even option brokers that
6 are now offering futures and customers are flocking
7 to that.

8 So voting with their feet, that's a
9 growing thing. And as I mentioned yesterday,
10 there's some -- there's some ways that customers are
11 taking advantage of the insurance protection on the
12 securities side with their excess margin. And so
13 unless futures has a level playing field when it
14 comes to that, I would expect that trend to continue
15 and that you'll see firms -- more and more firms
16 that are predominately stock firms, securities firms
17 as opposed to futures firms, that you are -- that
18 you are regulating.

19 MR. BARNETT: Bill.

20 MR. TIRRELL: Bill Tirrell, SIPA Capital
21 Committee. I would agree and echo what Grace and
22 Katie had mentioned earlier. I think actually in
23 terms of liquidity risk, I think you actually
24 introduce more liquidity risk. I can tell you years
25 ago, dealing with a firm that had a separate FCM and

1 a broker-dealer, we actually would use a funding
2 vehicle or funding entity to bridge the two, so
3 you're actually introducing a third entity into the
4 puzzle in order to facilitate the client needs,
5 which are really spanning across both of the FCM and
6 the BD with their products and their requirements.

7 And having separate -- two entities with
8 two different margin regimes and possible --
9 possibility of not having a complete view of the
10 client introduces more operational risk and funding
11 of those capital requirements and so on, starts
12 again, introduce more liquidity risk across the
13 whole entire entity.

14 MR. BARNETT: Thank you. Yes.

15 MS. COCHRAN: Gary, this is Christine
16 Cochran of the Commodity Markets Council. I just
17 wanted to chime in on this one because we had a
18 very, very heated conversation amongst our members
19 on this topic. And I'd like to say that we, as an
20 organization, would support what's been said here,
21 even though I don't see very many of my members
22 sitting around the table.

23 But I should point out that we did have
24 some of our FCM members who supported the idea. As
25 an organization, we have not endorsed it, but it was

1 a very heated conversation back in December for us.

2 MR. BARNETT: Separate --

3 MR. DeLEON: Hi. Bill DeLeon, PIMCO. I
4 just want to echo what many people here have said in
5 terms of the separation is sort of a difficult
6 situation. And a couple of anecdotes if I could
7 point out.

8 First of all, a lot of corporations will
9 have separation of legal entities, but they'll be
10 shells without any actual capital. So unless you
11 have a guarantee from the parents or a look through
12 the legal entities, you're actually in a worse off
13 situation because it's going to be less capitalized,
14 or more likely to be orphaned in a bad situation,
15 i.e. the good bank/bad bank type concept.

16 Another thing to point out, which is I
17 know it's been -- was in the original rules and sort
18 of there's been talk now about cross-margining.
19 Originally, if you look at the futures model, and if
20 you look at, see me, for example, you have
21 commodities, equities, fixed income and currencies
22 all in one pot and then with derivatives, they were
23 put into a different pot and then each different
24 derivative was put into another pot. You wound up
25 with a situation where you had no cross-margining

1 benefits which drove up the margining requirements.

2 So I think that that is less efficient for
3 capital usage as well as for clients. I think that
4 -- two other things I just want to add is one, when
5 you have more legal entities, you have more due
6 diligence and more wires and more inefficiencies
7 there. And most importantly, I think that when you
8 use different type of entities, the investor needs
9 to be aware, am I using four different type of
10 agreements and do I have four different type of
11 risks or one?

12 And I think that you can't fix that.
13 That's up to the client and what they're trying to
14 achieve and how they manage things. So you can't
15 fix everything by making different legal entities.
16 What you can -- and this one's your -- the earlier
17 point is making sure that the rules are sufficient
18 for capital and segregation and that they're
19 followed on a real time basis. And those are the
20 important things in my -- and more important in my
21 view than just arbitrarily splitting things out
22 without these other controls in place.

23 MR. BARNETT: Thank you. Yes.

24 MR. WINTER: Steven Winter. I would add
25 one other point and that's when you have a combined

1 broker-dealer FCM the decision making process is
2 also different within the firm because when -- if
3 you're an FCM stand-alone all you need to concern
4 yourself with are rules of the FCM. But when you're
5 both, now you have to concern yourself with the
6 rules of the broker-dealer as well because they do
7 impact each other.

8 And so I think that actually creates a
9 higher standard for them.

10 MR. WASSERMAN: How so?

11 MR. WINTER: Well, for example, and FINRA
12 can contest to this, but any of the banks that are
13 for example, expanding their FCM to get into the
14 swap clearing business need to make sure FINRA's
15 comfortable with that, where if it was a separate
16 entity, do I need to go to FINRA?

17 MR. BARNETT: So do you end up with your
18 --

19 MS. VOGEL: I can elaborate that -- on
20 that if you'd like.

21 MR. BARNETT: Sure. Yes, please.

22 MS. VOGEL: Grace Vogel. We have a rule,
23 1017, that requires firms to get our approval when
24 there's a material change to their business. So we
25 would view that if they are entering into the

1 derivatives business there would likely be a
2 material change in their business and we would have
3 to review the process, the controls in place for
4 that business.

5 MR. BARNETT: How do you -- what is -- can
6 you explain a little bit 1017 and what is the scope
7 of a material change to the business?

8 MS. VOGEL: I think that it's facts and
9 circumstances --

10 MR. BARNETT: Sorry.

11 MS. VOGEL: -- based.

12 MR. BARNETT: Also examples may be just
13 types of -- you know, something generic.

14 MS. VOGEL: Yeah, if a firm is getting
15 into the market making business for the first time
16 or doing underwritings for the first time, doing
17 private placements, if they historically have had an
18 institutional clientele and now they're getting into
19 the retail business and opening up branch offices.

20 MR. BARNETT: Got it. Got it.

21 MS. VOGEL: And we would include
22 derivatives, as Steve said. So if a firm has been
23 --

24 MR. BARNETT: Could it include -- could it
25 include taking on a new -- it could include taking

1 on a new business line?

2 MS. VOGEL: Yes, it does, taking on a new
3 business line.

4 MR. BARNETT: Okay. And would it include
5 maybe a significant change in the financing, you
6 know, in the capital, in the way the company's
7 financed?

8 MS. VOGEL: If there's a --

9 MR. BARNETT: And so a good kick in terms
10 of leverage?

11 MS. VOGEL: If there are changes to the
12 capital structure or ownership of the firm, that is
13 required to be approved by us. If it's a material
14 change, we have a different rule that requires
15 withdrawals of capital to be approved as well, which
16 would include the payment of dividends.

17 MR. BARNETT: Got it. Thank you. Yeah,
18 so I guess -- Anne, do we have -- do you have
19 anything similar under your membership?

20 MS. BAGAN: Rules for material changes?

21 MR. BARNETT: Yeah.

22 MS. BAGAN: Yes, we do.

23 MR. BARNETT: Okay.

24 MS. BAGAN: We do have that as well.

25 MR. BARNETT: Okay. All right. So --

1 yeah.

2 MR. LEE: Sorry, this is Robert Lee,
3 Deutsche Bank, for SIPA. Just following up on the
4 various points about portfolio margining and, you
5 know, given that in the future as we start seeing
6 more and more products that go into clearing, I know
7 a lot of products are already being cleared. But we
8 have this whole new OTC swaps and security-based
9 swaps that would be -- you know, that would be
10 subject to mandatory clearing in the future.

