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HEARING BEFORE THE
COMMODITY FUTURES TRADING COMMISSION
FEBRUARY 29, 2012, A.M. SESSION

TRANSCRIPT OF ELECTRONICALLY RECORDED HEARING
BEFORE THE
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COMMODITY FUTURES TRADING COMMISSION:

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COMMODITY FUTURES TRADING COMMISSION HEARING

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TOPIC FOR DISCUSSION: LSOC for Futures

BOB WASSERMAN: Thanks everyone for coming. So we have quite a lot to cover today, and so I'm going to get started right now.

Just a couple of housekeeping details for panelists. The red button or the button in the middle turns the mic on. When you're done, please turn it off. If everyone in the room could please turn your cell phones to vibrate.

Finally, we're going to have a break at 10:30 after this panel. We will have another break in the afternoon, in the middle of the third session. Restrooms outside, down that-away (indicating).

And so what I would ask is everyone on the panel to please state your name and affiliation. I will start.

Robert Wasserman, Clearing and Risk in -- at the Commission.

GARY BARNETT: Gary Barnett, Swap Dealer and Intermediary Oversight.

TOM SMITH: Tom Smith, Swap Dealer and

1 Intermediary Oversight.

2 MICHAEL GREENBERGER: Michael Greenberger,
3 University of Maryland, School of Law.

4 RON FILLER: Ron Filler, New York Law School.

5 SCOTT FERRIS: Scott Ferris, BMO Harris Bank.

6 STEVEN WINTER: Steven Winter, State Street.

7 SANJAY KANNAMBADI: Sanjay Kannambadi, BNY
8 Mellon Clearing.

9 JEFF HAINLINE: Jeff Hainline, Advanced
10 Trading and National Grain and Feed Association.

11 PETER BROWN: Peter Brown, Moore Capital
12 Management.

13 MARK SZYCHER: Mark Szycher, General Motors
14 Pension representing CIEBA.

15 CHRISTINE AYOTTE-BRENNAN: Christine Ayotte-
16 Brennan from Fidelity.

17 WILLIAM THUM: Bill Thum, principle at
18 Vanguard representing the ICI today.

19 ANDREW KARSH: Andrew Karsh with CalPERS.

20 JOHN TORELL: John Torell, Tudor Investment
21 Corp.

22 JOANNE MEDERO: Joanne Medero, BlackRock.

23 ROSS PARKE: Ross Parke, Barclays Capital.

24 SETH GROSSHANDLER: Seth Grosshandler, Cleary,
25 Gottlieb, representing FIA.

1 GARY DeWAAL: Gary DeWaal, New Edge.

2 MICHAEL SCHAEFER: Michael Schaefer, Public
3 Director for FIA.

4 LAURA KLIMPEL: Laura Klimpel, New York
5 Portfolio Clearing.

6 ERIC DELAIN: Eric Delain, Minneapolis Grain
7 Exchange.

8 JOSEPH OTT: Joe Ott, Kansas City Board of
9 Trade.

10 TIMOTHY DOAR: Tim Doar, CME Clearing.

11 LAURA ASTRADA: Laura Astrada, Division of
12 Clearing and Risk.

13 BOB WASSERMAN: Thank you.

14 Finally, I should address somewhat of a
15 perhaps elephant in the room. Staff -- CFTC staff cannot
16 engage in a discussion concerning matters involving MF
17 Global in light of our Division of Enforcement's ongoing
18 investigations, and we would ask the participants to
19 respect our request that specifics of that not be injected
20 into the discussion here today.

21 With that, I think let's get started.

22 And so the first -- the topic of that panel
23 is: LSOC for Futures.

24 As everyone knows, back in January the
25 Commission adopted final rules for projection of cleared

1 swaps customer collateral which implemented something that
2 has been referred to as Legal Segregation with Operational
3 Commingling or "LSOC" for short.

4 And in light of recent events, there's been
5 some discussion as to whether that should be extended to
6 the futures space, as well, and the -- essentially the --
7 the exchange traded futures customer account.

8 And so what I'd like to do is get folks' views
9 on the advisability and the practicality of doing just
10 that.

11 TIMOTHY DOAR: Tim Doar, CME.

12 No, you shouldn't.

13 So let's just review the terrain if we could.
14 I'd just like to cite the various documents we've
15 submitted to the CFTC over time concerning matters related
16 to customer protection. We have had, for purposes of full
17 disclosure, some degree of difficulty with LSOC as a
18 methodology for swaps.

19 Most fundamentally we are concerned about the
20 legal basis upon which the CFTC seeks to implement LSOC
21 for swaps. We're not quite sure what the reasoning is for
22 why it will work in bankruptcy.

23 Now, going beyond that, though, there are a
24 variety of risks that LSOC does leave open with respect to
25 followup customer risk.

1 Foreign clients going through a foreign
2 broker, which in turns clears as an omnibus account on the
3 books of USFC and will be treated as a single client, so
4 those foreign customers going through a foreign broker
5 face fellow customer risk, one to the other, it seems.

6 There are issues around variation margin which
7 I think the industry has talked about and has come to
8 understand that based on the way that DCO's process
9 variation margin, depending on the timing of a declaration
10 of default, and depending on the timing of when an FCM
11 goes into bankruptcy, there may be fellow customer risks
12 that are borne by clients in the OTC account class,
13 depending on how things are administered through the
14 default event, the timing of when the DCO knows which
15 clients are actually in a state of default relative to
16 when the FCM declares bankruptcy.

17 There's also a fairly robust set of
18 requirements for the DCO. No matter how good the DCO's
19 risk management policies and procedures and capabilities
20 are, the DCO must use, in effect, the defaulting FCM's
21 books and records to administer the default, the portfolio
22 of rights and obligations report, which is very
23 ambiguously defined in the regulations, by the way.

24 Now, given all of that, we are talking about
25 LSOC for swaps. Now, let's just examine the current

1 structure of the swaps market relative to the -- to the
2 current structure of the futures market.

3 Notwithstanding that the potential future
4 direction that the OTC swaps markets may take, today I
5 think we can probably say that there's a fairly discrete
6 timeframe in which swaps are transacted and submitted to
7 DCO's for clearing, so that the idea that the portfolio of
8 rights and obligations report, that the FCM submits to the
9 DCO, may be accurate in depicting the relative position
10 exposures of individual clients.

11 Futures though is a far different market.
12 We -- at least on LSOC we have the ability to set accounts
13 up with an eye towards how they can be optimized to meet
14 LSOC requirements from an operation perspective.

15 Futures account structures have grown to --
16 grown from a far different place over time. We should
17 note immediately that omnibus accounts will receive far
18 different treatment under an LSOC methodology than they
19 will under the existing futures methodology, if an omnibus
20 account loses its meaning, essentially, is my take, in an
21 LSOC environment, as opposed to the meaning it has long
22 taken on in a futures context.

23 But new accounts come and go. Frequently the
24 timing with which the FCM will have to disclose
25 information to the DCO relative to those accounts is again

1 a question. Trading occurs on 24-by-6 basis.

2 Once trades are executed, post-execution
3 give-ups occur with some degree of frequency. The idea
4 that the portfolio of rights and obligations report is
5 going to be an accurate depiction of an individual firm's
6 clients, as of an end-of-day processing is dubious, I
7 think.

8 The idea that FCM's can turn on a pin and
9 submit the portfolio of rights and obligations report
10 frequently to a DCO or in the course of any given
11 processing day may come to work at some future point, but
12 I don't think it will now.

13 So, in sum, what I would suggest is -- is that
14 the current state of the futures markets is far different
15 than the current state of the market for cleared OTC
16 swaps. I would urge that what the Commission do is
17 reserve its judgment on the applicability of LSOC for
18 futures until we have a chance to actually get our minds
19 around what the implications are, particularly with
20 respect to how defaults will be administered.

21 It is not clear at us to all what the
22 obligations of a DCO are realistically to determine which
23 client defaulted if the settlement bank tells us that the
24 firm is no good in its client origin, howsoever defined.

25 So, with all that having been said, I -- I

1 hope I've just indicated there are a number of different
2 concerns that we have. I'm anxious to hear what kinds of
3 concerns the rest of the people have here today. And I
4 would just urge that we do not rush to judgment that
5 having a single customer protection standard in place for
6 these diverse markets is wise.

7 BOB WASSERMAN: Contrasting views?

8 WILLIAM THUM: It's Bill Thum at Vanguard.

9 It's my impression, just to counter that, that
10 historically there's been little appreciation of the risks
11 to margin presented by the futures model.

12 As outside counsel, I often spoke to clients
13 about fellow customer risk, and they were astonished that
14 they had exposure to other clients of the FCM's. While
15 they could try to mitigate FCM fraud and investment risks
16 through due diligence, there is no way to assess and
17 monitor fellow customer risk by each client.

18 Prescient is the only way to describe the work
19 of Bob Wasserman and his team in identifying the need to
20 address fellow customer risks for cleared swaps.

21 Many of the buy side in particular are
22 grateful for his prescience and persistence in addressing
23 a need few appreciated at the time, to make such a
24 proposal when the futures model had functioned flawlessly
25 in the Lehman crisis and to challenge existing well

1 established market infrastructure took considerable
2 courage.

3 I remember at the end of my first meeting with
4 Bob and others, in October of 2010, I felt a bit like
5 Oliver Twist at the breakfast table when I asked whether
6 once established for cleared swaps, could the benefits of
7 LSOC be extended to futures. Bob's response at the time
8 was, "We'll see."

9 True to his word and with market events now
10 joining momentum for change I'm pleased that just three
11 weeks from LSOC -- the publication of the LSOC rule --
12 final rule, we're here to discuss the merit of enhancing
13 protection for futures.

14 Why is this so could compelling? One word:
15 Portability. The many enhancements of LSOC are designed
16 to facilitate the consistent, expedited, and efficient
17 porting of trades from a defaulting FCM.

18 Firstly, margin is segregated from both the
19 FCM and from the defaulting client. No longer must one
20 customer's shortfalls be met by another customer's assets.

21 Secondly, FCM record keeping must be shared
22 with DCO's daily both providing the DCO with full
23 transparency as to FCM clients, positions, and margin, and
24 mandating the discipline of the FCM to maintain robust,
25 accurate, and current records.

1 Thirdly, customer margin levels are -- more
2 truly reflect actual risk presented by their credit and
3 trades with FCM's and DCO's no longer relying on
4 mutualized risk assessments.

5 What arguments could counter such a change?
6 That loss mutualization related to fellow customer risk
7 has never occurred in the futures market? While MF Global
8 appears not to have involved fellow customer risk, it is a
9 counter -- it is a counter-proof argument for enhancing
10 FCM record keeping and transparency.

11 Consider how grateful MF Global's customers
12 would have been if MF Global was required to provide the
13 clearinghouse with daily records identifying customers'
14 positions and margin holders, as is now required under
15 LSOC's Rule 2211-(c), and if the clearinghouse would take
16 appropriate steps to confirm such information is accurate,
17 and complete, and provide it on a timely basis, in
18 accordance with LSOC Rule 2211(e).

19 For these reasons and others we support the
20 extension of the LSOC model to the futures market.

21 GARY DeWAAL: Recent events clearly have been
22 a bad reflection on this industry and a call for
23 something.

24 However, let's not pretend that there has
25 never been a situation of fellow customer risk causing a

1 major issue at FCM.

2 In 1985 Volume Investors Corporation failed
3 because of fellow customer risk because of a situation
4 where three traders, acting in concert, brought down a
5 firm, and there was a hole in the segregated pool, and
6 effectively but for a situation where the principal of the
7 firm ended up contributing to make up the shortfall, in
8 fact, customers would have failed to receive 100 percent
9 of their owed money because of fellow customer risk.

10 In response, this Commission and the NFA
11 studied many alternatives, some of which echo loudly
12 today. They discussed imposing an insurance requirement.
13 They discussed the possibility of requiring individual
14 accounts at the clearinghouse. And all these ideas were
15 ultimately rejected, because, in fact, the thought was
16 that those ideas would, in fact, increase risk, certainly,
17 the risk of moral hazard, the facts that people would not
18 be responsible for choosing their own broker wisely, the
19 fact that they -- individual brokers would not be
20 encouraged to put up the most capital possible.

21 For many reasons, again which echo loudly and
22 clearly today, these ideas, which seemingly sound good in
23 theory, in fact, will not work because at the end they
24 will discourage the intermediators from intermediating.

25 Think of the model of clearing today. Let me

1 make it more simple. I go to my insurance company, and I
2 say, "Please, I'd like to insure my car." My insurance
3 company says, "Okay."

4 "How much can I pay you for granting
5 insurance?"

6 Well, that's the clearing model. Okay? Today
7 FCM's effectively provide the insurance to the
8 clearinghouses on a mutualized basis. We've signed up for
9 that, and, in fact, for the privilege of insuring the
10 clearinghouses, we effectively pay for that.

11 It's a strange model. What we're proposing is
12 to make that model, which is questionable to begin with,
13 even more difficult. We're trying to extend the
14 mutualization to not only insure each clearing -- not only
15 to insure the clearinghouses but all our fellow members.

16 That's a very, very difficult risk for us to
17 calculate. That's a very, very difficult contingency risk
18 to guard against. Okay? We're taking a system that
19 probably is somewhat broke to begin with, and we should
20 figure out how to fix it, and making it worse.

21 There is answers to some of the questions. I
22 think later on in this event there'll be discussion of
23 some of the FIA-proposed responses to enhance internal
24 controls at FCM's.

25 At the end of the 1985 debates, which lasted

1 through 1987, in fact, that was the bottom line. The
2 bottom line was: You had to encourage the FCM's to
3 enhance their internal controls, and measures which
4 distracted their expenditure of money from that event
5 were, in fact, destructive to the industry.

6 And so as a result the emphasis was to
7 increase internal controls. Unfortunately, over time,
8 maybe firms haven't been as diligent in that area that
9 they could have. We've got to get back to that. We've
10 got to get back to looking at the model, to making
11 clearing work. We've got to make sure that the
12 mutualization process, in fact, works well.

13 There are things that could be done. The
14 suggestion that you can't guard against fellow customer
15 risk -- we have customers often ask us: What's the
16 largest -- tell us about your top customers. Tell us the
17 amount of the percentage they exist in your segregated
18 pool. We want to make sure that this is a diversification
19 in your client base so that no one client can bring you
20 down.

21 There's got to be better questions asked.
22 Everybody's got to participate here.

23 But my concern is that anything that increases
24 the contingency risk on intermediaries risks making those
25 intermediaries disappear. Without intermediaries, this

1 business of clearing won't work.

2 BOB WASSERMAN: I would just request if folks
3 can -- in order to maximize the discussion, if folks could
4 keep their remarks a little bit more brief -- that's not
5 directed at any particular --

6 UNIDENTIFIED SPEAKER: Just after the longest
7 speech.

8 KEN ACKERMAN: I'm Ken Ackerman. I share with
9 Gary DeWaal of the experience of having been here at the
10 CFTC and been involved in the investigation of the Volume
11 Investors case in 1985, which, as he mentioned, did raise
12 some of these same issues.

13 I -- I was frankly somewhat surprised when I
14 became involved in this issue, very recently, to have
15 pulled out a copy of that report and seen so many echoes
16 of that case here.

17 The one point on which I will dis -- would
18 disagree somewhat is that in the past several years I've
19 been mostly involved in the insurance world, and I believe
20 that there are some responses to the practical issues that
21 were raised to customer account insurance in the debate in
22 the 1980's, which may have solutions in the insurance
23 world, which I think would be appropriate for discussion
24 in the afternoon panel.

25 For the discussion in this morning's panel --

1 I guess reading through the background on LSOC there were
2 two questions that popped up in my mind, and I'll just
3 present them as questions to the panel, because I don't
4 know the answer.

5 When you look at a rule like, this you look
6 at, one, what are the costs, and, two, what are the
7 benefits?

8 I did not see a clear answer to either of
9 those in the -- in the record that I looked at.

10 In terms of what are the benefits, the
11 question to me was: How do we measure this risk of -- of
12 default, of breach of segregated funds, of -- of risk of
13 other party -- of -- of another customer defaulting,
14 placing non-defaulting customers at risk?

15 If we are looking at the Volume Investors case
16 and MF Global and a big void in between, that's a very
17 small risk. It's a risk that can be measured, contained.

18 If the risk is more than that, if there are
19 other cases, if there are other -- if there have been
20 other close calls along the way that did not make it into
21 the headlines, then I think that risk has to be somehow
22 calculated and measured so it can be part of the equation.

23 In terms of what is the cost, again I've seen
24 a lot of general statements in the record about the -- the
25 technical costs, the reporting burdens, the -- the need to

1 set up complex systems, but I haven't seen that put down
2 in -- in numbers that can be assessed.

3 So I guess I would -- for my part I would
4 simply throw out as a question to the group: Do we have a
5 better calculation or a more specific calculation of the
6 costs and benefits?

7 RON FILLER: Thank you.

8 So when I look at this issue -- I probably am
9 going to contradict what I thought I -- my original
10 thoughts were several months ago, when the LSOC rule --
11 and in looking at it, when I saw the LSOC rule come out
12 for cleared swaps my first reaction was: Why didn't they
13 do the same for futures? Why is it not comparable -- if
14 the theory of LSOC is to provide enhanced customer
15 protection, why shouldn't that same protection apply to
16 futures?

17 Because the CFTC, in its history, is a futures
18 regulatory agency, why did they not look to the futures
19 world and provide the same protection?

20 But then you go further into the LSOC rule,
21 and I think one of the big issues with LSOC -- and Tim
22 mentioned it a little bit, but he didn't go into more
23 detail -- is: We don't really know, right now, what the
24 additional costs will be for LSOC and the clear-swap
25 world.

1 We -- I haven't seen any conclusive statements
2 of how much increase in the initial margin amounts are
3 going to be required by the DCO's for the LSOC rule for
4 cleared swaps. I haven't seen yet -- and maybe it's been
5 published -- how much more guaranteed fund contributions
6 are going to be required for the LSOC model for cleared
7 swaps. And when you try to compare the cleared-swap model
8 to the futures model, you now have to look to the number
9 of accounts.

10 At MF Global there was some 35,000 futures
11 accounts, and if you look at all the major FCM's, we're
12 talking hundreds of thousands of these individual accounts
13 that would have to be accounted for and provided records
14 for. And how much more is the initial margin going to be
15 for futures? How much more will the guarantee fund
16 contributions will be to go to the LSOC model for futures?
17 And I -- I would just ask to see the CFTC to try to do
18 that economic study, do that economic analysis.

19 You're balancing the need to protect customers
20 against fellow customer risk versus the additional cost,
21 additional capital, additional outlay of funds that both
22 customers and FCM's must pay, and -- and we haven't seen
23 those numbers.

24 In the LSOC model you saw DCO's throwing out
25 something like additional 50, 60, 70 percent increased

1 margin. You saw guarantee fund contributions going -- I
2 don't know what it is now at the MRG. It's probably
3 around 3 billion dollars the last I looked. I'm hearing
4 25 or 50 billion dollars or more maybe under the LSOC
5 model for cleared swaps.

6 I think we really need to sit back and balance
7 the need for this fellow customer risk versus the actual
8 costs that LSOC for futures or even LSOC for clear swaps
9 might bring.

10 Thank you.

11 JOSEPH OTT: In the event of a customer
12 clearing member default, DCO's need to be able to act
13 immediately in order to address the steps needed to be
14 taken to mitigate the risk associated with the default.

15 Under the current regulations, once a customer
16 account becomes under margin, that customer has five
17 business days to meet that call. The five business days
18 consist of:

19 On Day 1 the account become under margin.

20 Day 2, the account is called for margin.

21 Day 3 it's the first day the call's
22 outstanding.

23 Day 4, the second day the call's outstanding.

24 Day 5, the third day the call's outstanding.

25 As a DCO, we cannot wait five business days to

1 see whether or not that call is met or not. DCO's need to
2 be able to act immediately, again, to address the risks
3 associated with -- with the default, and they need this
4 immediately in order to preserve not only the capital of
5 the DCO, but as well as the capital of the other clearing
6 members.

7 Under our current default rules, if there's a
8 client member default, currently we're allowed to apply
9 the defaulting clearing member's margin deposits, as well
10 as guarantee deposits that are on -- on deposit.

11 Under the LSOC rules this will greatly
12 restrict the amount of our default package. The LSOC
13 model only allows for the defaulting customer's collateral
14 to be used in the -- in the default package.

15 As a result of this restriction in our default
16 package, DCO's will have to substantially increase their
17 security deposits in order to have some -- have some
18 available funds to tackle a default, and we think this may
19 have an adverse effect on members remaining as clearing
20 members if we have to raise our security deposits
21 drastically.

22 ANDREW KARSH: So obviously it's interesting
23 to hear everybody's view in terms of the ways that the
24 margin requirements potentially could go up and the cost
25 to DCO's.

1 So as a customer of the futures clearing
2 market, and the DCO's, and the brokers, and the banks, you
3 know, one of the things that we look at is -- and to the
4 points raised earlier is: What is a fellow customer risk?
5 What are we paying for that? You know, how are we being
6 compensated for the risk that we, as an institution,
7 that's unlevered, are taking on behalf of other clients in
8 the market?

9 And so, you know, I think that the thing that
10 we are contemplating and concerned about is, to be frank,
11 some of the questions that are being raised about margin
12 increases and how that's going to affect businesses -- you
13 know, I think that the reason we're all sitting here is
14 because some of the events of the past few years have
15 illustrated that increased leverage and increased margin
16 capabilities and relaxed efforts from some of the SRO's
17 and regulatory bodies has sort of allowed things to happen
18 that none of us thought would have happened.

19 And so the thing that, obviously from CalPERS'
20 perspective, that we think about and want to understand,
21 and sort of -- you know, obviously LSOC seems to be an
22 improvement on the model -- is, you know: How do we get
23 more comfortable with putting margin out to DCO's and
24 FCM's and having -- although obviously you can ask
25 questions, there's still a lack of transparency about the

1 risks that we're taking, and, you know it's something that
2 when we think about other institutions in the market, and
3 the fact that the futures market, in particular, compared
4 to cash securities market, like bonds or stocks, that we
5 all think about, you know is much more inherently
6 leverable because of low margin requirements.

7 You know, you go buy a billion dollars of
8 Treasury Bonds, you're going to pay a billion dollars.
9 Right? Unless you've got a prime broker who's lending you
10 the money.

11 And so our view is that we're really we think
12 that we need more security in the market, and we, and many
13 of the people in our position, are willing to pay extra
14 margin if we have that security. And certainly in light
15 of the past six months in the market, that it's something
16 that, you know, hopefully the people in this room
17 understand that, you know, our concern is -- you know,
18 again, it's been said all too often, you know, return of
19 capital, not return on capital.

20 And so certainly that's something that, you
21 know, we, as an institution, are willing to take into
22 consideration as this model evolves, and certainly, you
23 know, whether it's the LSOC structure and how that
24 interplays with the Bankruptcy Code -- some of the issues
25 raised before -- you know, if it requires increased

1 margin, I think that's something that we're willing to
2 pay, as long as it reduces our risk in the longterm.

3 CHRISTINE AYOTTE-BRENNAN: Listening to the
4 concerns about LSOC for futures, what strikes me is that,
5 barring one or two comments, is that what I'm hearing is
6 not a concern of applying LSOC to futures. I'm hearing a
7 concern about LSOC.

8 And I think that where we are is LSOC has been
9 adopted. I know we're going to talk about some
10 alternatives today, as well, but the fact of the matter
11 is: We have to get ready for LSOC, and the DCO's and the
12 FCM's have to get ready for LSOC.

13 So I think we need to focus on making sure
14 we're all comfortable with that, and then once we have it
15 right, I don't see any reason why it can't be used in the
16 futures model, as well.

17 If it provides the increased stability to the
18 market, and it -- we're willing to pay for it, I don't see
19 an operational reason, you know, stick -- holding that up.
20 We all have to change our operations in connection with
21 LSOC, as well, and I think that as an industry we have to
22 adopt that.

23 JOSEPH OTT: I'd like to followup on some of
24 the comments.

25 I think one of the things that we have to

1 remember is that the futures space is occupied by a very
2 different class of inhabitants than exists in the OTC
3 space.

4 The liquidity providers tend to be
5 the e-locals, the market makers in the pits, and so forth
6 and so on, and their ability to transact is very much
7 impacted by the margin requirements on the positions that
8 they undertake.

9 So to the extent that enhanced, increased
10 margins are going to be required -- and I think they will
11 be -- the ability of those participants to continue in
12 that market space and to continue to provide liquidity is
13 going to be adversely impacted as well.

14 So the small pool operators, the -- the
15 training advisers, the options market makers in the
16 treasury pits, the S and P market makers, all of the
17 markets that -- that we're interested in as customers,
18 will be impacted in terms of liquidity, and I don't think
19 we should lose sight of that, as well.

20 I don't think we should sacrifice -- I don't
21 think we should rush to sacrifice the good for the
22 perfect. I think we need to analyze all of the cost
23 benefits associated with the proposals that are before us
24 and -- and make a reasoned decision at the end of that
25 kind of analysis.

1 JOHN TORELL: Yeah, I would just -- speaking
2 as a -- as a fiduciary to client assets, our reason for
3 being here today is -- is protection of assets. And we
4 believe that LSOC, while it's not perfect for OTC -- and
5 we're going to talk about future or better models later
6 this morning -- we think it actually is better than what
7 you have in the current futures market.

8 And so we support trying to implement that and
9 then hopefully that will migrate to something even better
10 in the future.

11 I think it's a very dangerous thing to say
12 that we sacrifice good for the perfect, because good costs
13 a whole bunch of clients and a whole bunch of employees of
14 MF Global a lot of problems. So I think we are all here
15 today to protect assets.

16 We know it's going to cost more. We know it
17 might increase margining. There are a bunch of buy-side
18 participants who are willing to pay more, and what I've
19 heard from exchanges or some of the FCM's here is reasons
20 why you can't do something, as opposed to: How do we do
21 so something to protect assets?

22 UNIDENTIFIED SPEAKER: If I could just follow
23 up on John's point, MF Global is not a case of fellow
24 customer risk. LSOC would not have prevented MF Global,
25 and it wouldn't do in futures, either.

1 JOHN TORELL: We -- we agree with that, and
2 that's why we need to find a custody solution that you
3 used to have in the futures market and that you have in
4 the OTC market, but that's for the next panel.

5 THOMAS HAMMOND: Thank you, Bob.

6 I am thinking about the some of the discussion
7 around the table, and -- and it strikes me that one -- one
8 fact is missing, and that is that while we talk about the
9 cost of increased margin, that horse has left the barn.

10 I mean, when you look at what's required on
11 November 8th, it is a gross margining model for futures,
12 and, as such, essentially the way -- and I'm not going to
13 know it off the top of my head -- but essentially the way
14 that margin has to be calculated is as if each one of the
15 customers were actually a clearing member in the
16 clearinghouse, an aggregate at the FCM.

17 So I mean, I -- as we talk about that and try
18 to apply it to LSOC, I think that's done. I mean, we are
19 now struggling with trying to get that information in a
20 format that we can be compliant as a DCO on November 8th.

21 I think that the -- I think that the
22 Commission and probably the industry is going to be a
23 little bit hard pressed to come up with explanations to --
24 to the marketplace on why a model, that exists in OTC for
25 ECP's and for large -- and large hedge funds can't be

1 applied to farmers, ranchers, and cotton growers in the
2 U.S. if it adds extra protection and it's cost effective
3 in the manner for the protection that it provides.

4 I agree that -- that LSOC is certainly a more
5 complex model in futures. There's no denying that. It's
6 a large portfolio of product. It's -- it's an enormous
7 amount of accounts, but I think there are probably some
8 benefits that we can gain from the way that we structure
9 gross margining in regards to some of the -- some of
10 the -- the requirements that we want to see, maybe giving
11 some of the value and portability, giving some -- some
12 value into the -- into the vision, into account structure
13 and risk at an account level at the DCO level.

14 And I think it's important that we also think
15 about, as we talk about our markets and futures, that we
16 don't forget that we still have a great offset product and
17 correlated risk on the OTC side.

18 So to get access to that -- to that offset you
19 have to have some risk structure that -- that can apply in
20 both markets, and generally what we see is that the more
21 conservative model win's that battle.

22 So you -- you've got to correlate a risk in
23 futures. You want to have the ability for -- for cost
24 effectiveness to apply into the OTC -- into the OTC market
25 and vice versa.

1 And -- and finally, I mean, I agree with
2 everything that's been said here on -- on essentially the
3 moral hazard and the impact to the FCM model. I mean,
4 that's something that we have to look at hard to make sure
5 that we don't do anything that will adversely affect what
6 I call one of our key risk management waterfalls, and
7 that's our -- that's our FCM's, who are here every day,
8 presenting their capital, putting their risk management,
9 and applying the distribution into our markets with the
10 knowledge of their customers for -- for the betterment of
11 our -- of our risk management model on a whole.

12 CHRISTINE COCHRAN: I represent the Commodity
13 Market Council, and we -- our members including a broad
14 spectrum of commercial participants who are heavily
15 engaged in the future side. And I've really appreciated
16 hearing all of the comments today, and I would just like
17 to add that I think we just need to be careful.

18 What we hear, internally, amongst our members
19 is a -- a deep conversation about the model that exists
20 today in the futures space, but there is also significant
21 reservation about implementing a structural change without
22 a deeper conversation, not only about direct costs, which
23 is what we've been talking about today, but the indirect
24 costs, and the impacts to the market, and the innovation
25 and tools that these folks will have access to, to manage

1 their business risk.

2 BOB WASSERMAN: Eric?

3 ERIC DELAIN: Thank you.

4 And I think to echo what Christine was saying,
5 there's a lot of costs that are being talked about, and
6 with LSOC, as has been mentioned before, we're talking
7 about something that's been in the books for three weeks.

8 And to start going to the next stage of
9 talking about expanding into futures before we've seen it
10 in action, definitely seems premature. And Tim and other
11 people have talked quite a bit about costs and things like
12 that.

13 And I understand there's people from the buy
14 side here, but there's a lot of people from the sell side,
15 and when you start looking at the smaller entities that
16 trade in the futures -- and again we're talking thousands
17 of accounts -- I think we need to take our time and -- and
18 make sure that it's going to work on the futures model as
19 opposed to just looking at how it may work for a swaps
20 model that's being relatively built from the ground up, as
21 opposed to a dramatic shift to things that are already in
22 play.

23 BOB WASSERMAN: And if I could make just one
24 additional request, if folks could state your name at the
25 beginning of your remarks so that -- because there's some

1 folks on the phone who are listening in.

2 Anyone else?

3 MARK SZYCHER: Mark Szycher representing
4 CIEBA.

5 Just to follow on, on the last panelist's
6 comments, certainly CIEBA members unequivocally support
7 any additional protections for clients, including
8 ourselves, in the futures market, certainly including but
9 not limited to fellow customers.

10 And we, of course, would be supportive of an
11 LSOC implementation that would fully address fellow
12 customer concerns, risk concerns.

13 That said, notwithstanding our support for
14 those additional protections in the futures markets, we
15 would urge the Commission to very carefully consider
16 bandwidth issues for FCM's and DCO's, if we were to go
17 forward in a short-to-medium-term timeframe with
18 implementing a version of LSOC in the futures markets.

19 Let's consider the fact that, by and large,
20 it's the same FCM's, and in some cases it's the same DCO's
21 that are -- that, from the swap market, that are going to
22 be tackling a herculean task in getting themselves ready
23 for the swap clearing mandate.

24 In particular, there are tens if not hundreds
25 of thousands of legal documents to be executed, myriad

1 changes in systems and operations, risk management and
2 compliance procedures, reporting, et cetera.

3 In essence, we would ask that from a
4 prioritization standpoint that we ensure that FCM's,
5 DCO's, and other market participants are ready for the
6 clearing mandate before tackling a legitimate but perhaps
7 problem of lesser importance in the futures markets.

8 LAURA KLIMPEL: Laura Klimpel.

9 I agree with a lot of what Tom, and Eric, and
10 others have said in terms of the cost benefit analysis,
11 and the need to -- to do it carefully.

12 One other issue that the Commission should
13 take into consideration are the changes that LSOC would
14 require to the new rules that the Commission has just
15 promulgated for DCO's that we're building out to right now
16 for May.

17 In particular, the stress and back testing
18 requirements that the DCO's have to come into compliance
19 with by May, require stress and back testing at the
20 customer omnibus level as opposed to the under -- the
21 individual underlying customer level.

22 Essentially a lot of that work would be throw-
23 away if we had to, in the future, implement LSOC.

24 BOB WASSERMAN: Seth?

25 SETH GROSSHANDLER: I'm Seth Grosshandler.

1 Other things to think about, that need to be
2 done for existing LSOC: Many FCM's and their affiliates
3 extend credit to customers based on margin that is either
4 posted at the FCM level or at the DCO level, and although
5 I think the intent of the LSOC proposal was to allow that
6 to continue to proceed as it has been done in the futures
7 space, I think there's a real lack of clarity because of
8 some things in the introduction and in the release that
9 need to be clarified.

10 Another -- and that would be just for LSOC for
11 cleared OTC derivatives much less LSOC for futures.

12 Variation margin and the ability of the DCO to
13 net variation margin payments, owing to one customer
14 against a deficit from the other customer, I think is also
15 not very clear in the existing LSOC model. And I think
16 there are circumstances where that can happen, and there
17 are some circumstances where that probably can't happen,
18 but the rule is not particularly clear.

19 And then another point -- and maybe this is
20 more for the DCO's, who -- there's a lot, I think, that
21 maybe we need to understand from the DCO's as to costs
22 and -- and the like of LSOC, but if -- if there were a
23 closeout of multiple customers, how is the DCO going --
24 and is the DCO going to do that on an individual basis,
25 and then allocate it individually, or if it doesn't on a

1 portfolio basis, how will it allocate that portfolio
2 closeout to individual customers?

3 BOB WASSERMAN: So a couple things. I think
4 we will, separately from the proceedings today and
5 tomorrow, have contacts, both more formally and perhaps,
6 as well, informally with folks, in terms of questions on
7 LSOC for swaps, but I think for the moment we should
8 probably focus a bit on LSOC for futures.