11 I think one of the things that I think
12 people have alluded to is that Dodd-Frank has sort
13 of bifurcated certain product classes even within
14 that space, such as CDS into swaps and
15 security-based swaps. And to the extent that both
16 those products, index swaps, which are swaps, and
17 single named CDS that are security-based swaps, are
18 being cleared by the same clearing house and by the
19 same client, I think that is an area where I think
20 portfolio margining probably should be -- you know,
21 should be looked at very closely or as one of the
22 first things to be looked at given that the indices
23 are essentially a basket of individual single names.
24 And when you have a credit event, you know, for a
25 single name and it also constitutes a constituent in

1 the index, they will settle at the same price and at
2 the same time.

3 So from a customer perspective, I think
4 there is a great demand and desire for portfolio
5 margining and I think -- and to be able to achieve
6 that, not only would the CFTC and SEC basically
7 allow for it, but the second step, which is more of
8 a practical issue, is that you need to have probably
9 the same legal entity that clears for them.

10 So given that the offering says that you
11 clear swaps for customers with FCMs and on the SEC
12 side you can't clear for customers on security-based
13 swaps with an FCM, you just -- you may be forced to
14 look at a dually registered BD FCM to be able to
15 achieve this. So I just wanted to get it out there.

16 MR. BARNETT: Thank you. Katie?

17 MS. TRKLA: I fully agree with everything
18 you say. I think there's a real demand for
19 portfolio margining. I think there are some issues
20 that need to be worked through in terms of the legal
21 analysis and so it is important, I think, for the
22 SEC and CFTC to be coordinating on addressing those
23 issues, including depending upon the choice of the
24 account structure, if it's held in a 40F segregated
25 account, or in a securities account structure, how

1 does the bankruptcy code regime apply to those
2 accounts?

3 I know ICE clear credited -- in their
4 petition they addressed that issue. I know other
5 clearing houses are looking at providing portfolio
6 margining. They're also carefully evaluating those
7 issues, but in light of recent events, I think it's
8 very important to actually have a clear
9 understanding of what would happen in a bankruptcy
10 context and how those accounts would be treated.

11 But I would also add that short of
12 portfolio margining, I think we have to assume that
13 even without portfolio margining available, the
14 firms that are going to be providing clearing for
15 CDS as swaps and CDS as security-based swaps are
16 going to be dually registered. They're going to be
17 participating in one of the clearing houses as
18 opposed to DCO and a clearing agency.

19 And I think there are some basic issues in
20 terms of account structure on the securities side
21 where there is, I think, some potential uncertainty.
22 And I'm thinking in particular of the general
23 framework for securities under 15c3 and rule 15c3-3,
24 which applies generally to securities, but then the
25 separate provisions specific to security-based swaps

1 in 3E of the Exchange Act where for -- in the
2 cleared security-based swap context, the language is
3 virtually identical to what was added to 40F for
4 cleared swaps.

5 And the SEC, I believe, in addressing the
6 compliance and effective dates, identified that as
7 one of the provisions that took effect or could take
8 effect without further rule-making. But I find
9 myself thinking, is there something inherent in the
10 3E language that almost requires that for cleared
11 security-based swaps that it has to be held, the
12 funds, separate from other funds for cleared
13 securities?

14 And that's not a position I'm advocating,
15 but I think there are some interpretative issues and
16 some issues where the marketplace and FCM BDs would
17 benefit by greater clarity on are you working under
18 the 15c3-3 framework? Are you working under the 3E
19 framework? How do the two interrelate just as a
20 basic threshold matter to be able to implement
21 client clearing for security-based swaps?

22 MR. BARNETT: Yes.

23 MR. LEE: Just maybe to complicate things
24 even further --

25 MR. BARNETT: Oh, good.

1 MR. LEE: -- for European CDS they do have
2 restructuring as a credit event, and to the extent
3 that it's a name in an index that has a
4 restructuring credit event, it doesn't get
5 automatically triggered. It's still up to either
6 the buyer or the seller to trigger. But what
7 happens from the index context is that it's actually
8 spun off into a single name.

9 So you go from what used to be a swap now
10 into a swap plus a single name, you know, a
11 security-based swap.

12 MR. RAMSEY: I will not try to complicate
13 things further. This is a very complicated area.
14 But I would just say that I think, my view at least,
15 I would say probably the staff's view is that
16 ultimately we imagine an environment, a world where
17 there is a legal construct to be able to -- and the
18 regulations support a concept for having as much
19 portfolio stuff that is reasonably related to each
20 other that can be portfolio margined together, held
21 together and put in the same account, in a single
22 account, and we -- I don't think we think that there
23 is anything in the statutory scheme as amended by
24 Dodd-Frank that would preclude that.

25 But it's -- you know, there's a lot of

1 individual steps to get there. The thing on the
2 table that seems to be of most interest to market
3 participants now is cleared swaps and security-based
4 swaps on CDS marketing in particular. So that's
5 what we're focused on is a -- as a first step and
6 we've been working with staff at the CFTC and others
7 to try to make that happen.

8 So I think it's going to be a process. I
9 think over time potentially the pool of things that
10 could be dealt with on a portfolio basis may expand.

11 MR. BARNETT: Thank you. Tom?

12 MR. SMITH: I'd just like to go back to
13 where we started in the conversation with
14 disclosure. Now that we've had the benefit of
15 hearing the complications of portfolio margining and
16 complications of a dual-registered bankruptcy, if
17 anyone would like to elaborate maybe on the previous
18 thoughts on disclosure. How can we make effective
19 disclosure for all these types of issues that are
20 with the firm with respect to I'm a customer, I want
21 to trade either on the future side or the security
22 side or both sides?

23 What should I really understand about this
24 organization? How can we do that with all of these
25 complex issues? Is it just a very high-level type

1 of disclosure or do you look at what type of
2 business you're going to conduct?

3 I just wanted to see if anyone had any
4 further thoughts on what we talked about at the very
5 beginning?

6 MR. DeLEON: Hi. Bill DeLeon. I think
7 what needs to be disclosed is what regulatory bodies
8 each unit falls under and to the extent that there
9 are certain customizable things that are
10 permissible, you need to have some disclosure on
11 what they're doing along the spectrum. And I think
12 that -- those are the important things, so that
13 there is some reasonableness when you ask a
14 question, okay, you're doing it under 1.25 or can
15 you give us more details? Or how is your margin
16 held? Is it held at your bank? Is it held at
17 another bank?

18 Those things should be easy to obtain
19 because you want to know okay, soup to nuts, what is
20 this person doing with my money? If I have funds
21 with them in a prime brokerage, you're kind of
22 behind the wall there and that's structural in the
23 prime brokerage. But you want to make sure that if
24 you open a futures account it's clear. Is it part
25 of the PB or is it part of the standard futures

1 agreement?

2 And those sort of things, I think, are
3 where people get in trouble and don't necessarily
4 always know or are aware that a PD relationship is
5 completely different than a futures broker or a
6 securities account. And that's where I think people
7 get into trouble and I think that the rules are very
8 clear and there's a lot already publically available
9 in terms of if you're in one of these entities, what
10 type of protections you get or don't get, why you
11 may get better rates or not.

12 It's a the question of do people know
13 which entity they really are in and how things work?
14 And that's where confusion comes about, especially
15 when people open multiple type of agreements with
16 the same legal entity.

17 So I think while people should be doing
18 their homework, not necessarily every one does, or
19 it's a little confusing -- and I think Kathryn
20 pointed out, when you get documentation for a
21 futures agreement, the number of pages of bold and
22 black-lined disclosures can be quite lengthy and not
23 everyone has the ability to read all gazillion
24 pages.