9 One issue I'd like to get folks focused on --
10 we have about 20 minutes more. So, as has been pointed
11 out, there are a number of things that are now part of the
12 landscape already.

13 So gross margining, effective November 8th,
14 it's part of the landscape.

15 LSOC for swaps, effective November 8th, also
16 part of the landscape.

17 Given those things, what I think would be very
18 helpful for us to get from the panel is discussions of
19 their understandings of costs and benefits that would
20 arise as -- from adding LSOC for futures to those existing
21 things.

22 I would be very surprised if that were to
23 happen on November 8th, but if we were to, in due
24 course -- and I'm being deliberately vague, frankly, on
25 that timing point -- add LSOC for futures, what are the

1 benefits? What are the costs? What are the
2 implementation difficulties? What are the solutions?

3 So if I can get folks to talk to that.

4 Michael?

5 MICHAEL GREENBERGER: I'll try and talk to
6 that little bit, but I also want to comment on some of the
7 things that were said.

8 I'm Michael Greenberger. I'm at the
9 University of Maryland, School of Law, and I'm here today
10 representing Americans for Financial Reform.

11 First of all, in terms of cost-benefit
12 analysis and tinkering with LSOC as it applies to futures,
13 this is not going to happen overnight in the CFTC.

14 There's a -- I would assume that there -- if
15 there isn't a concept release, there will be a notice of
16 proposed rule making, a proposed rule. In that effort it
17 will be more than just the people sitting at this table
18 who will have a lot of things to say about this, both as
19 to the substance of LSOC for futures and as to the cost
20 benefits.

21 One thing people should keep in the back of
22 their mind is we may not have the luxury of waiting
23 forever to come up with something to appease the great
24 unhappiness with middle class America here, farmers,
25 ranchers, heating oil dealers, petroleum marketers, which

1 have been substantially and seriously hurt, and are angry
2 about the situation as it exists. I think the
3 good-versus-perfect analogy -- I think, as a political
4 matter, getting people to say that the present system is
5 good, whether that's right or wrong as a rational
6 matter -- I think as a political matter, not a lot of
7 people are going to run around on either -- either the
8 Republicans or the Democrats saying the present system is
9 good.

10 They're real people who've lost money that put
11 them interrorum in terms of the way they live their lives,
12 and as Ron said, when you look at LSOC for futures, his
13 initial instinct was, well, why -- LSOC for swaps? Why
14 not LSOC for futures?

15 I think that's going to be a mantra that's
16 going to be heard in the halls of Congress. If this is
17 good enough to protect the buy side in the swaps market,
18 why isn't it good enough to protect people, who frankly,
19 are abandoning, in too large numbers, the futures market?

20 What we -- if anything, whatever the
21 protections are, it is right now more to get protections
22 for customers in the futures market than it is in the swap
23 market. The swap market went on for years without --
24 without segregation concerns by the buy side. And -- and
25 now they've got it, but what -- I haven't looked at the

1 most recent statistics, but trading in conventional
2 futures, people who are hedging business exposure is down.
3 It's -- people are aggravated. There are obviously going
4 to be follow-on indictments, subpoenas, investigations.
5 That is going to increase the bad publicity that the
6 futures market has.

7 So my view is that I -- I think that the LSOC
8 for futures idea is certainly one that is worthy of more
9 detailed comment. It is instinctively something that
10 politicians are going to want to know. I think there were
11 even questions raised when LSOC for swaps was passed,
12 about why there isn't the same.

13 Now that comment may have come: Why don't we
14 have the futures model apply to swaps and have one uniform
15 model? But I think the reverse argument is going to be
16 much more handy.

17 And in terms of the economic analysis, you
18 know, that can be done. It could be done very, very
19 quickly. You know, people who are at this table, who
20 might be adversely affected by LSOC for futures, if they
21 had to, could get economic analyses done, I believe, on a
22 relatively quick basis.

23 But the point here is -- and what I worry on
24 cost-benefit analysis is too much looks at the cost per
25 the regulation and too little to the benefit. You see

1 from the supply side here, they are prepared to pay more
2 to have better security.

3 I think the question needs to be asked, but my
4 instinctive view is that on the futures side the people
5 who are now worried about losing the capital that is owed
6 them, are willing to pay more to have that kind of
7 protection.

8 Now, I don't know what that would mean on the
9 margin. I'm very sensitive to the fact that the
10 commercial hedging and the margin that's used is in the
11 form of an insurance policy, and if you raise that margin
12 too much, yes, you may drive people from the hedging.

13 But my point right now is people are being
14 driven from hedging from their fear of a system that broke
15 down. And by the way, it's not just MF that we're talking
16 about. There's now a major lawsuit in Southern District
17 of New York with -- with Miami Children's Hospital and
18 others suing with regard to the Revco failure, and their
19 claim that segregated funds were not properly given to
20 them. It's a class -- massive class action in the
21 Southern District of New York.

22 I know that people thought Revco worked out
23 well. You should check the Complaint in that case.

24 WILLIAM THUM: I wanted to jump in with a
25 couple thoughts the cost and benefits, and --

1 BOB WASSERMAN: Bill, if you could -- your
2 name.

3 WILLIAM THUM: Sure. It's Bill Thum from
4 Vanguard.

5 So in terms of the costs, obviously, there's
6 infrastructure, build-out, and costs associated with it.
7 Mark went through the list very well, and it was great to
8 hear Bob say that while it may be contemplated, it's
9 unlikely that LSOC would apply the futures model ahead of
10 November 8th. So there would certainly be time allocated
11 to achieve that infrastructure enhancement.

12 The interesting thing is that the infra-
13 structure enhancement has to happen, in any event, for the
14 cleared swaps market. So some of the same entities that
15 have to make those changes will already have to be doing
16 it for the cleared swaps market.

17 In terms of heightened margin, you know, I
18 think that it's a very hard argument to make that it's
19 going to be challenging for DCO's or FCM's to contemplate
20 having to look at individual clients and understand that
21 they don't have adequate margin to cover the risk.

22 We, on the buy side, certainly of Vanguard,
23 view it as should pay your own freight, and the risk that
24 you present to the system, you should be accountable for
25 in terms of the margin that you're required to pony up.

1 Certainly for some clients margin may actually
2 be less, or certainly less than it will be for other
3 clients. Market participants, such as Vanguard, that have
4 a very conservative approach to investing and present
5 other risk mitigating factors in terms of their
6 strategies, may indeed have a more appropriate approach to
7 margin applied to them than certain hedge funds that
8 present heightened risk in terms of their strategies and
9 trading approach.

10 So we really feel that it's pay your own
11 freight. If you present the risk to the system, be
12 prepared to put the margin up or not participate.

13 In terms of the benefits, the one benefit that
14 I didn't mention is certainly portfolio margining and the
15 ability to look across the cleared swaps market and
16 futures market to see what benefits can happen in terms of
17 trading offsets and margin efficiencies. So that's
18 another major benefit if we could have both the margin
19 approach for cleared swaps aligned with the margin
20 approach for futures.

21 BOB WASSERMAN: All right. Sanjay Kannambadi.

22 SANJAY KANNAMBADI: I absolutely agree with
23 Bill on that last part, because cross-margining of assets,
24 as they take off and progress, we need to make sure
25 that -- there's asset protection on both sides of the

1 equation, whether it's futures or swaps, are well aligned
2 and harmonized. Otherwise you will have a regime or an
3 account type that has a different asset protection versus
4 the other.

5 BOB WASSERMAN: I should just -- on that last
6 point I should observe the way we set things up in the
7 cleared swaps customer collateral rule making is
8 essentially: If there is, by -- under 4 D, you bring
9 futures into the swaps account, they would then be treated
10 in accordance with the swaps account rules.

11 On the other hand, if you were to take swaps
12 and put them in the futures account, they would be treated
13 in accordance with the futures account rules. So the
14 possibility then of cross-margining is there now, and it
15 would then follow the rules of whichever account the
16 positions are being brought into.

17 GARY DeWAAL: Gary DeWaal.

18 Again, you know, I was struck when I looked at
19 the December seg numbers published by the CFTC with much
20 greater detail, I might add, to note that approximately 10
21 firms held 80 percent of all customer funds seg and
22 secured, combined. That's an incredible concentration.

23 And my guess is that concentration is much
24 greater today than it was 10 or 15 years ago. Yes, I
25 mean, I hear what -- what the good buy-side people and

1 Mike are saying about this issue, and, yes, there are
2 things that need to be done. There are -- the system
3 clearly needs to be fixed somehow.

4 My concern, again, is -- you know, certainly
5 what I'm reading and certainly what I'm seeing, and
6 certainly what I'm feeling is that internal controls need
7 to be enhanced. Disclosure needs to be enhanced. I'm
8 concerned about making modifications broad based to a
9 system that has lots of -- lots of unknowns.

10 But, moreover, increases the -- the risk that
11 the individual FCM's are going to be underwriting. You
12 know, it may seem very theoretical. It may seem very, you
13 know, not real, but it is real. And -- and the proof is
14 in the pudding.

15 The number of FCM's out there that are holding
16 the -- the large amount of customer funds is diminishing,
17 and we've got to take note of that.

18 PETER BROWN: Peter Brown, Moore Capital.

19 In terms of costs, I think the FIA issued some
20 recommendations last night. I was a little bleary when I
21 was reading them, but I think those are, you know, easily
22 achievable, I think, low cost.

23 Another key recommendation, which we didn't
24 see there explicitly is: How does the pool of segregated
25 funds, you know, remain protected at all times in terms of

1 the FCM's ability to dip into those funds?

2 The CFTC issued a few questions for the
3 panel -- maybe later today -- about whether regulatory
4 authority at some level needs to have some role in
5 ensuring those, you know, pooled assets are always intact,
6 that the residual interest of the FCM is -- is monitored
7 or potentially even approved in terms of release of those
8 assets back to the FCM.

9 So, you know, a key concern for us -- and the
10 comment was made that LSOC, whether it's futures or
11 cleared swaps, doesn't protect customers from an MF Global
12 misappropriation. The key concern for us is: How does
13 the customer pool -- what better protections can be
14 implemented to ensure that it's there at all times,
15 whether it's additional regulatory oversight of that pool,
16 whether the DSRO's [sic] need to have a stronger role in,
17 you know, having -- you know, insight into that pool in
18 real time, and whether there's a role for them in terms of
19 approving return of residual interest.

20 You know, we think that's a critical aspect of
21 all this, that is far in a way the most important factor
22 to get right, whether it's futures, swaps, or anything
23 else.

24 RON FILLER: Another food for thought for the
25 panel and for the Commission staff as they consider this

1 issue, and carry on just a little bit more what Gary just
2 said, and one issue has not been raised, and, to me, it's
3 a big issue that could have a tremendous impact on the
4 risk of this industry, and that's the net capital
5 requirements for FCM's.

6 So in the LSOC rule, when you adopted it for
7 clear swaps -- I think I'm correct in this statement --
8 the CFTC estimated that the margin would be somewhere in
9 the \$800 billion range -- a range -- and that a lot of the
10 DCO's thought it was going to be another 50 percent or
11 more increase. So we're up to 1.2 trillion, and I've
12 heard \$2 trillion in margin for the cleared swap world.

13 And the extra 50 percent was cause for the
14 LSOC rule, and you'd have to apply this 8 percent capital
15 requirement. The guaranteed funds requirement by FCM's
16 are going to increased dramatically with the LSOC rule for
17 cleared swaps, and I assume the same would be true, and
18 any contributions for the guaranteed fund contributions
19 don't count as good capital for purposes of 1.17.

20 And if we start applying this to the futures
21 world, and there's going to be additional capital
22 requirements -- just to talk about what Gary just said,
23 there's not enough capital among the FCM community today
24 for three, or four, or five of these are going to be
25 concentrated in that type of a group.

1 And given all the other capital requirements
2 under Basel iii, and all the things that the fed is
3 considering, I am very concerned that as we raise these
4 margin levels, we raise these guaranteed fund
5 contributions, unless the Commission is also willing to
6 revise or relook at the next capital rules, I'm not sure
7 there's enough FCM capital out there to play the game
8 going forward.

9 BOB WASSERMAN: So I should note one thing:
10 Some of the increase in margin and guarantee fund is due
11 to LSOC over naught. I should note a large part of that
12 increase is also due to the fact of essentially bringing
13 cleared swaps -- bringing swaps into clearing. And so
14 it -- one has to compare with and without, rather than
15 with mandatory clearing and without.

16 RON FILLER: But -- you're correct, but even
17 if you have increased amounts, either in contributions or
18 margin -- because this 8 percent of margin is the capital
19 requirement. If you increase that by 500 million --
20 billion dollars, that's another \$40 million of capital
21 that's required to play the game.

22 I'm just worried that there's not enough
23 capital among the FCM's to play this game going forward,
24 and are we not concentrating, as Gary just mentioned, the
25 risks of the system among a small number of FCM's going

1 forward?

2 BOB WASSERMAN: Michael?

3 MICHAEL GREENBERGER: Yeah. I mean, whenever
4 you add up the costs of the systems, you've got to look at
5 the benefits. I mean, the overall cost of clearing swaps,
6 and segregating swaps must be measured against the
7 trillions of dollars taxpayers pay for a system that
8 didn't have those protections.

9 And it's just -- to make these systems
10 viable -- because if they break down again, all hell will
11 break lose. To make these systems viable, there will be a
12 regulatory cost, and the figures you raise in the
13 trillions -- I mean, the notional value of the regulated
14 futures market has been pronounced by the CFTC to be 40
15 trillion. The notional value of the swaps market
16 world-wide is 800 trillion. The CFTC has been using the
17 figure of 300 trillion.

18 There's a tremendous push to open the clearing
19 up for more members to be part of clearing for swaps.
20 It's going to be, as I see it, a very profitable endeavor.
21 And I think the problems with concentration in the FCM's
22 is not so much the inability to raise capital to be an
23 FCM, but anti -- the anti-competitive structure of
24 clearing facilities which hopefully will be remedied by
25 membership requirements and capital requirements by the

1 CFTC.

2 But, you know, this is a profitable good
3 business. The clearing facilities have done well, and if
4 they need to raise more money to protect not only the
5 customers, but the systemic functioning of the worldwide
6 economy, I think that the business is good enough that
7 they can raise that money with the appropriate business
8 plans.

9 And we're certainly seeing at least that the
10 wealthy buy side is prepared to pay their fair share to
11 keep this system afloat.

12 BOB WASSERMAN: Okay. Well, we've run out of
13 time.

14 TIMOTHY DOAR: Okay. Right under the wire.
15 Tim Doar, CME. I'm sorry, Steve.

16 Generally speaking, look, as has been noted,
17 LSOC for swaps is going in. As a DCO, we'll confirm our
18 policies and procedures and risk management to administer
19 to LSOC requirements, of course.

20 We do, though, have a duty to understand what
21 the risk of the LSOC methodology is and a responsibility
22 to understand how we will mitigate those risks.

23 We start with the legal analysis upon which
24 the LSOC is based. We question what we lean on to know
25 that we'll get the kind of outcome that we all expect,

1 should a bankruptcy occur. We're not sure what that
2 rationale is.

3 So we start there. I would just urge that
4 before we go further into implementing LSOC for futures,
5 that we think clearly about structural differences in the
6 markets for futures, as opposed to the swaps market as it
7 exists today, so that we get a reasoned outcome in the
8 name of enhancing customer protection.

9 It's very easy to understand why the buy side
10 responds well to LSOC. If you're not the guy that caused
11 the fault, the DCO no longer has the ability to use your
12 margin at the clearinghouse level to clear the default.
13 We respond well to that. We understand, but it's got to
14 hang together. It's got to make sense, and we just want
15 to make sure that, in fact, it does.

16 BOB WASSERMAN: And that will have to be the
17 last comment for this panel. And so we're going to take a
18 break on begin very promptly at 10:45.

19 (Proceedings recessed until 10:45)

20 (Conversations over telephone connections not transcribed)

21 UNIDENTIFIED SPEAKER: This is the two-minute
22 warning.

23 (Proceedings paused briefly)

24 BOB WASSERMAN: If folks could start taking
25 their seats, particularly the panelists, please.

1 (Proceedings paused briefly)

2 TOPIC FOR DISCUSSION:

3 Alternative models for custody of customer collateral

4 BOB WASSERMAN: Thank you again, and apologies
5 for being fairly strict in terms of the times, but we do
6 have a lot going on today.

7 So I think since we do have some same
8 panelists, some different panelists, we should probably
9 once again simply go around the table and introduce folks
10 by names and affiliations.

11 Bob Wasserman CFTC.

12 GARY BARRETT: Gary Barrett, Swap Dealer and
13 Intermediary Oversight.

14 TOM SMITH: Tom Smith, CFTC.

15 BAS ZEBREGS: Bas Zebregs, representing the
16 European Federation of Retirement Professionals.

17 RON FILLER: Ron Filler, New York Law School.

18 SCOTT FERRIS: Scott Ferris, BMO Harris Bank.

19 CHRISTINE COCHRAN: Christine Cochran,
20 Commodities Markets Council.

21 STEVEN WINTER: Steven Winter, State Street.

22 SANJAY KANNAMBADI: Sanjay Kannambadi, BNY
23 Mellon Clearing.

24 KEN ACKERMAN: I'm Ken Ackerman. I'm
25 representing the American Feed Industry Association.

1 JEFF HAINLINE: Jeff Hainline, Advanced
2 Trading, representing the National Grain and Feed
3 Association.

4 PETER BROWN: Peter Brown, Moore Capital
5 Management.

6 HILARY CORAL: Hilary Coral from Franklin
7 Templeton Investments, representing the Asset Management
8 Group of as SIFMA.

9 MARK SZYCHER: Mark Szycher, General Motors
10 Pension, representing CIEBA.

11 CHRISTINE AYOTTE-BRENNAN: Christine Ayotte-
12 Brennan, Fidelity.

13 WILLIAM THUM: I'm Bill Thum from Vanguard
14 today representing the ICI.

15 CHRIS PERKINS: Chris Perkins from Citi.

16 ERIC BAGGESEN: Eric Baggesen, California
17 Public Employees Retirement System.

18 JOHN TORELL: John Torell, Tudor Investment
19 Corp.

20 JOANNE MEDERO: Joanne Medero, BlackRock.

21 SETH GROSSHANDLER: Seth Grosshandler, Clearly
22 Gottlieb, representing FIA.

23 ROBERT LEE: Robert Lee, Deutsche Bank,
24 representing ISDA.

25 JOSH COHN: Josh Cohn -- oops.

1 Josh Cohn, Mayer Brown for ISDA.

2 OLIVER FRANKEL: Oliver Frankel, Goldman Sachs
3 for ISDA.

4 BYRON BALDWIN: Byron Baldwin, Eurex.

5 CHRIS EDMONDS: Chris Edmonds, ICE Clear
6 Credit.

7 JOSEPH OTT: Joe Ott, Kansas City Board of
8 Trade.

9 TIMOTHY DOAR: Tim Doar, CME.

10 DANIEL MAGUIRE: Danny Maguire, LCH Clearing
11 Group.

12 BOB WASSERMAN: Okay. And I am constrained to
13 repeat -- and you'll be hearing this at the beginning of
14 each panel. CFTC staff cannot engage in a discussion
15 concerning matters involving MF Global in light of our
16 Division of Enforcement's ongoing investigation. We ask
17 the participants to respect our request that such
18 specifics not be injected into the discussion here today.

19 And so this panel is on Alternative Models for
20 Custody of Customer Collateral, and the first question to
21 get is started is: What are the alternative models that
22 participants believe should be adopted?

23 And I should note in this context, at least
24 from, I think, a staff perspective or at least my
25 perspective, there's a couple of things we need to

1 accomplish in terms of this.

2 Number one, it has to work within the
3 construct of the Bankruptcy Code, and particularly 766 H,
4 which mandates rateable distribution of customer property.

5 Second, it seems to me is we need to find
6 models that meet the vital interests of all of the
7 stakeholders, and that includes the buy side. It includes
8 the firms. It includes the clearing organizations. It
9 includes the depositories. And so we need to figure out
10 something that really does work for everyone.

11 So with that, is there anyone who would like
12 to get us started?

13 MARK SZYCHER: Mark Szycher representing --
14 rep -- Mark Szycher representing CIEBA.

15 For many years pension schemes, mutual funds,
16 large-asset managers, a number of insurance companies have
17 opted to protect client assets with third-party collateral
18 segregation models. We simply cannot accept the notion
19 that Congress intended, through the Dodd Frank Act, to
20 weaken the client protections once we've moved to a clear
21 swap environment.

22 Hence, we worked very closely with the CME to
23 develop a model where we believe that the requirements,
24 Bob, that you've laid out, have been addressed or will be
25 addressed in certain cases. And furthermore that three of

1 the most important protections that we are afforded today
2 would remain in a new re -- in a new regime.

3 And those three are that the client would be
4 ultimately shielded from an FCM bankruptcy or insolvency,
5 that -- that the independent third party would maintain
6 records and the client would have full transparency
7 regarding the assets posted, and, thirdly, that the
8 collateral is maintained exclusively to secure clients'
9 obligations and remains safe from misuse by the FCM.

10 To the extent possible, in terms of setting up
11 the objectives of this model -- and we could call it the
12 CIEBA CME model, but the essence of it is it's an
13 individual segregation account where we, as the client,
14 become, in essence, not a customer of the FCM, but instead
15 we have a special clearing status, we've termed the
16 guaranteed clearing participant.

17 And in essence the objectives that we've
18 attempted to achieve are the following: To the extent
19 possible, we've maintained the current operational
20 structure substituting certain -- in certain operational
21 sense the client for the FCM, regarding the DCO settlement
22 bank operations.

23 Second, we've prevented the margin from being
24 classified as customer property of the FCM.

25 Thirdly, third-party controls and reporting

1 over margin have been maintained as we have in the current
2 structure.

3 And, lastly, we believe that -- that this
4 model does not conflict and does not supercede, in any
5 way, other models that could exist side-by-side with the
6 CIEBA CME model.

7 JOHN TORELL: Yes, John Torell from Tudor
8 Investment Corp.

9 I think, as a lot of people in this room,
10 we've become educated in the last few weeks or few months
11 about the CIEBA model, the -- the GCP model, the
12 quad-party documents, and, you know, we are very
13 encouraged as a -- an asset manager that there are
14 potentially a few different solutions that actually truly
15 protect client assets segregated in a custody account or
16 some kind of arrangement that we currently enjoy under
17 OTC trading that is not enjoyed under the futures model.
18 So we're very enthusiastic about that.

19 I think, as a non-attorney here, it does sound
20 like we're trying to create a model that can be viewed as
21 a non-customer account in order to not touch the third
22 rail of the Bankruptcy Code. And so as a non-attorney I
23 fully endorse these models and think they do work under
24 bankruptcy.

25 However, if they don't, I think there are two

1 things that are going to be important. One, the CFTC is
2 going to have to step to the plate and interpret these
3 models to fall outside of that, to the extent that that's
4 helpful in the event of some bankruptcy of some SEM, and,
5 two, if that doesn't work, then I do think that it
6 shouldn't be off the table, that a bankruptcy change in
7 that code couldn't be part of the solution, because we
8 have a solution that works now under OTC.

9 You had a solution in the futures market that
10 allowed asset managed -- assets into customer accounts,
11 and that was taken away about seven or eight years ago.
12 So we know that there are models that work, and we should
13 all figure out ways to make those work as opposed to
14 reasons why they can't be put in place.

15 Thank you.

16 BYRON BALDWIN: Byron Baldwin, Eurex.

17 I guess from last August Eurex introduced an
18 individual client asset protection listed by way of double
19 title transfer. So it's -- it meets the needs of the
20 clearing member, seeing the collateral that has been sent
21 from the buy side that's kept at Eurex clearing in a total
22 segregated account. So that gives protection.

23 The aim from Eurex will be to introduce that
24 individual client asset protection in the U.S. to meet
25 U.S. jurisdiction, and -- and that gives the buy side

1 complete segregation in the event of an FCM default.

2 HILARY CORAL: Hilary Coral from Franklin
3 Templeton.

4 Yeah, I mean, we -- you know, to the Eurex
5 point, you know, we've been hearing, you know, that, as
6 well. And, you know, our understanding is that, you know,
7 the European Parliament's also considering putting a full
8 segregation, not just as an option but as the default,
9 that participants would have to opt out of.

10 And, you know, our view is that there is
11 certainly a recognition outside of the United States for a
12 need to protect customer collateral, and we feel that in
13 the U.S. the regulations should give the same level of
14 protection to the customers here.

15 So, you know, we do feel that full segregation
16 should be made available to protect, you know, market
17 participants, you know, as -- as several of my buy-side
18 colleagues have said, you know, there is a current
19 framework, you know, in our OTC world, where we have that,
20 and I don't think that the introduction of centralized
21 clearing should decrease the protection for customer
22 margin from what we have now.

23 Thank you.

24 BOB WASSERMAN: Seth?

25 SETH GROSSHANDLER: Seth Grosshandler.

1 So obviously margin is posted, in the first
2 instance, to protect the DCO and the FCM from the customer
3 risk, right? DCO is it counter party of the FCM as -- as
4 the guarantor.

5 And so in looking at all these models we need
6 to make sure that that, you know, initial goal of why the
7 margin is there is also -- is also fulfilled. And in the
8 CIEBA proposals I think that it would get rid of a lien,
9 altogether, in favor of the FCM, and I think that that
10 is -- that is problematic from a risk management
11 perspective, and it gets very complicated. You can talk
12 about the lien for the exposure to that DCO, and another
13 DCO, the FCM in its capacity as a broker-dealer, or the
14 FCM's affiliates, you know, all sorts of -- all sorts of
15 issues.

16 There are capital issues with not having that
17 lien under Basel Capital rules that require first prior --
18 you know, a perfected security interest in favor of the
19 FCM for the customer exposure that the FCM is taking on.
20 That needs to be worked through.

21 Now, we've had some discussions about maybe
22 there are ways to have that lien and still -- I think the
23 objection to the lien is that it might get in the way of
24 porting. Right?

25 And there may be ways under certain federal

1 statutes that FDICIA, fiduciary clearing organization
2 netting provisions of FDICIA, that may get around that,
3 but that need -- that's a very key issue.

4 Also need to think about the impact of the
5 lien on the customer property analysis as to customer
6 property. If you don't change the code -- really the
7 question is: If everybody does this, in all spaces,
8 there's no customer property left. And how is that really
9 consistent with the Bankruptcy Code mutualization which I
10 think anticipates that there will be some customer
11 property.

12 Finally, the -- I mean there's -- I'm trying
13 to keep my remarks brief, because the -- I could talk a
14 lot of things for a long time on all of this.

15 You know, you look at this structure and you
16 say: Where's the FCM? Where -- this is entirely
17 disintermediating the FCM. It's really just an insurer.

18 And I think I'm sure other people on the panel
19 will talk about the economic effects of this on FCM's that
20 are just insuring -- and as Gary DeWaal said on the last
21 panel, ironically they're paying to insure, but there are
22 legal issues.

23 What is the pow -- if the FCM really isn't an
24 FCM any more, but just an insurance company, does it have
25 to be licensed as an insurance company? Right? What

1 are -- what are the authority issues there?

2 So just some things to think about.

3 BOB WASSERMAN: So if I could -- I think now
4 might be a good time to sort of pin down some of the
5 details here, because I think we need to understand what
6 the model on the table is in order to understand some of
7 the implications there.

8 And so first -- I think, Mark, one of the
9 things I heard you say was that this is something that
10 would go on perhaps in parallel to, for instance, the
11 model that we currently have, say, for LSOC. And so it
12 may or -- is this necessarily going to involve each and
13 every customer, or would this be for those customers who
14 are willing to essentially participate in this kind of a
15 model?

16 MARK SZYCHER: Mark Szycher from CIEBA.

17 Bob, I think our view has been and continues
18 to be that, first, with respect to clients, that this is
19 voluntary to the extent that one's level of risk aversion
20 business strategy, as a client, demands or one decides to
21 avail themselves of this option, we'd like this option to
22 be available.

23 And we believe also in order for that to
24 happen, we would urge the Commission to, regardless of the
25 specifics of the segregation or alternative segregation

1 model that was selected, to require the DCO to offer that
2 model or at least to support it.

3 We recognize, with respect to FCM's, they may
4 come to different commercial decisions, and we, as
5 voluntary participants in this model, would work out the
6 appropriate commercial arrangements with the FCM.

7 BOB WASSERMAN: And then, as I understand it,
8 the -- these participants would, I'm assuming from other
9 things you've said, not be participating in the mutualized
10 guarantee resource.

11 MARK SZYCHER: Mark Szycher from CIEBA.

12 Yes, Bob, that's correct. The way we have
13 envisioned this process is that the -- the client would
14 take on a slightly different status from that which exists
15 today. That is a cus -- today we are deemed to be a
16 customer of the clearing merchant, whereas in the model
17 that we're proposing, we would be a guaranteed clearing
18 participant.

19 So in certain respects, in certain operational
20 respects, we would appear in some ways like a clearing
21 member with respect to direct access to DCO settlement
22 accounts and the like, whereas from the -- with respect to
23 other obligations of a clearing member we would not take
24 those on, for example, guaranteed pay -- payments into the
25 guarantee fund, the requirement, potentially, to take on

1 positions of a failed -- another failed clearing member,
2 should that be necessary.

3 So again we would simply look operationally to
4 disintermediate with respect purely to margin processing,
5 replace the role that the FCM takes on today, but in no
6 other way do we wish to take on the roles,
7 responsibilities, and obligations of clearing members.

8 BOB WASSERMAN: So then I guess there would be
9 an FCM that would be guaranteeing those obligations.

10 And then I guess the issue is -- I -- I would
11 assume there would need to be some interest that the FCM
12 has, to the extent they actually have to, for instance,
13 make a variation payment, they would need to have some way
14 to access the collateral that the guaranteed participant
15 has posted with the clearing org.

16 MARK SZYCHER: That's right, Bob. In essence
17 we -- it would still be required that the guaranteed
18 clearing participant, in fact, have a sponsoring clearing
19 member, and that clearing -- sponsored clearing member
20 would really have the sole responsibility -- or its only
21 responsibility would be to the extent that the -- that
22 there was a shortfall, when the DCO's required margin,
23 that, in fact, that margin be topped up in order to
24 prevent a default to the DCO.

25 And from an op -- from an operational

1 perspective, the FCM would in fact, or the sponsoring
2 clearing member would, in fact, have access to the
3 accounts such that that topping-up process, should it
4 become necessary, could be effectuated within the
5 appropriate timeframe for the DCO.

6 BOB WASSERMAN: So let me just throw open a
7 question then.

8 If there is, perhaps by DCO rule, that
9 mechanism is implemented, and then the FCM would have
10 access, by that rule, to excess collateral to the extent
11 it ended up having to make good on that guarantee, is that
12 something that might help the FCM's make this work for the
13 FCM's, Josh?

14 JOSH COHN: Speaking for ISDA, we've been
15 thinking about this. We -- we think it is possible. It's
16 certainly something that the FCM's need, one way or the
17 other, that is, to have a second lien, to have rights at
18 the DCO, perhaps rights as a secured party, second to
19 DCO's rights as a secured party with a holding directly in
20 the DCO's own account.

21 There -- there are other options one could
22 consider, like a mini-seg account at the FCM, where the
23 FCM had a first lien, retained a first lien in the same
24 way it does now, but over a perhaps smaller account. I
25 don't know the figures. Perhaps one of my colleagues

1 could speak to that possibility.

2 But there does need to be something, which I
3 think goes back to a point that -- that some of us have
4 made, that is, there -- this needs to be a cooperative
5 effort where DCO interests are protected, FCM interests
6 are protected, and customer interests are protected.

7 And so we have to work in a way that doesn't
8 destabilize the existing system while we do that.

9 BOB WASSERMAN: Seth?

10 SETH GROSSHANDLER: If I understood -- Seth
11 Grosshandler representing FIA.

12 If I understood your question, Bob, you were
13 asking -- I think you were asking: Does the FCM actually
14 need a lien, as opposed to can it just rely on some right
15 against the DCO to payment?

16 And it's a very complicated question. There's
17 no question that a lien is preferable. Without a lien
18 there may be some federal statutes against FDICIA if,
19 under this model, the customer is no longer a customer but
20 is a participant in the clearing organization, that may
21 mitigate some of those risks.

22 But without a lien -- I mean, these
23 participants, they may be non-U.S., they may be offshore.
24 You need to think about non-U.S. laws, right, as to
25 priority. Because the -- the question is going to be:

1 The unsecured creditors of that failed guaranteed clearing
2 participant versus the FCM's rights in these assets, and
3 without a security interest you instantly say maybe the
4 FCM has to share.

5 BOB WASSERMAN: So let me -- if I could just
6 press on that for a second, as I'm understanding it, the
7 participant is essentially posting margin to the DCO as a
8 direct participant.

9 The rights in that collateral then are
10 essentially established by the DCO rules, obviously within
11 and under the framework of both the -- the statutory and
12 regulatory environment, but essentially those rights, it
13 seems to me, would be established by DCO rules.

14 And so just as the DCO has an unfettered
15 right, and under federal law, of course, to use the
16 collateral to meet any defaults to the DCO, if, in fact,
17 the DCO, pursuant to its rules, goes to a guarantor and
18 says, no, you need to make this payment pursuant to your
19 guarantee, but, on the other hand you may have an interest
20 in the collateral over and above mine, again, all as part
21 of the rules, all pre-established, I'm not sure where, for
22 instance, the law of the participants -- guaranteed
23 participants' jurisdiction, where that would be relevant.

24 SETH GROSSHANDLER: Well, if they're
25 bankrupt -- and there's a bankruptcy proceeding in -- you

1 know, pick your jurisdiction, Cayman Islands. Right?

2 In the Cayman Islands, the rights of the
3 creditors of that bankrupt are going to be to determined,
4 in the first instance, by Cayman Islands law, and the
5 question is: Would you defer to U.S. law?

6 And we're positing that the FCM does not have
7 a security interest. Right? And the normal rule is:
8 Unsecured creditors share. Right? And so what's the
9 rationale for why the unsecured FCM doesn't have to share?
10 There are a couple. Right?