25 MR. BARNETT: But if you were buying a

1 note issued by the joint FCM BD, you would get one
2 kind of disclosure, but -- a pretty fulsome set of
3 disclosure. When you have customers relying on the
4 FCM BD and the information they're currently getting
5 about the entity can pretty sketchy, I guess the
6 question -- I'm not suggesting you equalize them,
7 but based on what we heard from the industry today
8 in terms of covering certain risks with notices and
9 reports and so on, given the fact that it's
10 happening on both sides of the business or elsewhere
11 in the business, trying to think through how to get
12 that together.

13 MR. DeLEON: I understand your point. I
14 wouldn't -- I don't want to be accused of defending
15 the dealers here. However, I think that the thing
16 to be careful about, there are certain things that
17 unless you go through a future statement, you would
18 not be aware of.

19 So while the disclaimer will say you can
20 -- might -- you may do the following things, and it
21 can be a long list of things, unless you actually go
22 through your futures statement and you do it every
23 day, you don't know if they're doing it. And
24 there's something in between, I think, that is
25 important in terms of notification or ability to

1 find out that isn't necessarily easy.

2 And I can tell you we've gone through some
3 statements and we've found things that lead us to
4 ask questions. It's just not easy to do.

5 MR. WASSERMAN: I want to press on that
6 and the members of how I can help out. Because on
7 the one -- I think you're right, you're searching
8 for a middle ground between two little information
9 an so much information that people will throw their
10 hands up in the air and not go through the 100
11 pages.

12 So what should we as regulators be doing?
13 How do we -- how do we find that balance or should
14 we be the ones finding that balance? What should we
15 be doing?

16 MR. DeLEON: I think -- you know, I think
17 in terms of you open a futures agreement, you should
18 be responsible for reading it. It's a one-time
19 event. You can't necessarily take that away. Not
20 to bring up another touchy subject, but if you get a
21 mortgage, you got to read the agreement.

22 However, I think that when the agreement
23 says that a firm can do X, Y or Z or 1 through 100
24 items at its discretion, you need to know okay, are
25 -- which ones are they doing from this menu of

1 items? Or if they start to do something they hadn't
2 been doing, I need to know.

3 And having to go through a 100-page
4 document, statement every day, to go hey wait, oh,
5 they're doing this, not that anymore, that is where
6 it becomes difficult. And it's in a place where
7 it's not easy to find. So unless you have
8 technology that goes and looks for it, you're going
9 to miss it.

10 So something there where they do change
11 what they're doing, even though they told you they
12 may, I think is a helpful thing. You can't -- you
13 can't make it so simple for people. The reason we
14 have so long -- such long documents is because we
15 want to disclose everything. It's just sort of the
16 menu things, when they change them, you need
17 something going hey, we changed that. It's sort of
18 like when you get a credit card, right, when they
19 change information about what they're doing, they
20 have to send you a notice.

21 Now most people probably don't read it.
22 However, you do get it and it's not something you
23 have to go find on your statement.

24 MR. BARNETT: Thank you. Go ahead, Dan.

25 MR. DRISCOLL: Yeah, Dan Driscoll from

1 NFA. You know, one technique you can --you can use
2 to help here is that -- is that you can require
3 disclosure that you believe in your estimation would
4 be useful for all customers regardless of their
5 sophistication and then have other information that
6 a firm is required to provide on request where other
7 customers that are going to take the time to ask
8 those questions could get it, but not every customer
9 has to get every piece of all that potential
10 information.

11 MR. BARNETT: Steve?

12 MR. WINTER: I was kind of going to lead
13 to what Dan just mentioned in that when you look at
14 the relationship between clients, FCMs,
15 broker-dealers, it's not a one-size fits all. The
16 relationships from client to client are different
17 with their FCMs and the broker-dealer's relationship
18 between the FCM and the broker-dealer is different.

19 And therefore, when you try and do
20 disclosure, if you're going to do disclosure to
21 everybody, it's going to be at a very high level.
22 You have to at least maintain a certain minimum
23 requirement that you have to disclose and then the
24 question just becomes what's the relationship
25 between the client and their supplier of services.

1 And it's really for the two of them to go through
2 proper due diligence.

3 MR. NICHOLAS: I think what customers
4 might find very useful would be a side by side
5 comparison which would examine the differences in
6 the bankruptcy regimes and the customer protection
7 regimes in particular, things like differences in
8 ability to re-hypothecate differences in the
9 frequency of the computation, differences in the
10 investments that can be done with customer funds.

11 There are some basic differences between
12 the two -- the two regimes. And just a straight
13 forward simple side by side comparison I think would
14 be very usual.

15 MR. BARNETT: Thank you. Carl?

16 MR. GILMORE: I just echo a little bit
17 what some others were saying, but to Bob's question
18 about what should you as regulators be doing, I
19 mean, there are a couple of different approaches.
20 You could come up with a 50-page document, every
21 eventuality, but as Grace pointed out earlier,
22 nobody would understand it.

23 So I would urge you as regulators to take
24 the most -- what I think is the most reasonable
25 approach and that would be to identify the issues

1 that are common to the greatest number of customers,
2 and then to require disclosure or to make
3 disclosure, as Tom said, at least to the basics or
4 at a high level.

5 Ultimately, that's about all you can
6 really do and I think that's the best benefit for
7 customers. So if you give them the basics so that
8 they understand some of the basics on both the
9 security side and on the futures side, if they have
10 an account with a multiplied registered
11 broker-dealer or FCM, that probably does the most to
12 make them aware the information's there. And then
13 if they want to follow-up and get specifics, now at
14 least they're armed with some basic information.
15 And that's the approach that I would advocate.

16 MR. BARNETT: Katie? I think we'll give
17 Katie the last word because we're going to --

18 MS. TRKLA: Oh.

19 MR. BARNETT: -- we're done.

20 MS. TRKLA: Okay.

21 MR. BARNETT: Better be good.

22 MS. TRKLA: I better make it a good one.
23 No. I agree with everything that's been said.
24 Further to John's point, at least some high-level
25 comparison or overview of the different bankruptcy

1 regimes and what could happen, to me sort of part
2 and parcel in terms of what a customer wants to know
3 does relate to what I think of as sort of clearing
4 house disclosures, what also does it mean from a
5 clearing house perspective and what does the
6 clearing house guarantee mean, what can I really
7 expect?

8 Because again, I come back to a point I
9 made before. I think there was some
10 misunderstanding based on perhaps the rhetoric that
11 we've used traditionally in the futures industry
12 that led many to believe that a clearing house was
13 standing behind the obligations owed to the
14 customers of a defaulting FCM, which is a very basic
15 misunderstanding.

16 I mean, it is a misunderstanding that is
17 incorrect. And I recall post -- I'm dating
18 myself -- but the Behrings default back in what, the
19 nineties. One of the outcomes of the FIA task force
20 was to recommend sort of a basic high-level clearing
21 disclosure document, but it does seem to me the
22 issues crossover and are related to the bankruptcy.

23 MR. BARNETT: All right, well I thank you
24 all for participating and we're going to conclude
25 the session. And we'll be back in 15 minutes to

1 start our last session of the day on SROs and SRO
2 oversight. Thank you very much. Thank you.

3 (A recess was taken.)

4 MR. BARNETT: Okay, welcome back to our
5 third and final session today. As we continue to
6 look at various issues and ways of enhancing
7 customer protection, in this session we're going to
8 look at issues relating to the SROs and SRO
9 oversight and to help us explore these issues,
10 panelists will go around quickly. But especially
11 want to mention Tom McGowan from the SEC and Grace
12 Vogel from FINRA, and we thank them for joining us
13 for this session.

14 So let's go around again. Gary Barnett,
15 CFTC.

16 MR. SMITH: Tom Smith, CFTC.

17 MR. PICCOLI: Kevin Piccoli, CFTC.

18 MR. MCGOWAN: Tom McGowan, Securities and
19 Exchange Commission.

20 MR. DRISCOLL: Dan Driscoll, NFA.

21 MR. GILMORE: Carl Gilmore, Penson.

22 MR. NICHOLAS: John Nicholas, Newedge.

23 MS. VOGEL: Grace Vogel, FINRA.

24 MS. MCCARTHY: Sandy McCarthy, FC Stone.

25 MS. BAGAN: Anne Bagan, CME.

1 MR. WASSERMAN: Bob Wasserman, CFTC.

2 MR. BARNETT: And Bill we missed, but --

3 MR. DeLEON: Bill DeLeon, PIMCO.

4 MR. BARNETT: Great. Thank you. And then
5 again, the disclaimer. Because of the Division of
6 Enforcement's ongoing investigation, we can't engage
7 in a discussion concerning matters involving MF
8 Global. We ask each of you to respect that rule,
9 that we not inject MF Global or specifics about MF
10 Global into the discussion here today.

11 So here's some background facts. It's a
12 big topic to get into, so here's some background
13 facts to start off our conversation. First, the SRO
14 system actually pre-dates the CFTC. In 1859, the
15 Chicago Board of Trade first formalized it's
16 self-regulatory powers and its founding charter and
17 it wasn't until the early twenties that the federal
18 government began to directly regulate the futures
19 market.

20 Under the SRO system, the exchange, which
21 is the Self-Regulatory Organization, is the first
22 line of supervision of its FCM members. We'll talk
23 about this in more detail in a few minutes, but in
24 broad strokes, the SRO examines its members and the
25 CFTC oversees the SRO.

1 Third, because members could become
2 participants in multiple exchanges, it was clear
3 that if each exchange examined each of its members,
4 duplicative examinations with varying scopes would
5 occur, resulting in inconsistent findings and
6 efficient costs, uses of resources and so on. So
7 there has traditionally been productive cooperation
8 among the SROs and the future market -- the futures
9 markets, including formal coordination of the SROs'
10 compliance examinations of future Commission
11 merchants.

12 CFTC rule 1.52 expressly provides for such
13 cooperation among SROs, recognizing that such a
14 system of assigning each FCM to a designated SRO or
15 DSRO for exam purposes helps avoid redundant burdens
16 on FCMs. It makes more effective use of SRO
17 resources and fosters important information sharing.

18 And then under rule 152 -- 1.52, it
19 reserves for the Commission a role of improving and
20 monitoring the system. Obviously, we want to help
21 look at appropriate modifications that may be needed
22 to strengthen customer protections in the futures
23 and derivatives markets.

24 Now other piece of background information.
25 When the SRO -- and this is all going to be

1 important for the discussion -- when the SRO system
2 was emerging, the exchanges were then mutually owned
3 and non-profit. They would trade on physical
4 floors. They were relatively high cost of high
5 barriers to entry and it created an environment
6 which was widely assumed that the exchanges had
7 significant incentives to self-police and supervise
8 their members, because their interests were in
9 protecting the reputation, brands and products.

10 So it was felt that enlightened
11 self-interest would work in that regard and that
12 combined with the fact that the exchange was close
13 to the business would help with wiser decision
14 making.

15 However, by the early 2000s, the futures
16 industry was experiencing a massive change due to
17 new technologies and innovation, as was the rest of
18 the world, of course, but here it created doubts
19 about many of the assumptions underlying the
20 strength of self-regulation. So we went from
21 mutual, you know, non-profit physical floors.
22 Computers made the physical floor unnecessary.
23 Competitor exchanges could more easily enter the
24 market. Members became competitors with exchanges
25 while new exchanges could bypass certain members.

1 Exchanges could issue rules which affected
2 their -- affected their competitors. And yet those
3 who were in charge of self-regulation might be
4 regulated by or regulating their competitors. As a
5 result of all this, and the exchanges switched from
6 being member cooperatives to public corporations,
7 conflicts arose that once didn't exist and the
8 alignment of interests came under scrutiny.

9 So then the industry and the CFTC examined
10 the futures SRO system seeking changes that would
11 allow self-regulation to work in the new
12 environment, and those solutions were found -- that
13 were found related to poor governance. For
14 instance, by including directors that adequately
15 represented all of the members and independent and
16 public directors. And in protect -- in particular,
17 the regulatory function of the SRO was placed under
18 the supervision of a ROC or a regulatory oversight
19 committee made up of public directors.

20 And the discourse which began -- and Dan
21 and I were just talking about it -- the discourse
22 which began in 2003 was finally put in place around
23 April 2009.

24 So we'll come back to the ROC, but first
25 let's talk about examinations. Let's just start

1 with scope of review. So what does the SRO examine
2 when it looks at an FCM, and is there any need to
3 modernize the scope of that review? And I guess in
4 particular, I don't know if it's fair to talk --
5 some of the changes that have been recently
6 considered. Anne?

7 MS. BAGAN: Anne Bagan, CME. We are
8 required to do a regulatory audit of our clearing
9 member firms every nine to 18 months, but more
10 typically nine to 15 months. And they are risk
11 based where we look at the history of the firm,
12 whether it's financial issues that they've had or
13 disciplinary issues that they've had, concerns
14 others have brought up with us, as well as a
15 rotational aspect, if you will, of certain programs
16 that we do.

17 The scope of those audits is fully
18 detailed and delineated within those audits so that
19 we know exactly what we're looking at and why we're
20 looking at it. And that can be expanded as issues
21 are found during the audit.

22 So what do we look at? We spend a lot of
23 time on customer seg, obviously, all the different
24 balances that go into customer seg. That's a huge,
25 huge piece of work for us and that's tying out to

1 third-party documents, examining, reconciling items
2 to make sure that they make sense and that they're
3 cleaned up on a timely basis. We are looking at
4 capital compliance to make sure our firms are
5 maintaining the minimums at least and that they are
6 reporting those things correctly to us.

7 Another big area is to look at the firm's
8 margin procedures and to make sure that they are
9 following our rules for calling for margin and
10 taking appropriate capital charges when -- when they
11 need to. We look at books and records. We look at
12 AML. We look at sales practice type of things, with
13 -- especially for those that have guaranteed IBs.

14 So the audits, we have five months to
15 complete an audit and for some of our firms, it
16 takes a good chunk of that five months to get that
17 done. If we do not complete those within five
18 months, we have to self-report ourselves to the
19 CFTC.

20 So our audits, as life has gone on, have
21 gotten a lot more complicated. The issues are a lot
22 more complicated. And the firms themselves, with
23 mergers and new business practices, they've become
24 more complicated as well.

25 MR. BARNETT: What is the size of the

1 teams that go out in these five months of audit?

2 MS. BAGAN: Depending on the size of the
3 firm, the teams can be -- you know, we've got a
4 couple of very small firms that maybe have two or
5 three auditors. We have very large firms that can
6 take, I'd say, up to six people usually. And that's
7 a range of experience levels, with an in-charge that
8 takes the lead out in the field and then a manager
9 back in the office that is there to review
10 everything to make sure it's proper.

11 MR. BARNETT: Grace, can I ask you, like
12 how does that compare with the scope of the review
13 which FINRA does for its BDs?

14 MS. VOGEL: Well, the areas that Anne
15 mentions, financial responsibility, which would
16 include compliance with 15c3-3, the SEC's customer
17 protection rule and then the capital rule, books and
18 records, margin, those are all very, very similar.