11 One is subrogation. They stand in the shoes
12 of the DCO, but that only gets you to the allegations to
13 that DCO. It doesn't get you to allegations to another
14 DCO, et cetera. Right? Okay? So maybe subrogation is a
15 theory, but does subrogation work in the Cayman Islands?
16 I have no idea.

17 So there's subrogation. There's also -- you
18 know, if the federal statutes, that give primacy to
19 clearing organizations rules, FDICIA, in particular, will
20 the Cayman Islands respect that against the normal
21 principle of pari (phonetic) pass-through distribution for
22 unsecured creditors, I don't know.

23 Whereas, if you have a lien, you can be pretty
24 sure, in most every jurisdiction, a secured creditor is
25 going to come ahead of an unsecured creditor.

1 CHRIS PERKINS: Chris Perkins, at Citi
2 representing FIA

3 I think we all want the same thing here. We
4 want to have the most robust and iron-clad segregation
5 regime that is possible in the context of bankruptcy law
6 and regulation.

7 That being said, I think we have to be careful
8 in these designs in that customer protections were
9 originally designed to give customer protections.

10 And now what we're doing is we're taking them
11 out of those protections, and by restricting FCM's
12 liens -- there's a couple of issues that Seth highlighted.
13 I think the first is: We have some regulatory capital
14 concerns that must addressed, and the seconds thing is our
15 risk.

16 And I think, you know, if you look at what
17 we're trying to accomplish here, as we get more complex
18 with these structures, they're going to take a lot of time
19 for us to fully vet an understanding of our recourse to
20 collateral.

21 And if it makes it look too much like customer
22 money, when a bankruptcy does, in fact, occur, we could
23 stuck at the place, where is 776 H, loss sharing. So
24 that's one theme.

25 I think the other theme we have to develop

1 is -- there's two issues here. The first is the 766 H,
2 loss sharing. The second is malfeasance. And what can we
3 do, together, as a group to address instances of
4 malfeasance? What controls can we put around, operational
5 controls, transparency can we provide.

6 But, you know, we are open. We'd like to
7 continue to discuss these issues.

8 The last thing I'll say is that the structure
9 contemplated does put additional burden or
10 responsibilities, if you will, on the DCO, itself. In
11 fact, they're going to have to take a -- some
12 responsibilities during the liquidation of a GCP
13 portfolio.

14 I think we have to make sure that they're, you
15 know, willing, capable, and are able to build that
16 capability in -- in the time necessary to implement any
17 kind of changes.

18 BOB WASSERMAN: Chris?

19 CHRIS PERKINS: I want to ask Mark a question
20 first.

21 For the responsibilities that you -- you put
22 out there, that would be outside the GCP's set of what
23 you're signing up for, is it your anticipation that you're
24 guaranteeing FCM at that point in time, or whoever is
25 sponsoring you into the clearing house, would fulfill

1 those responsibilities?

2 Are you anticipating that the DCO either
3 wouldn't have access to those types of responsibilities or
4 would need to find some other way to cover that?

5 MARK SZYCHER: I apologize. I'm not sure I
6 understand the question.

7 CHRIS PERKINS: Okay. You don't want to --
8 you don't -- you don't want to be on the hook if their
9 positions are allocated at the end of a waterfall. You
10 don't want to make guaranteed fund distributions I think
11 were the two that you raised, as two examples of
12 responsibilities that GCP would not have in this
13 structure. Right?

14 Are you anticipating that the DCO's not having
15 those resources available to it, or that your sponsoring
16 FCM would covering that as part of the relationship you
17 would have with the FCM?

18 MARK SZYCHER: I think it could be either of
19 the latter two, but, in essence, it would not be a
20 guaranteed clearing participant's responsibilities.

21 CHRIS PERKINS: So at the end of the day, as
22 long as it's not you doing it, you don't care, to kind of
23 shorten it?

24 MARK SZYCHER: Well, we -- we care deeply
25 about -- about systemic risk, and then appropriate and

1 proper operation, but from purely our own self-interest we
2 are not concerned as long as, in essence, what is
3 devised -- the system works under that regime.

4 CHRIS PERKINS: Okay. And, Bob, a question to
5 you, and as you understand this, and we begin to work
6 through it, it seems to me there's a slight conflict that
7 we would have to exempt under your idea -- your
8 questioning -- your line of questioning around the rule --
9 if the DCO had rule around some of this that may we have
10 to, as a DCO, provided that we could get comfortable with
11 such a structure, that we would have to file -- I'm
12 guessing -- for an exemption to make sure FCM's in this
13 case are not collecting more than DCO minimums as part of
14 the new promulgated rules?

15 BOB WASSERMAN: So, as I understand the model,
16 and I probably should -- now is a really good time to
17 mention the -- the other disclaimer, which is, of course,
18 that anything that I say does not necessarily represent
19 the views of the staff, the Commission, or even myself if
20 one of my bosses tells me to change my mind.

21 UNIDENTIFIED SPEAKER: On behalf of the
22 (participants talking at the same time) -- we're happy to
23 hold you accountable, and we know how difficult that is.

24 BOB WASSERMAN: And so in this model it seems
25 to me that's part of where there would not be a customer

1 relationship.

2 Essentially -- and it strikes me for a number
3 of reasons. And, again, I will reiterate my disclaimer,
4 but it strikes me for a number of reasons that, on the one
5 hand, you do need somebody stepping up to those
6 responsibilities. We need to balance off the risks to the
7 DCO.

8 I think one -- I think also that this is the
9 sort of thing that would benefit from rule making, so that
10 there is essentially a supporting rule structure that
11 addresses some of the -- both addresses some of these
12 issues and gives, perhaps, some at added legal certainty
13 to how the model works.

14 And so part of that, I think, is then the FCM
15 would not be collecting the collateral. It's the DCO.
16 One would expect the DCO to collect at least its normal
17 minimum level of collateral from these participants, as
18 from any other. I don't know if that answers --

19 SETH GROSSHANDLER: Seth.

20 I think it does. The sounds to me like you --
21 because it's not customer, maybe the other rule doesn't
22 impact, but maybe you could volunteer to write another
23 rule that there's going to provide certainty to that. I
24 won't commit you to that at this point.

25 But, you know, from my perspective, I -- I

1 think we all share the same concern, as Chris said, you
2 know, protection of customer collateral is a -- paramount.
3 We get that.

4 Protecting customer collateral and de --
5 destabilizing the system, we become concerned at that
6 level. So that's why these two issues that you raise for
7 us, or at least for me, running the DCO, is -- as long as
8 we're all in the same net position, I think we -- we find
9 a way forward.

10 When someone here -- and it's always someone
11 that's going to end up with a different level of risk and
12 how they're going to go compensated for it, how they're
13 going to manage it or whatever that may be, that's where
14 it's becoming a little bit concerning.

15 We all -- all the clearinghouses represented
16 here today, rely, in varying degrees on our membership to
17 provide certain functions. If we're going to start
18 cherrypicking which of those functions that we're taking
19 away, that they should provided or we should provide,
20 we're fundamentally changing the structure of clearing at
21 this point, and maybe -- maybe that's where we need to get
22 to at that point.

23 I'm not exactly sure that's where we've gotten
24 to in the current set of regulations that we're operating
25 under or managing to, but as we do that I become very

1 concerned that we are losing that level protection that
2 the membership does provide.

3 And we can take about moral hazard, and
4 that's -- you know, it was belabored in the last panel.
5 We don't need to go back there, but that is an issue
6 facing us at this point in time.

7 I want to find every way I can to protect your
8 collateral all the time, or the -- at least to value your
9 collateral. You know, actual collateral -- we'll have a
10 different conversation on that one -- but the value of
11 that collateral.

12 I'm just very concerned that if we begin to
13 cherrypick those things away, we're going to lose those
14 who provide this membership level for the DCO's, and that
15 seems to be a very bad outcome in the world we're trying
16 to stabilize.

17 BOB WASSERMAN: Tim?

18 TIMOTHY DOAR: Okay. Thanks. Tim Doar, CME.

19 So I feel compelled to just sort of offer some
20 context for how we got here.

21 You'll remember that in the early stages of
22 the comments, that the CFTC put out around customer
23 protection, that the CME was for a futures model with the
24 proviso that added disclosures to be made by the FCM to
25 clients of better assessments could be made to fellow

1 customer risk.

2 As events transpired, fellow customer risk
3 became -- what to do about it became what the centerpiece
4 of CFTC rule making initiatives, and ultimately LSOC was
5 the methodology that carried the day with respect to
6 cleared swaps. So be it.

7 Now, the question then becomes, though, from
8 the standpoint of some clients, in considering this issue
9 of how to protect against fellow customer risk -- you've
10 heard it mentioned a couple different times: Why should
11 the move to cleared -- to clearing for -- for swaps
12 occasion a weakening of protections that some clients
13 currently enjoy in the current OTC setup?

14 And so we considered the question: What do
15 you do to assure client protection in that kind of a
16 model? And the answer was: Well, work within the context
17 of the Bankruptcy Code. I'm not a lawyer, by the way, but
18 761(10)(D), you know, of the code, to assure that the
19 client's property is not customer property, per the
20 Bankruptcy Code, and so therefore if the client has no
21 claim on the estate of a bankrupt FCM, it's not subject to
22 766 H, rateable distribution.

23 So what does that mean? It means that, as
24 Mark suggested in his comments, that the entity that
25 avails itself of this approach has an account directly

1 with the DCO, and that, though, the FCM has some kind of
2 recourse, we think a secondary lien to the collateral, and
3 that's all that changes, you know, in the way that we've
4 thought about this.

5 So the question of: Well, who provides
6 resources to the waterfall? The answer is: The
7 guaranteeing FCM.

8 Now, look, there's a lot of issues that this
9 proposition has promulgated. The relationship between the
10 FCM and the guaranteed clearing participant is a very good
11 example of that, the quality of the claim of the FCM on
12 the collateral of the guaranteed clearing participant
13 matters for a variety of reasons.

14 The relationship between the guaranteed
15 clearing participant and the bank that provides settlement
16 services is another good example of a relationship that
17 needs to be delved into. The relationship between the DCO
18 and the FCM is equally another relationship that needs to
19 be delved into.

20 Costs, in general, are a good topic. We can't
21 really understand what the cost implications are to the
22 model until we figure out, for instance, what the
23 guaranteed clearing participant's relationship is going to
24 be with the bank. Who's going to provide the funding and
25 liquidity for -- for the account to meet settlements is a

1 primary example of that.

2 So -- so, that said, we were interested in
3 exploring how to advance the discussion or on how to offer
4 this kind of methodology, but -- and I respond very well
5 to the notion that we've got to do so in a balanced way.
6 It doesn't do us -- any of us any good to put a
7 methodology in place that fundamentally changes the
8 landscape of the relationship between DCO's, FCM's, and
9 clients in a way that offers the potential for
10 destabilization. So it's a tricky subject, but one that
11 we see no reason not to address head-on, so we can begin
12 to understand what is achievable.

13 BOB WASSERMAN: Joe?

14 JOSEPH OTT: Joe Ott, Kansas City Board of
15 Trade.

16 And we're actually of the opinion that these
17 subaccounts should be required to post a guaranteed
18 deposit. We felt like a guaranteed deposit will provide
19 protection to both the DCO as well as the FCM.

20 The subaccounts are protected when the FCM
21 defaults, but if the subaccount defaults -- what
22 protection does the FCM have? We just felt like the -- if
23 they are required to post a guarantee deposit, that will
24 be additional protection for the FCM.

25 And we also felt like if the subaccount would

1 default, then the DCO is without -- has a participate
2 without a guarantee. So that would provide some
3 additional support and comfort, I think, to the DCO's if
4 we knew that there was additional funds to attach to
5 there.

6 BOB WASSERMAN: Joe, if I could just press you
7 on that for a second, when you're speaking of a guarantee
8 deposit, are you talking about a sum over and above margin
9 that would guarantee the participant's obligations or are
10 you talking about a contribution to the mutualized default
11 structure which could be used in the event of the default
12 of a different participate?

13 JOSEPH OTT: No, it would just be for the
14 clearing participant.

15 BOB WASSERMAN: Essentially this would be
16 more -- something that is -- economically --

17 (Participants talking at the same time)

18 JOSEPH OTT: It's a margin --

19 BOB WASSERMAN: -- equivalent to margin or
20 just an additional amount.

21 JOSEPH OTT: Yes.

22 BOB WASSERMAN: Mark?

23 MARK SZYCHER: Mark Szycher with CIEBA.

24 I'm struggling to understand the -- the
25 gentleman from Eurex's comments insofar as even if we were

1 not proposing this structure, the FCM would still be on
2 the hook for my obligations as -- as a traditional client
3 of the FCM.

4 The amount of margin that the DCO requires
5 should allow for the market risk of the positions that
6 I've entered into, that is, within some reasonable level
7 of confidence with a fairly severe market move.

8 Furthermore, in -- in any traditional model,
9 and as well is contemplated in the CIEBA CME model, if the
10 sponsoring or guaranteeing FCM feels, from -- as a matter
11 of credit worthiness or perhaps lack of creditworthiness,
12 additional margin beyond that, that was demanded by the
13 DCO, were necessary, that is a commercial matter between
14 the client and the FCM, and again that is contemplated
15 here -- the bankruptcy issues around liens, not
16 unimportant, but at the same time are contemplated here.

17 So again we struggled to understand how
18 this -- how this scenario that you described is, A,
19 different from today, and, B, not dealt with via DCO
20 margin plus any add-on that the clearing member might
21 demand.

22 BOB WASSERMAN: Ken?

23 KEN ACKERMAN: Well -- I'm sorry.

24 BOB WASSERMAN: Folks, please do make sure --
25 sometimes we're a little bit soft spoken. Please make

1 sure you're talking into the microphone, so that both we,
2 as well as the court reporter, and the folks on the phone
3 can hear.

4 KEN ACKERMAN: I'm Ken Ackerman with the
5 American Feed Industry Association.

6 Just looking -- looking at this on behalf of
7 the -- of customers in the agricultural world, who tend to
8 be smaller -- relatively smaller customers, the question I
9 had -- and I think you may have just answered it is: If a
10 farmer has -- posts a -- establishes an account, has a
11 position at an FCM and there is a bankruptcy anywheres in
12 this chain, either at the FCM at the GC -- at the -- at
13 the GCP or anywheres in the chain, can the customer
14 ultimately still hold the FCM accountable for their money?

15 Does the -- does that relationship -- does
16 that relationship survive? Is the FCM still accountable?
17 Can the farmer still look to the FCM for their money?

18 MARK SZYCHER: Mark from CIEBA.

19 In other words, Ken, are you saying for the
20 margin that they posted against their positions, to the
21 extent that they are the one -- they, the client, is not
22 in default?

23 KEN ACKERMAN: Correct.

24 MARK SZYCHER: Well, we would look at this
25 model as providing a significantly greater degree of

1 protection in exactly that situation.

2 To the extent that the client is the one --
3 the customer is the one who has defaulted, of course, all
4 bets are off at that point, and we are -- we're -- we're
5 not looking in this model in any way to diminish the
6 protections that margin provides to both the DCO as well
7 as the FCM.

8 And, again, we're happy to grant liens. We're
9 happy to do anything that doesn't entangle us into a
10 bankruptcy stay, but we do that believe this model --
11 clients that avail themselves of this model, put the DCO
12 and the FCM in exactly the same economic position with
13 respect to recourse that they had previously, but provides
14 the clients with protection against malfeasance,
15 protections against -- in essence, situations that were
16 not of their own doing.

17 KEN ACKERMAN: So it does not weaken the
18 ability of the ultimate customer to seek recourse, against
19 the FCM because there was another player involved?

20 MARK SZYCHER: Well, we believe the DCO --
21 Mark from CIEBA.

22 We believe that -- that this model provides
23 the DCO with all the recourse -- or we're intending to
24 provide the DCO with all the recourse against the FCM that
25 it would have in -- absent this scenario.

1 BOB WASSERMAN: So just to clarify, though, as
2 I understand it, under this model, the -- a guaranteed
3 clearing participant is responsible to the FCM and the DCO
4 for its defaults. The FCM is responsible, just as it is
5 now, to all -- both its -- well, it's responsible,
6 actually, only to the clients, because the -- under this
7 model, the FCM would never be in a position of owing the
8 guaranteed clearing participant anything.

9 It would, if necessary, make good its
10 guarantee to the DCO, in which event it has, in essence,
11 lent money to the GCP, but the collateral would be in the
12 hands of the DCO, and therefore the FCM would never owe
13 the GCP anything.

14 The clients, on the other hand, the -- the
15 customers would remain in the same relationship, which is:
16 The customer owes the FCM for their defaults. The FCM,
17 holding the collateral, owes that collateral back to the
18 customer.

19 The point is: In the event of an
20 insolvency -- in the event of an insolvency of the FCM,
21 the FCM would owe the customer's money, namely, the
22 collateral that it's holding. And to the extent the
23 perfections of otherwise being imperfect, then the --
24 those customers are exposed to loss in a way that the
25 guaranteed clearing participant, who are not -- who do not

1 have funds in the hands of the FCM would not be.