19 Our focus is on the security side, so we
20 don't look at the futures activity unless there's
21 something that's concerning to us, like -- I can't
22 think of an instance recently when we looked at the
23 futures side. We are risk -- risk based so there's
24 -- our program is set up so that we have a
25 coordinator assigned to every firm. That

1 coordinator is responsible for day-to-day
2 surveillance and contact with the firm, and as we
3 talked in the previous panel about changes to the
4 firm's business, that those changes need to be
5 approved or we need to be notified of them, new
6 products.

7 The coordinator has knowledge of the
8 disciplinary history of the firm. The coordinator
9 is also attuned to what's happening in the markets
10 and therefore will be in contact with a firm to
11 assess the impact of what's happening in the markets
12 to the firm's business.

13 The coordinator is then responsible for
14 sitting down with the examination team and actually
15 planning the examination. So identifying which
16 areas, because we have 100 different -- that's an
17 estimate -- different scope chapters and obviously
18 we need to identify a smaller number for each
19 examination.

20 Each year we identify more thematic
21 priorities that are included, to the extent that
22 they're applicable, and we actually send out an
23 examinations -- an examination priorities letter.
24 That letter went out, I think, about two or three --
25 probably two weeks ago. January 31, I think it went

1 out.

2 And the things from the financial and
3 operational program that were included in that
4 letter this year, for example, are price
5 verification. So looking at the authority of
6 independent evaluation groups, the communication
7 with finance group, looking at off-balance sheet
8 exposures, understanding the risks and the margining
9 practices, liquidity, fully paid lending programs,
10 compliance with the new SEC rule 15c35 on direct
11 market access.

12 Those are just examples of areas that are
13 a priority for us this year. So the coordinator,
14 having an understanding of the firm's business, will
15 instruct the examiners as to which of these, what
16 I'll call hot topics for the year, should be
17 included in the current year's examination.

18 MR. BARNETT: So how long does it take to
19 do an average -- I'm sure you got all kinds of size
20 BDs, but typically, what would you, in terms of team
21 size and audit team size and time, to do an audit?

22 MS. VOGEL: Depending upon the size of the
23 firm and whether or not it's a collaborative exam
24 with our sales practice group, so I -- my team goes
25 into almost every carrying and clearing firm, every

1 firm that holds customer assets on an annual basis,
2 with rare exceptions.

3 My general policy is to do an annual
4 examination. If the firm is subject to the
5 alternative net capital rule, which is the rule that
6 allows them to use internal models to compute
7 capital, I have a separate team of examiners with
8 expertise in that area. Those teams, between the
9 FINOP and the ANC examiners, could be probably 12 to
10 13 people and then there could be another half dozen
11 people from the sales practice side.

12 We probably spend about 4,000 hours on the
13 -- between FINOP and the alternative net capital
14 side at one of the large firms. And then we have
15 smaller carrying and clearing firms where we can do
16 an exam in 300 hours, the FINOP portion of the exam.

17 MR. BARNETT: Thank you. Sure.

18 MR. WASSERMAN: Anne, as I recall, in
19 addition to your regulatory audits, you also have a
20 group that does risk reviews?

21 MS. BAGAN: We do. We have a risk
22 management group that is within our clearing house
23 that goes out and does meet with our firms on a
24 scheduled basis, and they talk about credit issues,
25 stress testing, liquidity issues, sovereign -- you

1 know, sovereign debt problems or whatever, and then
2 they -- you know, there's a report that comes out
3 that -- issued internally on that.

4 MR. BARNETT: Thanks. Kevin, did you have
5 something? Oh, okay. Dan, how about -- yeah, NFA's
6 approach?

7 MR. DRISCOLL: So really, with regard to
8 the annual examinations, we have all of the same
9 areas of coverage as the CME does. Our FC -- now,
10 we also do exams of RFEDs and CPOs and CTAs and a
11 lot more IBs, but on the -- on the FCM side, our --
12 the firms we're responsible for tend to be smaller
13 because they tend not to be -- well, they're not
14 members of CMEs, so they tend to be smaller.

15 So we might have slightly smaller audit
16 team size and the audits might take us -- might not
17 take as long. And with some of those firms we
18 probably spend a lot more time on sales practice
19 than we have to on capital. But in terms of the
20 programs and how we approach it, we try to -- we're
21 very consistent with how the CME handles it.

22 MR. BARNETT: Thank you. The -- and
23 Kevin, I may need you to help here -- what do we
24 look at when we examine an SRO? And then I want --
25 I will ask you what you guys look at when you do --

1 when you look at an SRO.

2 Kevin, what do you look at?

3 MR. PICCOLI: Sure. From the CFTC
4 perspective, we have a group that's focused on
5 examining the SROs, the CMEs, the NFA and right now
6 I think we're developing a little bit more into what
7 we're doing. But I think traditionally it's been
8 focused on reviewing the work performed by the -- by
9 the SROs actually going in -- into the fields,
10 selecting a firm, and re-performing the audit work.

11 I think that has historically been our
12 approach. I think we're morphing that now into
13 getting more into the governance and the -- how the
14 process is done, not necessarily going in and
15 re-performing as much, because I'm not sure there's
16 as much value in just re-performing the audit work,
17 rather look at the primary objectives and are those
18 objectives being made, starting at the top of the
19 house and the risk committee and the board and what
20 are they looking at and how are issues resolved?
21 Are they being communicated effectively and
22 appropriately, independence, all of that good stuff
23 that you would expect would be happening at that
24 level?

25 And then taking that down to how are

1 issues raised up to that level? What's -- you know,
2 if there's a business conduct committee, what
3 happens at that committee? How do things get
4 raised? When issues are identified to the firm, how
5 are they -- how are they resolved? Are they -- you
6 know, are they appropriately reviewed by the
7 supervisor in the field and waived and said, yeah I
8 get it and that's okay? Or are they raised up the
9 line? Are the right people involved in the
10 decision-making?

11 So taking, I think, a slightly different
12 approach, and we will look at work papers because we
13 still have to say did the SRO -- you know, was the
14 exam properly supervised? Were the people properly
15 trained? Were they properly qualified? Did they
16 follow generally accepted ordinary standards? Were
17 conclusions and work papers properly documenting
18 what they found?

19 Did they -- did they draw the appropriate
20 conclusion? Were issues identified at the report
21 level? And things like that. But I think that's
22 sort of a high-level of where we -- where we are,
23 where I think we're going, and I think we will
24 continue to evolve on that process. I think we need
25 to look a little bit more at sort of the environment

1 and not necessarily just re-performing the work,
2 which is where traditionally I think we have been,
3 which was effective, but now it's time to just think
4 a little bit differently.

5 MR. BARNETT: So Tom and Grace, I don't
6 know how your -- how different your SRO system is
7 from ours, and what you examine versus whether you
8 have something like we have. How does your SRO
9 system work?

10 MR. MCGOWAN: Maybe I'll give a little
11 overview and then address some of the examination
12 issues at the end. And I'm less familiar with the
13 SRO process on the future side, so maybe things are
14 -- I think there's more similarities than
15 differences.

16 I'll just kind of go through the basics.
17 Every broker-dealer registered with the Commission,
18 before it can do business as a broker-dealer, needs
19 to be a member of at least one SRO. If you're a
20 member of more than one SRO, for example, if you
21 work on one exchange or another, and more than one
22 exchange, you can be members of two SROs. One is
23 going to be designated as the -- designated
24 examining authority for the broker-dealer.

25 That SRO will have primary responsibility

1 for enforcing the financial responsibility rules
2 over that firm. So that responsibility -- the
3 intent of the responsibility is to be allocated in
4 an efficient way, clear and efficient way among the
5 different SROs.

6 Also, if a broker-dealer is going to do
7 business with the public, it has to be a member of
8 FINRA. So FINRA is DEA for a great number of firms,
9 but sometimes firms are members of FINRA and DEA to
10 another SRO depending upon where the majority of
11 their business is.

12 The SROs, some, I think, took the CFTC's
13 approach. SROs on the securities side are the
14 frontline regulator of the broker-dealer. They're
15 responsible for the day-to-day monitoring or
16 monitoring between examinations to the firm. They
17 do the -- they have the primary examination
18 responsibility for the broker-dealer. The
19 Commission can do exams as well, but the SROs ought
20 to do the first-line examinations of the firms.

21 SROs on the security side also have a
22 number of rule writing responsibilities. They've
23 been allocated especially for suitability purposes.
24 There's been a range of rules that have been
25 implemented that deal with customer relationships

1 and business conduct, withdrawals of capital and
2 things like that where the SROs have their own rules
3 that have to be followed by the appropriate dealer
4 as well.

5 And also a lot of the financial reporting
6 is done through systems set up by the SROs. For
7 example, the monthly focus reports that are filed by
8 broker-dealers for the security side are submitted
9 through the SRO and then made available to the other
10 regulators. So that's another responsibility that
11 they do.

12 But just like broker-dealers, SROs also
13 have to register with the Commission and they're
14 subject to Commission oversight. They're subject to
15 examination reporting requirements with the
16 Commission. One of the biggest responsibilities the
17 Commission has for an SRO is review and approval of
18 their rules, so any time that a change is made to an
19 SRO rule, it has to be filed with the Commission
20 notice, if it's significant, would have to be
21 noticed for comment and ultimately approved by the
22 Commission itself. So there's a Commission rule in
23 approving most of the substantive and even
24 operational rules at their SROs as well.

25 Similar to the CFTC, the SEC does do

1 examinations, so that's rose themselves. I think we
2 cover a lot of similar topics that you described
3 Kevin, about how they follow their internal
4 procedures and whether they're the ones that have
5 been drafted and reviewed and approved by the
6 Commission or actually been implemented.

7 There's also a review of how the SROs do
8 their financial responsibility examinations that I
9 have a little more familiar with -- familiarity
10 with. So our examiners will go in, then it will be
11 a team from half a dozen or more, depending upon the
12 availability of staff and the breadth of the
13 examination, to review examinations that have been
14 done by the SRO, look at the work papers, look at
15 the broker-dealer materials to see if the SRO's
16 following its own procedures there again and what
17 they look at, if they've done an appropriate job of
18 assessing what areas need examination, that they've
19 been -- issues have been escalated appropriately,
20 and also to see whether they've interpreted the SEC
21 rules correctly so that sometimes issues come up
22 where maybe the rule is not well understood as it
23 should be. So this is the opportunity to correct
24 those -- correct those as well.

25 The other thing I'd say that's kind of a

1 more macro level is that on the escrow side of the
2 securities markets, a few years ago there's a
3 separation between generally for -- between a number
4 of the SROs and the market they are with. Most
5 notably, the New York Stock Exchange and the NASD
6 split off their SRO function to other -- to FINRA,
7 ultimately the New York Stock Exchange regulation
8 responsibilities with FINRA as well.

9 So that's -- you know, that's a little bit
10 different on the securities markets and things.

11 MR. BARNETT: Thank you. Kevin?

12 MR. PICCOLI: Just following up on that,
13 Tom. We know in many ways the CFTC and the SEC, I
14 assume the same part of our function is to provide
15 an oversight. And when I first got to the
16 Commission I was thinking about it and saying well,
17 the accounting firms where -- I'm pretty familiar
18 with their approach. You know, they have the peer
19 reviews. They have the PCAOB review of their firm.

20 Do you view the SEC in a similar way or
21 where the peer review of an accounting firm, it's
22 looking at how well the auditors didn't audit?

23 MR. MCGOWAN: That's a good question. I
24 don't -- I wouldn't say necessarily, but I'll be --
25 I'm an attorney versus an accountant, so familiarity

1 with the exact procedures, you'll forgive me for
2 that, for the exact procedures of a peer review.

3 I think the intent is not too indifferent
4 -- too different to say that what could be done
5 better in the process of their oversight, because we
6 do examinations as well, the broker-dealers. So I
7 think there's some ability to learn from that and
8 form our reviews of the CFTC.

9 But it goes -- like I said, it does go to
10 are the examinations as effective? And so I
11 think -- which is the real heart of the peer review
12 and not just that they're following the procedures
13 and interpreting the rule, but are they effective
14 for what they're designed? That's a harder thing to
15 look at, but it's -- I think it is one of the goals.

16 MR. BARNETT: Thank you. Hey, Dan, how
17 will -- and Anne, I guess -- how will -- and do we
18 know at this point how the system will apply to swap
19 dealers and NSPs? They will be members, but they
20 might also be joint -- they could be an FCM that
21 ends up registered as a swap dealer. How do you
22 think it's going to work?

23 MR. DRISCOLL: Right. Dan Driscoll, NFA.
24 So we don't know at this point. We know most of the
25 firms that are going to come in with at least one

1 swap dealer, but we don't know which of their
2 entities they're going to register. But I think
3 it's probably safe to say that there will be at
4 least some firms that are both registered FCMS,
5 members of the CME and registered swap dealers,
6 members of NFA there. And we haven't really
7 discussed this yet, but given our history, I think
8 the inclination would be that CME and NFA would get
9 together and figure out a way to do those
10 examinations where we both fulfill our mandates to
11 the Commission and to the public and not duplicate
12 efforts, and so that, for instance, swap dealers
13 have both internal and external business conduct
14 rules.

15 My guess is that NFA would do examinations
16 of those. The CME's probably not going to have
17 rules on their books that require these firms to
18 comply with those. The CME's already doing
19 basically the capital exam and looking at seg funds.
20 So either going in at the same time or at different
21 times, I think the best bet is that we'll work out a
22 plan where we cover the waterfront and don't
23 duplicate.

24 MS. BAGAN: Anne Bagan. I totally agree
25 with you. We will do reviews if those entities are

1 clearing members or members of CME, but Dan's right,
2 we're going to have to do coordination between our
3 two firms.

4 MR. PICCOLI: Anne, would you view that as
5 a joint audit? I know there's pros and cons of
6 that, the biggest con being trying to coordinate it.

7 MS. BAGAN: If we go in together?

8 MR. PICCOLI: Yeah, going in together.

9 MS. BAGAN: But I think Dan is right on
10 how we would split up responsibilities as well.

11 MR. DRISCOLL: And I know from -- from the
12 feedback we've got -- have gotten from members over
13 the years, that they tend to -- most of them prefer
14 joint audits, as long as we don't completely
15 overwhelm them for a long period of time. They
16 prefer that to two separate exams.

17 So we may very well do quite a few joint
18 audits. And we -- and we do that with -- over the
19 years, we've done that with FINRA as well.

20 MR. BARNETT: So now I want to jump to a
21 question that goes back to the reason I laid out
22 this history thing before. Because of the SROs
23 putting their regulatory function under the
24 oversight of the ROC, over the Regulatory Oversight
25 Committee, and I just in thinking in terms of the

1 incentives that may affect the quality of
2 supervision in the examination and the regulatory
3 function generally.