2 And the -- and, of course, it would be, on the
3 other hand, from the perspective of the guaranteed
4 clearing participant, a more expensive relationship, in
5 terms of the -- the operation -- if nothing else, the
6 operational infrastructure necessary to do that.

7 Does that -- is that in accord with the folks'
8 understanding?

9 MARK SZYCHER: Agreed. Mark from CIEBA.

10 Just two quick comments, Bob, one of which
11 relates to the possibility that something is owed back to
12 the client in a client-default situation.

13 If a circumstance were to -- were to arise
14 that the amount of margin that was posted by the client is
15 more than enough to satisfy any obligations to the DCO, as
16 well as the clearing member, the residual, of course,
17 would come back to the client.

18 Another point to make, very quickly, is what
19 one -- at least we believe one of the beauties of this
20 model is, in the event of an issue with an FCM that could
21 be a -- frankly, a business issue, insolvency issue, or
22 other issue, the -- we envision that from a quote/unquote
23 porting perspective there would be no porting to from one
24 FCM to another in the traditional sense.

25 That is, if all -- if I were, as a GCP, in

1 good standing with my FCM, but something happened to my
2 FCM, I don't have to extradite myself from my FCM in a
3 sense. What I need to do is I need to find a substitute
4 clearing member to become the sponsoring clearing member
5 for my guaranteed clearing participant relationship. So
6 nothing else changes with the exception of the guarantor
7 having gone from firm A to firm B.

8 KEN ACKERMAN: Okay. Just one more question
9 along these things. Do you -- do you picture any
10 situations that could arise where the customer would have
11 to look -- be concerned about a bankruptcy of the GCP?

12 MARK SZYCHER: Mark from CIEBA.

13 I'm not sure I understand the question, Ken,
14 in -- in the sense that the customer is the GCP, at least
15 the way we're asking it.

16 BOB WASSERMAN: I think the question is: How
17 could a default and insolvency of a GCP, how, if at all,
18 could that redound to the harm of the customers of the
19 guaranteeing FCM?

20 And I -- I think the answer is probably not,
21 in the sense that they would -- if the FCM became unable
22 to essentially continue, because it had to make good on
23 its guarantee, and it was unable to do so, those customers
24 would still have their segregated funds segregated.

25 Now, obviously a default of an FCM is always

1 going to be -- you know, even if everything's in seg, at
2 the very least, disconcerting, and if -- if there's not a
3 transfer very promptly, harmful in that sense, but that
4 would be the case of any fellow customer.

5 But I think in fairness the question really
6 is: Is this going to be put them at a different risk than
7 they would be in the context of an ordinary customer
8 relationship?

9 Dan, I know you've been waiting to speak for a
10 few moments.

11 DANIEL MAGUIRE: Thanks, Bob. Daniel Maguire
12 from LCH Clearing House.

13 So listening to the conversation and the
14 various industry forums around us, I still struggle to see
15 how any of this isn't solved by LSOC.

16 And we -- well, I think members are sure we
17 embarked on LSOC at a roundtable when Bob introduced it in
18 October 2010. And the reason for getting around a table
19 was the identification of fellow customer risk, that some
20 did know and some didn't know they were exposed to in the
21 futures model.

22 We worked hard as an industry to arrive at a
23 solution, which is LSOC, and that's to -- for all intent
24 and purposes removes fellow customer risk. It protects
25 the customer from the default of the FCM.

1 And actually something that's not been
2 discussed, and as a DCO, it's a hard thing to say, but
3 also protects the customer from a DCO default, as well,
4 which you have to consider in all of this.

5 The other aspect that emerged from this was
6 the potential for investment risk. Something new that's
7 been introduced subsequently is the context of malfeasance
8 and fraud risk following MF.

9 But in terms of how this works -- let's just
10 talk through this pretty quickly. If a client has a
11 margin of 100, and the clearing member wants to introduce
12 that to the clearinghouse, to the DCO, the clearing member
13 has to post 100 -- 100 whatever. It could be treasuries.
14 It could be, you know, MBS or whatever. It has to post
15 100, and that 100 is held at the DCO.

16 I'm not going to give that money back to the
17 FCM in their demise, in their default. I'm going to hold
18 that money. I've got the client position. I'm going to
19 let the -- port the client on their associated collateral
20 to a non-defaulting FCM.

21 There is a quirk in the Bankruptcy Code that
22 emerged from this about ratable distribution, but that
23 really isn't about fellow customer risk. It's about this
24 investment risk, and investment risk is basically if we
25 receive cash or we receive securities, and we like to

1 liquidate that as a DCO, to enable porting, if we make
2 losses that exceed the value of that -- and that's going
3 to happen when there's a large market move or where the
4 haircuts that we apply to DCO, which should be prudent are
5 breached.

6 If we're doing our job that shouldn't happen,
7 and we protect the value. So we don't protect the piece
8 of paper you give. If Mark gave 120 with securities, but
9 we haircut at 20 percent, so therefore had a market value
10 of 100, we protect 100. That's what we do as a
11 clearinghouse.

12 So I think there's some -- some sort of bad
13 press around LSOC and what it does. And there have been
14 different interpretations of this.

15 So in my view and our view -- and we actually
16 have implemented this in December of 2009 in Europe, and
17 every client in Europe is using an LSOC type model.
18 Appreciate that there are different Bankruptcy Codes
19 insolvency laws there, but it -- it is used and is
20 practiced.

21 It does remove fellow customer risk. The DCO
22 is, if they're doing their job, can either, A, mitigate,
23 or, B, remove the investment risk, or, C, use the default
24 waterfall to cover that.

25 Fraud risk is a totally different thing, and I

1 don't think we're solving all the fraud risk by putting
2 any of these proposed models in place.

3 I think just to clar --

4 JOHN TORELL: Whoa, whoa, whoa, whoa, whoa.
5 The concept of a custody account can protect you again
6 operational risk, or fraud, or something like that. So
7 LSOC does not solve MF Global.

8 A bank vault or custody account at a custodian
9 bank solves that problem, at least from our perspective.

10 DANIEL MAGUIRE: Okay. And if a custodian
11 goes into default, what happens?

12 UNIDENTIFIED SPEAKER: How does a custodian go
13 into default and my assets -- or my client's assets aren't
14 protected?

15 Bank of New York goes into default. Those
16 monies are in a custody account. That -- it's not a
17 counter-party risk issue.

18 So if Northern Trust or Bank of -- you know,
19 State Street, or anybody else goes into default, I don't
20 care, because my assets are protected, and I can get them,
21 I think.

22 DANIEL MAGUIRE: I think that's not right,
23 because you're going by cash you're probably just an
24 unsecured --

25 (Participants talking at the same time)

1 JOHN TORELL: All right. I'm going to put
2 treasuries in there. Am I protected now?

3 UNIDENTIFIED SPEAKER: More protected,
4 certainly.

5 DANIEL MAGUIRE: But not fully protected.

6 JOHN TORELL: A lot better than LSOC, right?

7 DANIEL MAGUIRE: I'm not disputing that.

8 JOHN TORELL: Yes, you did. You just said
9 it's not going to -- it's going to solve the problem.

10 DANIEL MAGUIRE: I didn't say it would solve
11 the whole problem.

12 BOB WASSERMAN: Okay. Let --

13 DANIEL MAGUIRE: Just moving on, just going
14 back to the points that were raised about LSOC in the
15 previous debate, there was some comment with regard to no
16 DCO actually saying what the size of the cost was.

17 Some CC -- DCO's said that they'd increase
18 their initial margins by 50, 60 percent. I don't know if
19 that's happened yet, but from our perspective we were very
20 public. We don't rely on this. We do not expect to
21 increase margins. There will be no increase in margins.

22 Secondly, there will no increase in default
23 fund, because we do not rely on this fellow customer risk
24 or this or this capability to raid the other customers in
25 the eventuality of default.

1 We do not rely on that, and we feel prudent in
2 doing that, and everybody's aware of this risk and feel
3 very vindicated by that. 75 percent of client funds left
4 Lehman five days prior to its default. I think if we saw
5 a similar scenario and a gradual decline we'd see a higher
6 number than 75 percent.

7 BAS ZEBREGS: Then can I comment on that?
8 The -- you just mentioned the -- Bas Zebregs from the
9 European Federation of Retirement Provisions.

10 You just mentioned that the whole of Europe is
11 now using LSOC, and, indeed, big progress has been made by
12 various CCP's, and swap clearing is the dominant CCP,
13 especially for interest rate swaps, but it doesn't mean
14 that buy side in -- in Europe is -- is fully satisfied and
15 fully happy with what is going on.

16 And what is a different, I think, with the
17 U.S. is that if you look at any legislation, the first
18 thing they say is that, both for OTC enlisteds --
19 products, a CCP should at least often -- offer an omnibus
20 and a client segregated option. So that means there is no
21 ratable distribution issue. At least you have a choice.

22 And second of all -- yeah, I think Mr. Baldwin
23 can -- can elaborate on that more, but there are CCP's,
24 and I think swap clear's thinking about it as well, and --
25 about further segregated models.

1 And I think in the end Eurex maybe has four
2 segregated -- segregation models in the end.

3 BYRON BALDWIN: Yes, that's correct. I guess
4 from Eurex's point of view we aim to offer the buy side
5 choice. So we will be, forth quarter of this year,
6 offering LSOC, and so from Eurex's point of view, our aim
7 is to offer LSOC full segregation.

8 In -- in all answer to Ken's comments, its --
9 its full segregation is achieved by double title transfer
10 at a separate custodian account, away from the FCM, daily
11 statements in terms of collateral, collateral movements
12 ascent to the registered customer, i.e., the buy side
13 account, as well as the FCM.

14 The FCM has total knowledge of the collateral,
15 because it's trouble title transfer. So it goes through
16 the clearing member, and there is no transformation -- and
17 so the buy side has got complete segregation.

18 But the other important thing is that they've
19 got choice. They can go down the road of LSOC or they can
20 go down the road of -- of individual segregation on a
21 per-fund basis and per-registered customer is the Eurex
22 individual segregation model.

23 BOB WASSERMAN: Okay. Hilary.

24 HILARY CORAL: Thank you. Hilary Coral
25 Franklin Templeton.

1 You know, Dan, first of all, I completely
2 agree with you on the -- you know, margin, and that it
3 shouldn't make a difference, you know, from the DCO
4 standpoint on the level of margin that they're charging
5 under either of these models. It's based on the market
6 risk of that particular investment. So I think that makes
7 complete sense.

8 I do think, though, that your comment of --
9 you know, you kind of blew through, I think, some of the
10 risks that are still inherent in LSOC. You've got, you
11 know, accounting risk at the FCM that they've tracked
12 this -- you know, all this money correctly that's in
13 omnibus accounts.

14 You have investment regs, and then, honestly,
15 you know the fraud risk. And -- and I do think those are
16 three real risks that this kind of full segregation model,
17 you know, does alleviate.

18 DANIEL MAGUIRE: I think just on the point
19 about the accounting risk, I think there are the different
20 models from different CCB's. So if you are reliant on the
21 FCM to provide you the positions on the cash balances or
22 the security balances, then I agree with that point.

23 The model we have in place is: We see through
24 to every subaccount, every subfund we calculate the risk,
25 the IM. We calculate the VM, the valuation, the

1 market-to-market. We calculate the DBO1, so we know what
2 we need to trade if there's a default of a client or
3 clearing member.

4 And to just put the record straight on that,
5 that's hundreds of -- hundreds of thousands of accounts
6 being calculated intraday and end-of-day for in -- for
7 swaps.

8 So if you're not reliant on the FCM for that,
9 I think it does remove that. That would be the first
10 point.

11 The point about investment risk, I fully -- I
12 admit I -- I accept, but I think DCO's -- that risk will
13 exist if there's investment being done by the DCO.

14 BOB WASSERMAN: So before we move on, I'm
15 going to interrupt the flow for just a few moments in the
16 sense that since the -- the topic of this is alternative
17 models, I just want to make sure that -- we've spoken
18 about, essentially, guaranteed clearing participant model
19 for -- we've spoken, of course, about LSOC and how it
20 works.

21 If there's somebody who has some third model
22 that they want to talk about, I'd like to give them a
23 chance to put that on the table.

24 ERIC BAGGESEN: Let me take a stab at that,
25 Bob. Eric Baggesen from CalPERS.

1 One of the things that is really obvious in
2 this entire discussion is that we're basically having a
3 great dilemma over exactly what constitutes a really valid
4 custodian of assets.

5 And the models that we currently have, have
6 moved into a place where we actually have custodial
7 entities also being entities that at times are taking
8 risk, and that risk can ultimately bleed through to the
9 client security.

10 And I think that that's one of our greatest
11 concerns, as a participant in this marketplace. In the
12 current over-the-counter market we find ways to secure
13 that our liability and our counter-party's liability in a
14 way that puts that -- that security off at a third party,
15 that, you know, is -- in essence, is not using that
16 capital in any risk-taking form.

17 One of the things that we've contemplated, as
18 a potential alternative model, is to actually utilize the
19 official custodians of our assets, in essence, as
20 collateral managers and have them facing our liabilities
21 to the clearing organizations, and literally
22 disintermediate that entire function from the FCM
23 category:

24 There are components of this that come through
25 in the CIEBA CME model. We have a certain amount of

1 attraction to that, because, in essence, then if we're
2 posting our collateral, the collateral is being posted
3 directly to the clearing organization, not through the
4 FCM.

5 So the clearing organization is getting the
6 gross value of our collateral instead of the net that
7 feeds through from the FCM, which then leaves us exposed
8 to FCM activities.

9 And if they were operating in an environment
10 that was consistent with, let's say, our custodial banks,
11 State Street over here, you know, we might have less
12 concern about that, but it's quite obvious that some of
13 the FCM's and this entire industry have not been able to
14 really understand the true risk imputed by participants in
15 this market.

16 We do not use these instruments in a leverage
17 fashion. So we can fully secure, basically, the
18 liabilities that we incur in this activity. It's the
19 presence of clients like State Street, or Vanguard, or
20 some of these other giant institutions, that not levered
21 players, that allow this entire risk sharing to happen
22 between customers, and now we've attached some of the
23 other market intermediaries in that.

24 And I think that this -- whatever models we
25 come to have to eventually really identify the risk that

1 the customers -- where -- where do defaults come from?
2 It's coming from levered players. It's not people that
3 have the capacity to secure their liabilities.

4 And as a fiduciary to CalPERS, I have a really
5 hard time thinking about exposing CalPERS' assets to
6 secure any other participant. That is a breach of my
7 fiduciary responsibility, ultimately.

8 So if I am knowingly, you know, securing some
9 other levered player in the marketplace, I actually really
10 have to consider that very, very strongly and determine
11 where I can even participate in that market structure.

12 BOB WASSERMAN: Let me just press you for just
13 a second. Are you talking about having the -- essentially
14 the -- the custodian guaranteeing your obligations to the
15 clearinghouse or not?

16 ERIC BAGGESEN: In the case of -- in the case
17 of what we're -- we've contemplated, in essence CalPERS is
18 fully capable of securing its liabilities. We have plenty
19 of collateral that we can put behind the positions that we
20 take in the derivatives market.

21 The question then, becomes: How can that
22 collateral be secured to protect CalPERS from any other
23 default in the marketplace and yet still be segregated out
24 for the benefit of the clearing organizations to defease
25 our liabilities?

1 That is exactly the kind of the activity that
2 we've set up with tri-party custody agreements, going back
3 decades, basically. And under the current LSOC model, and
4 any of the other existing models that operate in the -- in
5 the currently cleared futures markets, we basically give
6 up the security of that very clear segregation of the
7 assets.

8 So we would see, in essence, for players that
9 are not leveraged in the marketplace -- State Street
10 doesn't have to extend us credit. We can secure our
11 liabilities. That's a different kind of a customer from a
12 customer that actually needs someone to extend them
13 credit.

14 So there needs to be a separation in this
15 industry that attaches the cost of extending credit and
16 the risk of extending credit to the people that are
17 requiring it. And this whole mutualization model operates
18 because of the presence of institutions like CalPERS that
19 are not referred players.

20 If every one of an FCM's customers were a
21 levered hedge fund or something, they would have a really
22 hard time basically securing that kind of a potential
23 liability, and this is all about identifying and
24 allocating costs to the appropriate players.

25 BOB WASSERMAN: So if I could just -- on the

1 one hand what you may be describing as a model essentially
2 with having FCM's who are taking less risks or not
3 leveraging the collateral, and essentially tossing out
4 one -- you know, our Rule 125 and saying basically, no,
5 you just have to take what we have.

6 But beyond that, right now everyone in the
7 structure is either a customer of an FCM who is
8 guaranteeing them, or a direct participant, in which event
9 absent some slightly -- you know, some sort of guaranteed
10 model, they are exposed to the mutualized default.

11 And so if you're looking for a way to not be
12 exposed to mutualized default, I think you're going to
13 need somebody guaranteeing you who is.

14 CHRIS PERKINS: I want to seize upon one thing
15 you said, and I think we'd all agree that bad happens when
16 mutualization occurs.

17 And this was spoken about in the last panel.
18 We need the really focus on cultivating a defaulter-pays
19 model where people are paying for their own risk. That's
20 incredibly important to any structure that's put forth
21 going forward.