4 So is there -- from the, I guess,
5 non-SROs, is there -- how is the ROC system doing?
6 Does it work the way it's supposed to? Is there a
7 need to make any adjustments? Is there reaction to
8 that at all?

9 MR. GILMORE: Carl Gilmore, Penson. Well,
10 first let me say that we have -- as a regulatee, if
11 you will, I look around and I think that I have been
12 through an audit over the years by each and every
13 one of you at some point.

14 MR. BARNETT: Maybe tomorrow.

15 MR. GILMORE: Right, maybe tomorrow, after
16 that. But with respect to Penson, our -- certainly
17 on our futures side, our designated examining
18 authority has always been CME. And as you know,
19 from time to time over the years, there has been
20 some debate since they went public whether or not
21 they ought to have regulatory authority over their
22 members. And I will say that it has been my
23 experience that I think the staff has done a great
24 job of managing that potential conflict.

25 And so ultimately what I really think that

1 we should be thinking about and what we should be
2 talking about is with respect to the SRO system.
3 And by the way, I didn't know it went back to 1859.
4 And so if you look back over that 130 years, other
5 than some recent events, that system has worked very
6 well.

7 So I'm not of the view that the SRO system
8 itself is broken, but it is the 21st Century and we
9 ought to, just like we do with other areas of our
10 business, particularly in our risk management, it's
11 always looking at ways to improve it. It's always
12 looking at ways to do things better and it's
13 changing as the environment and the conditions
14 change.

15 So having said that, it's always been my
16 view that I think that the ROC system has worked
17 well. But I think there is some utility to the
18 industry and to customer protection to continue to
19 discuss and continue to monitor that and continue to
20 see how it's working.

21 MR. NICHOLAS: Yeah, I would agree with
22 Carl. I don't think the SRO system is broken or
23 inherently flawed. I think there's some things that
24 could be done perhaps to improve it, I suppose. I
25 mean, one is a coordination of exams. A couple of

1 folks talked about this. For joint broker-dealer
2 FCMs, I mean, obviously we're subject to audits by
3 CFTC, SEC, the SROs, DSROs, for entities that are
4 banks or affiliated with banks. We're subject to
5 audits by the Fed, state auditors on the security
6 side on occasion, various exchanges and clearing
7 corps.

8 So it's a full-time job really just to
9 manage all these audits and it does take a lot of
10 time and a lot of resources and internal staff time.
11 So the ability to coordinate these, I think, would
12 be -- would be appreciated on the firm side. I
13 think it probably would -- could be useful to the
14 regulators as well.

15 I mean, having a securities team and a
16 futures team go in and look at the same BD FCM at
17 the same time, there's going to be a lot of
18 information sharing. There's going to be knowledge
19 sharing, cross training, and less situations where
20 the same issue will be looked at by both sets of
21 regulators.

22 I mean, there are situations where one of
23 the teams will come in and take a look at something
24 that doesn't necessarily relate to futures or
25 securities but may relate to overall supervision,

1 you know, how does this firm handle personal
2 trading? How does this firm review outside business
3 activities?

4 And then that might be the securities
5 regulators and then three months later the futures
6 regulators look at the exact same issue. That type
7 of overlap might be avoided. But again, I agree
8 with Carl, I don't think it's a flawed system. I
9 think maybe just a few weeks here and there.

10 MR. BARNETT: Thank you.

11 MR. DeLEON: Hi. Bill DeLeon. I would
12 tend to agree that it's not a flawed system. I do
13 think though, that the frequency and the type of
14 audits needs to be reviewed and updated. From my
15 standpoint, we're very concerned both in terms of
16 the fact that the audits are done 18-, 15-, 12-month
17 intervals, and while for a business or a financial
18 entity that makes sense given the size and scope of
19 what's going on, doing a deep dive into all the
20 processes is certainly a good thing.

21 I think though that if you look at what
22 we're trying -- what we're worried about on the buy
23 side or what I'm worried about as a steward of our
24 client's capital, that's not frequent enough. So if
25 you think about the extreme other end of this, when

1 we open a futures clearing account or a derivatives
2 clearing account, we get audited by the exchange
3 we're doing business with via our clearing agent on
4 a daily basis, right?

5 We get a margin call on a daily basis. We
6 have variation margin we have to post. We have an
7 initial margin we have to post. The haircuts change
8 at the price. This is done in virtual real time and
9 then there are a few exchanges that are not here
10 that actually do intraday margining, and I know
11 that's been a topic. I'm not going to bring that
12 up. So there is a real extreme here.

13 And then if you look at what happened four
14 months ago, while there is an audit process and
15 things in place, what happened relatively quickly in
16 a rather nasty manner. So the question is, how do
17 you prevent that from occurring because the
18 frequency of audits are not sufficient?

19 I can tell you if I don't post margin for
20 one of my clients today, tomorrow I'm getting a
21 nasty phone call from somebody going where's the
22 margin? So given that's the standard for the people
23 we do business with, and John probably knows this as
24 well as anyone here, because he probably is making
25 some of those phone calls or has people working for

1 him who are, I can tell you I don't ever like
2 getting that phone call. And we strive incredibly
3 hard never to get one of those phone calls.

4 So given that's the standard, I would
5 think that we'd want to have similar type of not
6 deep dive business standards, but in terms of making
7 sure what's in the box is there and checking it and
8 ticking and tying things out, so that if a wire goes
9 out from the wrong account, someone knows the next
10 day that money's missing or not accounted for,
11 because that's a red flag.

12 And I can tell you that at our firm we are
13 looking at a huge amount of data for all of our wire
14 movements to and from custody banks, to and from
15 dealers, because we want to know today or tomorrow
16 that there was a problem yesterday or today. We
17 don't want to know in a week or in a month or in a
18 year.

19 And if you think about when you do a
20 financial audit, right, financials release quarterly
21 and they make statements on a regular basis. So as
22 a standard, I think you're supposed to be moving
23 there. So it's not that it's broken. I just think
24 that, as a few people said, we're in a different
25 world than the 1900s and we need to be much more

1 real time. And that will help, given the amount of
2 money that's moving, the amount of volatility in the
3 market and the uncertainty.

4 MR. BARNETT: Thank you. Sandy?

5 MS. McCARTHY: I guess from our
6 perspective, I do agree that the DSRO function is
7 working well. I would like to see potentially the
8 time frame shortened on those, because when it takes
9 us six and a half to seven months to get the audit
10 report, then I am down to a shortened amount of time
11 to potentially implement the procedures we need to
12 improve things.

13 And then the other issue I see is it seems
14 like I get in the middle between the exchanges a
15 lot. And I don't really know what the Joint Audit
16 Committee is supposed to be doing, but if I'm always
17 telling other exchanges, I think you should contact
18 the Joint Audit Committee about this, you know,
19 about these issues --

20 MR. BARNETT: Example. Can you give an
21 example?

22 MS. McCARTHY: Well, ICE constantly is
23 calling me about things that I'm like, I think you
24 should call the CME about things, because I'm like,
25 they -- I have reported things to them. You need to

1 call them. Don't call me. Because I thought the
2 whole concept of the DSRO function was I only have
3 to report to one person.