22 And one thing that we'd encourage regulators
23 to opine upon are minimum standards for an initial margin,
24 because as clearinghouses are commercial entities, and, in
25 theory, the lower the initial margin, the more attractive

1 it could be for client business.

2 So, you know, we encourage a very high level
3 of -- for the minimum standard, to ensure that the vast
4 amount of risk is mitigated through initial margin, so
5 that mutualization through guaranteed fund is minimized to
6 the largest extent possible.

7 RON FILLER: Thank you. Ron Filler, New York
8 Law School.

9 I -- I realize political winds are blowing
10 that changes are needed, and I don't think anyone here has
11 written as much about customer segregation or care about
12 customer protection as much as I am [sic].

13 I'm currently serving now on a special
14 committee at the NFA that we're considering a number of
15 different rule changes at the NFA dealing more with
16 reporting and disclosure. I know that's the topic for the
17 panel later this afternoon, so we can address that, but
18 I'd like to raise a lot of questions and issues regarding
19 this GCP model.

20 First, I don't understand why gross margin
21 doesn't eliminate the concern. Gross margin is requiring
22 FCM's to post at the clearinghouse the full amount of
23 margin for each individual client. There's a one-day
24 risk. I receive the money today. I post it tonight. So
25 there is a 24-hour risk on gross margin approach.

1 The client liquidates the position today,
2 returns it back. I have to return it back to the client
3 tomorrow. So there's that 24-hour risk, but other than
4 that, a gross margin model, I think, eliminates a lot of
5 the, quote, fellow customer risks or the concerns that
6 firms like an MF Global might misappropriate client funds.

7 The second thing of it is, under -- in
8 addition to gross margining -- this, I think, when all is
9 said and done with the FM Global, I really believe this is
10 going to be a 30.7 issue. And I know that's the subject
11 for tomorrow's panel with Gary, but I really believe it's
12 mainly a 30.7, and these issues -- this GCP issue does not
13 address 30.7, whatsoever.

14 The other part of this GCP model, if you want
15 to go forward with it, it -- it kills portfolio margining.
16 It kills cross-margining and approach. It's going to kill
17 the single-currency margining regime that we use now in
18 the futures market, and it's going to kill the global
19 clearing arrangement.

20 If I have a global client, and I was at
21 Lehman -- I'm probably the only one in this room who's
22 ever collected money from a client, but if you -- if the
23 client makes \$100 over in Tokyo and loses \$100 in the CME,
24 there's no margin call issue. Here, you're going to have
25 to have a lot more initial margin.

1 The other part I'm not hearing -- I'd like the
2 hear some more information on -- is what about excess
3 margin? An FCM has a right for the custody -- a customer
4 agreement to require more additional margin than that
5 required by the change or the clearinghouse. Is that
6 going to be covered in these CCP's or are they going to be
7 held by the FCM?

8 The CFT's own rules on DCO's requires the
9 DCO's to now require clearing members to collect more than
10 the initial margin. That's excess margin. Is that excess
11 margin going to be held by the FCM or is it going to be
12 held in these GCP accounts? So I think there's a lot of
13 issues that has to be addressed.

14 The other part of it is -- is there's a
15 operational risk. The operational risk is: How soon will
16 FCM's, who are going to act as guarantors, going to be
17 notified about a -- the clients putting money into the GCP
18 program? Is it the same day, the next day, two days
19 later?

20 When I was at Lehman we had a lot of pension
21 plan account. We had a lot of mutual fund accounts. Many
22 of those accounts were managed by large-asset managers who
23 instructed the custodial banks at the pension plans and
24 the mutual funds who sent money in -- and this is just
25 through into one pot, and I can't tell you the number of

1 times we had to go back and say, "We didn't collect your
2 money today," but we knew by the close of business that
3 day whether or not the initial margin or variation margin
4 came in.

5 How soon will FCM's be notified, because
6 they're assuming the guarantor in case?

7 The other part of it is -- and I think you
8 have to have a lien and secured of -- the FCM's have to
9 have a lien and security interest, because per the
10 customer agreement, if the client doesn't make these
11 payments to the GCP program, they have the right to
12 liquidate as part of margin.

13 Margin -- if you look at every case law out
14 there, margin is there for the benefit to protect the risk
15 of the FCM, and if you have a lien, and you have a
16 security interest -- I'm not so sure 760 H -- 766 H
17 doesn't apply, because is that not considered kind of
18 possession and control when I have that type of lien and
19 security interest over that account?

20 So I think there's a lot of issues we need to
21 raise. I think there's a lot of issues that need to be
22 addressed, and I haven't heard all the answers yet, before
23 you can go down this GCP model.

24 Thank you.

25 BOB WASSERMAN: Mark?

1 MARK SZYCHER: Let me try to unpack some of
2 those several good questions and good issues, I think,
3 many of which we've -- we've spoken about in a -- a
4 smaller set of participants regarding our conversations.

5 The first of which is gross margin eliminates
6 concerns -- or the contention that gross margin eliminates
7 concerns. We certainly agree that gross margin eliminates
8 some concerns, and in particular the concerns about
9 investment risk, that is to the extent that substantially
10 all the gross margin that is collected from clients then
11 gets, in essence, sent up to, if you will, the DCO.

12 The amount of money to be played with, that is
13 the difference between gross and net, obviously shrinks
14 maybe to zero, but it shrinks to perhaps a diminimous
15 amount.

16 That said, I think you did identify the
17 one-day transit risk, which is a bit of concern, and as
18 well we would also argue that from the perspective of
19 porting, we could still end up caught in a -- an FCM
20 bankruptcy situation whereby we are, in a reasonable
21 period of time, unable to ensure that our positions are
22 maintained through an FCM bankruptcy.

23 And that -- that was a very significant
24 concern of a number of public companies who held
25 commercial hedgers, who held positions through MF Global,

1 that is, my FCM is no longer in standing with my with --
2 with the DCO, and therefore do I have a -- do I have a
3 significant problem?

4 The 30.7 issue, I'm not a risk manager. I'm
5 not an attorney. So I -- that one I can't speak to.

6 With respect to this killing portfolio
7 margining, it's a little bit difficult to speak to that
8 concern, albeit is a legitimate one. I would suggest
9 first that there may be ways in the CME CIEBA model to
10 address that. I'm not sure we've addressed it as yet.
11 We've left it as a bit of place holder.

12 That said, if that -- or since this is
13 intended to be voluntary on the part of clients, to the
14 extent that, as a business matter, a client views a
15 sufficiently large disadvantage, as to make this an
16 untenable business proposition, then they simply wouldn't
17 adopt it.

18 With respect to excess margin, it is our
19 expectation that any excess margin, that is margin above
20 the DCO minimum, that has been required by the sponsoring
21 clearing member would, in fact, be held at -- at the GCP
22 account, that is in the individual segregated account, and
23 that account would be in the name of the customer for the
24 benefit of the DCO.

25 But in some way, that we've talked about and

1 may talk about later today, the interest in some way can
2 be, as a business matter, secured, if you will, with
3 respect to the FCM having a claim on that if needed.

4 Last but not least, in terms of operational
5 risk and timing of the payments, another great issue the
6 gentleman just raised -- and something we've been thinking
7 about a lot, and, in particular, I believe it was on the
8 last panel, the -- the professor from, I believe, the
9 University of Maryland, had brought this up regarding: Is
10 there enough capital, in essence, in the system, once swap
11 clients join a cleared paradigm for FCM's, in essence, to
12 be fronting money overnight or intraday to a hundred --
13 several-hundred-trillion-dollar-swap market?

14 We -- we remain very concerned about that, and
15 in this model we've contemplated the idea of -- and the
16 gentleman from CalPERS mentioned this in a sense -- that
17 transfers could happen, in essence, as a matter of book
18 entry, that is, the DCO settlement bank, who's likely also
19 your custodian bank or could become your custodian bank,
20 would have sufficient assets such that those transfers, in
21 essence, would be book entry transfers on the part of the
22 DCO settlement bank, and the sponsoring FCM could, in
23 fact, be notified within a sufficient amount of time.

24 We're looking on the order of about an -- 45
25 minutes to an hour prior to 7:30 Central Time, such that

1 if a topping-up of the DCO settlement account were needed,
2 that the FCM would have to do it within that timeframe.

3 I hope I've addressed some of your questions.

4 BOB WASSERMAN: Oliver?

5 OLIVER FRANKEL: Yes. Oliver Frankel, Golden
6 Sachs, representing ISDA here.

7 With regard to margin calls and -- as you have
8 in your model, FCM's as guarantors cannot pre-fund
9 guarantee TCP's, margin calls, because they would be a --
10 it would be essentially a gross call. We'd have no
11 ability to net gain with losses in that call.

12 And the size of those calls would then be very
13 big, and that would be a problem for us. So you're
14 proposing that you make your -- you make your own calls,
15 you meet your own call -- you meet your own DCO calls,
16 which is great.

17 The book entry transfer needs to be done in
18 cash, and if it's considered that you'll have mainly
19 treasuries or other securities in your settlement bank
20 account, that could be a problem, because you'll need to
21 transfer -- you'll need to turn them into cash to provide
22 to the DCO, as variation margin needs to be in cash.

23 If the -- if the custodian has to lend you
24 against securities cash, we create a lending situation
25 with the custodian. And one of the problems we have in

1 getting the security interests or any sort of affected
2 claim on -- on the account if we had to pre-fund a call,
3 is the conflict we have with custodians. Custodial
4 conflicts just creates sort of problems as we've seen.

5 Other things that we would need, in general,
6 to guarantee GCP would be of course, approval of all new
7 trades, continuous real time visibility into at least the
8 value of the collateral in the account, good control of
9 that collateral, which, you know, double title transfer
10 clearly was, but so that the DCO and the FCM have say over
11 whether that amount gets reduced, can be -- withdraw
12 money -- can be withdrawn from it.

13 And we can -- I think that's basically -- the
14 only remaining point that I think is major is that the FCM
15 needs to be the liquidator in the case of default. I
16 don't know how we can truly guarantee something when
17 liquidation of those positions that we've decided to
18 guarantee is done by somebody else.

19 MARK SZYCHER: Mark Szycher from CIEBA.

20 Oliver, in terms of several of your points, I
21 agree with the majority of what you said. I'm not certain
22 that the pre-funding issue -- although I agree with your
23 conclusion, I'm not 100 percent sure I've gotten to that
24 conclusion by the gross net reasoning, but nonetheless I
25 think we've come to the same conclusion, that is, that

1 it's our expectation to pre-fund, and, in fact, we
2 actually have to pre-fund or fund, in essence, a -- a call
3 with cash for both various initial, and then subsequently
4 we could substitute -- at least on the initial side we
5 could substitute, you know, pending satis -- satisfaction
6 of that call.

7 That said, with regards to approval of trades,
8 completely agree. That's within your purview today and
9 would continue to be.

10 With respect to what's in the collateral
11 accounts, again you have that today, and this arrangement
12 via the DCO settlement bank, the individual seg account,
13 as well as the DCO settlement account, you'd continue to
14 have that same visibility you have today.

15 We also agree with respect to liquidation,
16 that is, today in the event of a customer default you have
17 full rights to liquidation, and that would be maintained
18 under the scenario that we're envisioning.

19 OLIVER FRANKEL: We actually need greater
20 visibility than we have today, because we need to monitor
21 all these things across many accounts, thousands and --
22 tens of thousands of accounts. And so it requires some
23 sort of more automation than is currently in place. So --
24 but that's something to be built and can be built.

25 BOB WASSERMAN: Bill, and then Scott, and then

1 Ron.

2 WILLIAM THUM: Thanks, Bob.

3 I think, just to start out, we at Vanguard and
4 certainly other members of the ICI are very intrigued by
5 the CIEBA model and want to make sure that it gets a full
6 airing, particularly if it's presented as an optional
7 model where the buy side that are interested in avoiding
8 certain risks and are prepared to pay the costs, can opt
9 into it.

10 That being said, there is a wide divergence of
11 views among the buy side on this particular topic. And I
12 think many ICI members, such as Vanguard, have supported
13 LSOC since its inception.

14 Others have questions about certain aspects of
15 it as to its effectiveness, certainly issues that Seth
16 raised earlier in the -- in the meeting are issues that I
17 think need to be cleared up.

18 Some ICI members frankly have suggested that
19 they'll cease swaps trading if LSOC is the best protection
20 available. That's an extreme view, but it is a view of
21 some of the members.

22 The main consensus view seems to be that there
23 needs to be a better understanding of the gaps in risk
24 mitigation under LSOC, and then a balancing of such
25 residual risks in the cost and delays associated with the

1 eliminating all such risks.

2 The other point that I want to make in
3 addition to that cost-benefit analysis is indeed the
4 port -- portfolio margining issue that was raised earlier,
5 and our concern particularly with the strategy for many
6 members that enter into a diverse range of products
7 trading with -- through prime brokerage relationships and
8 otherwise. They're very concerned about a model that
9 could potentially foreclose the many benefits to their
10 margin efficiencies and trading strategies if they -- if
11 the margin was locked up the way it has been suggested.

12 Things that I -- I want to talk about
13 certainly -- we've talked about fellow customer risks.
14 We've also talked about operational risk. I think that it
15 is a bit unfair to say that the LSOC rules do not address
16 operational risk at all.

17 And I think that Rule 2211 C and E certainly
18 enhance the requirement for the FCM to maintain
19 transparency in its record keeping and provide the DCO
20 with a full window into its clients, the positions, and
21 their margin. And the DCO is mandated to police that
22 information flow and make sure that it is accurate,
23 current, and timely.

24 In addition to that, we meet with FCM's all
25 the time. They're all hungry for business, for cleared

1 swaps. And what they tell us is, quite frankly, there are
2 due diligence exercises that we can embark on to address
3 things like operational risk and investment risk that do
4 not involve some of the strategies that have been talked
5 about so far.

6 So in terms of monitoring FCM capitalization
7 levels, the FCM's that we talked to don't maintain capital
8 at the minimal levels. They maintain capital at many
9 multiples of those levels.

10 They also suggest that we look to what is the
11 investment pool that they work with in terms of that
12 excess margin, and the FCM's we're talking to don't invest
13 across the full range of Rule 120 -- or 1.25 securities.
14 They only invest in the top tier, the most liquid forms of
15 investments.

16 Also looking at the audit history of the FCM,
17 seeing has it maintained seg, has it been found to be not
18 in compliance with the seg rules in the past? And finally
19 take a look at the FCM custodians and make sure that the
20 custodians -- that there is a rigor in selecting the
21 custodians, and -- and that the legal underpinnings of the
22 custodian relationships are sound.

23 We were also heartened by the suggestion that
24 there will be enhanced SRO oversight and newly
25 standardized best practices for the industry, including

1 daily reports by the FCM to the SRO with biweekly audits
2 by the SRO, regular audits for internal control structure
3 deficiencies, enhanced FCM employee qualifications,
4 tightening up the FCM evaluation methodologies for the
5 assets being held and indeed the trades, themselves,
6 tightening the custodial standards and tightening the
7 approach to the access to excess initial margin
8 segregation.

9 So among the buy side there is a diverse view
10 as to whether LSOC is sufficient, whether there are gaps
11 in LSOC that should be identified and possibly corrected
12 by remedial rule making, whether the gaps are so large and
13 the costs manageable to come up with a new approach to opt
14 into may be the answer for some market participants.

15 But I think it's -- it's important that as we
16 consider alternatives we really identify what is the gap.
17 Is the gap something that can be closed within LSOC by
18 subsequent rule making? Is the gap something that can be
19 managed through SRO, oversight, through due diligence by
20 market participants, or whether there needs to be a more
21 extreme answer.

22 BOB WASSERMAN: Scott?

23 SCOTT FERRIS: Scott Ferris from BMO Harris
24 Bank. I'm here to represent sort of the perspective of a
25 settlement bank.

1 In addition to sort of the operational
2 services that we provide in that role, one of the other
3 important services we provide is essentially liquidity to
4 the -- today, to the FCM's.

5 I guess, you know, a question that I would
6 raise, as we're talking about these models is: How
7 broadly these models are going to be offered to market
8 participants?

9 And that's important, in that as we understand
10 an -- you know, the individual segregation, you know, it
11 would be akin -- today we -- we process margin payments to
12 and from the FCM and the exchange on a net basis.

13 And so as you start separating and
14 individually segregating, it's -- as we understand it,
15 then we would receive margin calls directly from the DCO's
16 for each of those individually segregated accounts, and we
17 would be asked to at -- at -- early in the morning
18 before -- before the markets are and -- and liquidity's in
19 place, to meet those payments.

20 I think that, you know, if we look at market
21 participants, like those that are seated at the end of the
22 room here, that would be a very easy decision for us to
23 make. There are -- there are market participants where
24 they won't be rich in collateral. You will need to make
25 credit decisions, and the willingness of settlement banks

1 to do that, I think to some extent, may be in question
2 with certain market participants.

3 You know, and the other thing that I would --
4 I would point out that -- so under that structure, you
5 know, when the exchange calls for a margin payment, that
6 basically has to be met within 60 minutes. And so once,
7 you know -- so, you know, the -- the -- the scenario
8 that -- that Ron detailed where, you know, the margin
9 didn't get there that day, it didn't get there the next
10 day, that sort of flexibility that may have been afforded
11 to certain participants in the past cannot be -- it won't
12 be allowed by settlement banks that are effectively making
13 those on a -- on a real time basis.