4 MR. WASSERMAN: Can you give an example of
5 such a thing?

6 MS. McCARTHY: No.

7 MR. BARNETT: Fair enough. Well --

8 MS. McCARTHY: But that is one thing I
9 don't like and I don't understand that.

10 MR. BARNETT: Okay, so why don't we --
11 yes, offline, maybe we could talk through some live
12 --

13 MS. McCARTHY: Yes.

14 MR. BARNETT: -- examples, so we know what
15 you're saying and we understand.

16 MS. McCARTHY: Yes.

17 MR. BARNETT: Okay, fair enough.

18 MS. McCARTHY: Yes, and I --

19 MR. BARNETT: Fair enough. Okay. So go
20 ahead, Carl.

21 MR. GILMORE: Sorry. Carl Gilmore from
22 Penson again. One thing -- I just want to address a
23 couple of comments. One thing I think that has been
24 a benefit over the last few years and I would urge
25 regulators, both self-regulators and government

1 agencies, to continue to refine is a concept of
2 risk-based auditing.

3 I think that concentrating and determining
4 and refining risk-based auditing, it has a number of
5 benefits. First, you get to deploy your resources,
6 which are scarce, on a more efficient way. Second,
7 in our own self-interest as a -- again as a
8 regulatee, we end up dealing with things that matter
9 and not things that don't matter. And so what I
10 would -- would urge you to continue to think about,
11 how you can refine your risk-based auditing
12 programs.

13 And then just the second comment, going
14 back to what Bill said, one of the benefits, I
15 think, of the SRO system is the flexibility to not
16 have to wait a year or 18 months. That might be the
17 schedule. It might be the framework. But again,
18 going back to risk-based auditing, if there's a
19 risk -- and certainly within the last few months, we
20 have seen teams come and audit off of the schedule.

21 I think the SRO model allows great
22 flexibility for coming in on a more -- on a closer
23 basis, on a more uniformed basis. And more times
24 they're given a time period if they think there's a
25 risk, and that really comes down to defining that

1 risk-based model.

2 So I think you're probably right that a
3 year or 18 months is too long if there's no other
4 exchange of information in that period of time. But
5 I think that now in the 21st Century again, we've
6 gotten to the point where we're communicating on a
7 very regular basis with the SROs and with the
8 agencies. And so I would be highly surprised that
9 if something happened because there had been no
10 communication within any registrant for a period of
11 time, you know, months let alone a year.

12 MR. BARNETT: Grace.

13 MS. VOGEL: Yeah, it's Grace Vogel. If I
14 left the impression that we will only go in on a
15 one-year on a one-year cycle, that was the wrong
16 impression, because if we identify a problem or a
17 concern, we will go in immediately at the time that
18 concern is identified.

19 One thing that we have also been doing is
20 using automation more efficiently to conduct our
21 examinations, so we have, I think it's approximately
22 60 firms now who one month -- one month before we
23 start our exam they actually provide us with their
24 stock record, their customer reserve formulation
25 allocation, other records in an electronic format

1 and we have various programs that we run against
2 that data to select our samples for testing and to
3 conduct reviews in the office before we actually go
4 out on an exam.

5 That helps us better identify problems,
6 because we have a sample that's more knowledgeable,
7 and it allows us to refine the work that we do in
8 the field.

9 MR. BARNETT: Thank you. Thank you.

10 MR. PICCOLI: Just want to follow-up on a
11 couple of those comments, because risk-based
12 auditing, I just order -- that's a sexy thing, that
13 we all love that. But are you thinking
14 specifically? Are you thinking more targeted
15 reviews? Are you thinking more control based? Are
16 you thinking let's go in, spend some time with
17 management, try to get a feel for what is the risk
18 in the firm and just focus on that?

19 What's your thoughts on that, Carl?

20 MR. GILMORE: Carl Gilmore, Penson. I
21 think it's all of the above. And it really depends
22 on a number of factors. It depends on the kind of
23 business. It depends on what's happening in the
24 marketplace. It depends on the financial condition.
25 So I hate to just say it depends, but it really

1 does.

2 But those are the broad categories and
3 depending on who you're auditing, when you're
4 auditing, what's happening out there in the world
5 and what's happening with that business, it could be
6 any one of those.

7 MR. BARNETT: I wanted to put a specific
8 question to you all. So we note that swap dealers,
9 MSPs, FCMS are now all required -- will -- you know,
10 as implementation occurs, will now all be required
11 to have CCOs which operate under certain duties and
12 provide certain reports.

13 So here's the question. Is there any
14 reason why similar requirements should not be
15 imposed on the chief regulatory officer of the ROC,
16 the idea being would that strengthen the ROC? So
17 that's the question. We know that the ROC typically
18 has a CRO. Should the chief regulatory officer have
19 comparable duties relating to the ROC, not reporting
20 to the general company?

21 Anne, do you have a thought on that?

22 MS. BAGAN: We actually call ours MROC,
23 Market Regulatory Oversight Committee. And both the
24 people that run our trade practices on compliance
25 area within market regulation, and then also me, for

1 doing financial surveillance, we do have a dotted
2 line reporting line to the independent board members
3 that are on that committee and we meet quarterly and
4 we report out our results, the investigations that
5 have taken place, the audit findings, what kind of
6 penalties have been given out.

7 And in addition, they review our
8 compensation and our performance evaluations. So
9 we've had this for a number of years. I think we
10 had it long before it was actually a requirement and
11 it seems to be working well. There's an open line
12 of communication if there are issues. They are
13 very, very focused on whether we're able to make our
14 regulatory decisions in an independent fashion. So
15 it appears to be working very well for us.

16 MR. BARNETT: Okay, thank you. Any other
17 thoughts? Carl?

18 MR. GILMORE: I'll give you the market
19 participant view. I think it really comes down to
20 what the standard is as a practical matter. So if
21 you want the chief regulatory officer to certify to
22 everything with all of the members that they audit,
23 that's probably not realistic. But if you have a
24 sort of a reasonableness standard, there might be
25 some benefit there in terms of offsetting any

1 potential conflicts. That might be one way to deal
2 with that.

3 But I think it's really going to come down
4 to the standard as to what you will be holding that
5 chief regulatory officer to.

6 MR. BARNETT: Thank you. Other thoughts?
7 No? Okay, general question for you all. What other
8 issues should we be considering with respect to SRO
9 -- the SRO oversight function? Very open ended.

10 MS. BAGAN: I'm sorry, I missed the
11 question. What was it?

12 MR. BARNETT: What other issues should we
13 be -- the Commission be considering with respect to
14 our oversight of the SRO?

15 MS. BAGAN: It's Anne Bagan. Well, to be
16 honest with you, year-end and a quarterly basis, so
17 I'm not sure what more you can be looking at with
18 us. But again, we do have a very open line of
19 communication.

20 One thing I can say is -- and maybe this
21 is a little bit to Sandy's point, but we'd like to
22 get the results of those reviews on a more timely
23 basis so we know what we need to be thinking about
24 or working on.

25 MR. BARNETT: Okay. Other thoughts? Dan?

1 MR. DRISCOLL: Well, obviously NFA and me
2 personally are big advocates of self-regulation.
3 But I also believe that self-regulation really can
4 only work if you have strong and effective
5 government oversight. And so while we too might get
6 frustrated every once in a while with all the visits
7 from Commission staff, but it's something I think we
8 really treasure, the relationship and the frequent
9 exchange of information, and I think it works quite
10 well.

11 So I don't have a specific recommendation
12 for other things that you might do, but I can assure
13 you that if something crossed our minds, you'd be --

14 MR. BARNETT: Start over, yeah.

15 MR. DRISCOLL: -- the first to know.

16 MR. BARNETT: Do you have anything?
17 Kevin, you have anything? Tom? All right, so I
18 think we've run through our questions. Your
19 participation's been very helpful, the input, and we
20 greatly appreciate it.

21 So we're going to call it in right now.
22 Thank you all very much.

23 (Whereupon, at 3:46 p.m., the meeting was
24 adjourned.)

25