14 BOB WASSERMAN: Robert then Oliver.

15 UNIDENTIFIED SPEAKER: No, I just wanted to --

16 (Participants talking at the same time)

17 BOB WASSERMAN: No, Robert. Do Robert first.

18
19 ROBERT LEE: Sorry, Oliver.

20 OLIVER FRANKEL: Sorry.

21 ROBERT LEE: It's Robert Lee at Deutsche Bank,
22 representing ISDA.

23 A number of commenters have raised the example
24 of tri-party custodial structures that are -- that are --
25 you know, that exist in the OTC market.

1 And, you know, one of the things, as we sort
2 of look to that and tried to bring forth -- you know bring
3 into sort of clearing space the same type of protections
4 for customers, I think we also need to sort of look at it
5 from the dealer's perspective in those structures.

6 I mean, the tri-party custodial structures,
7 there -- there is a contractual relationship among the
8 parties, and -- and direct recourse to the extent there
9 are breaches.

10 We need to think about how some of those
11 protections, particularly with respect to making sure that
12 there's transparency in terms of the amount of collateral
13 and the value of collateral that are in those custodial
14 accounts, but also protections against unauthorized
15 withdrawals. Right?

16 One of my concerns, and -- and hopefully this
17 is something that, you know, we -- we think about at --
18 you know, as we talk about these alternatives models, is
19 you know, if the -- the GCP, right, posts the collateral
20 or transfers collateral directly to the -- you know, to
21 the DCP accounts at the DCO's, we need to make sure that
22 the FCM's still have -- you know, because they still wear
23 the credit risk of the client -- they need to have sort of
24 full transparency at a real time level, right into the
25 value and the -- you know, of the collateral and the type

1 of collateral.

2 And we also need to ensure that there is
3 protections against unauthorized withdrawals, and it's not
4 only just unauthorized withdrawals with respect to the DCO
5 minimum margin that they're required, but any excess
6 margin that the FCM requires, as well.

7 So one of the questions I have for the group
8 is: Who's going to actually wear that risk, monitor it,
9 and how do we deal with it to the extent that -- and if
10 there's a failing there?

11 BOB WASSERMAN: Yes?

12 OLIVER FRANKEL: Yeah, I guess I was going to
13 say something but very similar, which is that if the
14 settlement bank were to fund -- you know, provide
15 liquidity on the basis of credit, that would create a
16 potential custodial conflict, that we actually would find
17 very difficult.

18 I think Robert said that much more
19 articulately than I.

20 BOB WASSERMAN: Peter?

21 PETER BROWN: Thanks, Robert.

22 So a couple of things. One of the
23 alternatives that we thought of is segregating just the
24 initial margin, which would require sort of a bifurcation
25 between the variation margin and the initial margin.

1 Yes, it gets very complex, the details around
2 settlement cycles, but we envision a role where the FCM's
3 obligations to DCO's to settle for customers doesn't
4 change. Customers, though, have the option to segregate
5 their initial margin into individual accounts at a
6 custodial bank. The DCO's have perfect transparency as
7 the FCM's would, into the balances in those accounts. So
8 it looks somewhat like the model we have today in the
9 bilateral OTC space.

10 And then, of course, because the FCM has --
11 has settled with the DCO already, with respect to both
12 variation and initial margin, the DCO is then over
13 collateralized because once the customer has funded, that
14 segregated account, and the FCM already has, then there's
15 a trueing up required between the FCM and the DCO, so that
16 the FCM is effectively being paid by the DCO.

17 But the customer at this point has the
18 transparency, you know, that it wants to be able to look
19 to the settlement bank's website and see for its accounts
20 it's got, you know, X of initial margin required to post
21 at DCO, and there it is.

22 And even though it's gross margining now, and
23 even though the DCO has the first lien control over those
24 assets, if customers want the option to do that, you know,
25 we think that that should -- is an option that should be

1 available.

2 And also by structuring it that way -- and,
3 again, it gets complex, no question. The FCM's role in
4 the settlement cycles doesn't change, that daily process
5 at 7:30 a.m. or whenever occurs, or throughout the day.

6 It's just that the customer then funds the
7 initial margin separately, and then the DCO's and the
8 FCM's true up to extent they are now over collateralized.
9 So, you know, we've -- we've talked through this
10 possibility with different FCM's and feel there's general
11 receptivity to it.

12 So it preserves the FCM-DCO relationship. The
13 DCO, has all the collateral it needs. The client has the
14 segregation of initial margin. The client can also -- can
15 always claw back excess, right, can choose not to leave
16 excess margin, but it's FCM, so its exposure remains the
17 initial margin, which is now segregated.

18 In terms of the lien issue -- and I can't
19 speak for others at the table, but I think the concern
20 there is not so much giving the lien, it's ensuring that
21 if the FCM were to become insolvent, that those positions
22 cannot be ported, right?

23 So as long as that ability to move positions
24 to another FCM is preserved and is not tainted by there
25 being an FCM lien over this account, however it's

1 structured, I think that's the paramount concern,
2 certainly for us.

3 There was a discussion of the custodian bank
4 risk here. You know, cash we recognize as deposit with
5 the bank and is at risk. However, you know, the
6 segregated account assets of customers today, we imagine
7 are sitting in these exact same custodial banks where
8 these segregated accounts would be held.

9 So, you know, we've done a fair amount of
10 research with our settlement banks or our custodial banks
11 in terms of, you know, the FDIC implication of a bank
12 failure, protection of fully paid customer assets sitting
13 in the custody range of these accounts at these banks, and
14 we're confident that those would be -- those would be
15 preserved for customer or beneficial owners. Cash is a
16 different matter.

17 One -- I'll just shift back a moment. I don't
18 think this room would be nearly as crowded if the MF
19 Global events hadn't occurred. And, you know, the -- the
20 malfeasance risk, you know, we think is real. Those
21 customers who choose to opt out, you know, means that
22 there's a lot of customers who remained in these pools,
23 you know, who may not have the -- the budget to pay for
24 the additional services.

25 And so, you know, as I mentioned in our

1 prior -- in the prior panel, you know, we think
2 significant attention needs to be paid to: How does that
3 customer seg pool -- what are the maximum optimal
4 protections around that pool of assets that prohibits the
5 FCM from whether inadvertently or by design,
6 notwithstanding rules to the contrary, from dipping into
7 that pool at the moment when its, you know, customers are
8 most at risk?

9 BOB WASSERMAN: Jeff?

10 JEFF HAINLINE: Jeff Hainline, representing
11 Advanced Trading and the National Grain and Feed.

12 And like Ken, we represent the buy side, but
13 the far end probably from the -- most of the other
14 participants, farmers, ranchers, and agra business.

15 The risks that LSOC covers, and the risks that
16 are still exposed seem -- there still seems to be many
17 risks in the LSOC regimen.

18 And moving forward with that regimen, with
19 those risks still exposed in this environment, doesn't
20 seem appropriate to our customers. While it is better
21 than where we may be today, it still has many holes in it,
22 not the least of which is the malfeasance, the investment
23 risks.

24 And so as you look at these other regimens,
25 whether it's the Eurex or the CME CIEBA, particularly the

1 voluntary nature of the CME CIEBA would be very attractive
2 as -- as an investment. It -- it transfers the
3 opportunity to have a higher degree of certainty at an
4 expense at the buyer's choice.

5 And so those are the kind of things that, as
6 we go forward, I hope the Commission waives heavily.

7 JOSH COHN: Taking me back a few minutes here,
8 but just on the -- on the question of custodial risk, it
9 seems there are a couple of levels of custodial risk.

10 And -- and we've talked about perhaps part of
11 it, but there's also the risk -- there's -- there are the
12 risks in custody that were observed when FIN SEG 10 was
13 amended in 2005, and, in fact, the CFTC saw some custodial
14 accounts that had come up short, with questions raised as
15 to exactly how the accounts had been managed.

16 But there's also a problem for custodians who
17 successfully managed their account, and in the CME CIEBA
18 proposal that would be somewhat more complicated than the
19 typical case because CME CIEBA raises the prospect of a
20 quad-party custody account. And so you have a custodian
21 with three parties around it with rights and obligations
22 to be served.

23 And there, there's the risk of the custodian
24 simply -- and -- and perhaps for good cause -- throwing up
25 its hands and throwing the whole thing into interpleader,

1 which, of course, doesn't particularly serve anybody's
2 long-term interests.

3 It's -- it's for these reasons that we,
4 thinking about this, at ISDA thus far, really prefer the
5 model, Bob, that you were perhaps broaching, where --
6 that -- that seemed custodian-free, and -- and that
7 essentially kept the money, for the most part -- kept the
8 collateral for the most part at the DCO, subject to rule
9 and perhaps security interests.

10 We would say that both is -- is the way to go,
11 but that seems to take one level of risk out of the
12 picture.

13 BOB WASSERMAN: At the risk of interrupting
14 the flow, I do need to raise one other thing.

15 Ken, earlier, you had asked what might be the
16 impact of one of these models on a guaranteeing FCM's
17 other customers. And I gave you what I should hasten to
18 add is one man's view, but I probably maybe shouldn't have
19 done that, but having -- regardless, I want to reopen that
20 question, because in looking at costs, I think we need to
21 look at costs and benefits, but we also needs to be
22 attentive -- what costs does this kind of an optional
23 model impose on those who do not opt in?

24 And I think that's something to be concerned
25 about, and so folks have views on that. I definitely

1 don't want whatever I might have said to squelch that, but
2 rather perhaps inform it, and so, Ken, you looked like you
3 had --

4 KEN ACKERMAN: Thank you. That's a very good
5 segue to the question I was about to ask. Quick -- quick
6 comment and then a question.

7 First, the comment. This has been a very
8 helpful conversation in looking at these different
9 options, the strengths and weaknesses of each, but clearly
10 at the end of the day I think it will be incumbent on the
11 industry and the Commission, as has been said several
12 times today, to come up with a solution so that the
13 outcome of this exercise is a system that still allows
14 another MF Global type event to occur five years from now,
15 as we -- as was the outcome with the Volume Investors
16 exercise a couple of decades ago.

17 The question I had is this, and this is for
18 Mark. And, again, this is just trying to understand
19 the -- the process.

20 You've made the point that the -- that the GCP
21 program would be voluntary, that people could opt in or
22 opt out.

23 As you envision it, are there classes of
24 people who you would expect to opt in and you would expect
25 to opt out? I'm -- specifically is this a system more

1 designed to benefit the larger players in the market? Is
2 this designed to benefit CalPERS or -- or the GM Pension
3 Plan?

4 Would this be as suitable for an individual
5 farmer, or an individual member of the grain trade,
6 someone from the agricultural world, the people who are in
7 a fix right now, in the wake of MF Global?

8 MARK SZYCHER: Mark Szycher from CIEBA.

9 With respect to benefits, I -- I'll maybe
10 answer your question more directly in a moment.

11 But I just want to be clear or to at least try
12 to be clear that our view is that -- that this model or
13 this -- this option, if you will, benefits all
14 participants to the extent that first it is available to
15 all, recognizing, of course, that with respect to whether
16 it's a DCO settlement bank, whether it's a sponsoring FCM,
17 no one's forced to do business with anyone they otherwise
18 would not do business with.

19 Now, we did say at the outset that we urged
20 the Commission to make it mandatory that DCO's offer this,
21 because obviously that -- if that part of the chain isn't
22 available, no one else can -- no one else can effectuate
23 these arrangements.

24 But that said, we would view this as a --
25 as -- as an option to all. We would also view this as --

1 it's a detriment to none, even if it turned out that
2 certain types of clients, by and large, might opt for this
3 and certain might not.

4 We also think that, to the extent that perhaps
5 a larger number of clients opt into this, there may be
6 some fixed costs that can be spread somewhat more broadly,
7 and thus the cost of this come down to other clients.

8 But perhaps to more directly answer your
9 question, I think we would somewhat have the expectation
10 that some of the larger clients that are fiduciaries to
11 pension plans and other clients, and furthermore have --
12 by the nature of their positions, demands for very, very
13 significant amount of collateral or margin, and therefore
14 have a lot to be risked -- a lot at risk, whether it's
15 operational risk, fraud risk, or other risk, would perhaps
16 be the more likely -- at least initially more likely
17 clients to opt in, but again that -- that does not
18 preclude other clients from opting in.

19 And I think just a last comment is that there
20 are many, many pension funds, institutional investors,
21 insurance companies, and others who have similar
22 arrangements in OTC land, as it is, and they're not -- we
23 think to some extent that the cost issue is a bit of a red
24 herring, not that there aren't some additional costs, but
25 frankly the cost of a couple of thousand dollars for a

1 custody account and some of the other processing
2 accounts -- processing costs, we don't believe are
3 necessarily well beyond the reach of a large percentage of
4 the clients.

5 Now, of course, they may feel that even, you
6 know, an extra dollar of cost doesn't buy them enough to
7 make it worthwhile, but we think that that's a -- that's
8 commercial decision, and it's not based on class or size
9 of clients, per se.

10 BOB WASSERMAN: Okay. And so we're building
11 up a bit of a line. Oliver, Ron, Seth, Dan and then Joe.

12 OLIVER FRANKEL: Well, I'll try and be quick.
13 So one of the -- one of the obligations of the TCP model,
14 I think to make it work for guaranteeing FCM's is that the
15 GCP funds its own margin calls and doesn't rely on the --
16 the guaranteeing FCM, which is a -- is not so much a cost
17 but it's an onus, I think, you know, with potential for
18 default if it's not done properly, you know.

19 Another issue is not so much for that, but
20 the -- you know, I'm not sure how we get to solve the
21 security interest requirement. I still haven't seen a
22 solution. And on the basis of those two things, I would
23 also recommend that we think about the LSOC model, the
24 2213 C paragraphs that allow for a DCO to provide greater
25 protection to protect excess collateral in the accounts so

1 that malfeasance and so on it -- to protect it against an
2 FCM's malfeasance and so on.

3 So it -- given that we have, in swaps
4 clearing, anyway, multiple CCP's clearing the same
5 product, I -- I would think perhaps the force of
6 competition would get them to create rules and procedures
7 that would also protect the clients that wish it, at the
8 extra cost of so doing, their own excess collateral with
9 the FCM.

10 RON FILLER: Thank you, Bob.

11 First let me try to answer your question.

12 Ron Filler, New York Law School. Sorry.

13 Let me try to first answer your question, and
14 then I have a question for the group if you don't mind.

15 In -- in clearing the world a zero-sum gain,
16 if I lose a dollar somebody else makes a dollar, and if
17 I'm one of the GCP's and I lose a dollar through the
18 trading of -- through that DCO, and the FCM acting as
19 guarantor doesn't have enough capital to meet my dollar
20 loss, then you have to look to the DCO rules, because
21 somebody's entitled to get a dollar.

22 They made a dollar that day, and you have to
23 look to the respective DCO's as far as which priority --
24 who they go after to collect, and under the futures world
25 they would go after the other customers of the futures --

1 of that FCM. Some of the DCO's have that type of right.

2 So I think there is a potential fellow
3 customer risk even under the -- the GCP model, only other
4 than if you can somehow -- you really strongly believe it
5 takes it completely out of the Bankruptcy Code, and -- but
6 then who pays that dollar to the customer who made a
7 dollar -- who made the profits that day? And it --
8 because if the FCM doesn't have that capital to pay. So
9 that would be my answer to it.

10 And I have a question. I've been hearing this
11 concept called -- concern about portability, and I've
12 heard it today a couple times in the first panel and again
13 today. And I'm just trying to understand exactly what the
14 concerns are on the right or ability of a client to
15 transfer their positions from FCM-A to FCM-B.

16 I mean, in the aftermath of the Revco and in
17 the aftermath of Lehman, I'm not aware of any large
18 institutional customer who doesn't have multiple clearing
19 arrangements today. I mean, they have clearing
20 arrangements at many different FCM's, and they have the
21 ability to transfer futures. And in the world of the
22 future, clear swaps from a FCM to B.

23 Now, I think the concern is that -- what if
24 that FCM-A is about to file for bankruptcy or has filed
25 for bankruptcy?

1 Is the issue on portability that you want to
2 have the right to transfer it to another firm without the
3 other clearing firm accepting these positions, or is it
4 more that if the FCM files, that you have clearing those
5 products, filed for bankruptcy, you want to take whatever
6 measures possible to make sure the trustee doesn't
7 liquidate the open position and give you a certain number
8 of times to either open an account, or transfer it, or
9 whatever.

10 I mean, the bankruptcy rules already provide
11 you some -- it gives the trustee discretion. They have
12 the right to liquidate the same day, but that -- I mean,
13 at Lehman and MF Global, both trustees in place gave
14 basically a -- five days to transfer your position --
15 whether five days is adequate or not.

16 I would like to hear from the group who's
17 concerned about portability what really they're seeking.
18 I'm not sure. I've heard different explanations, and I'm
19 just trying to understand that issue from a -- their
20 concerns.

21 Thank you.

22 BOB WASSERMAN: Seth?

23 SETH GROSSHANDLER: Seth Grosshandler,
24 representing FIA.

25 A number of points. First of all, Bob, on

1 prejudice to the other customers who don't opt in, it's an
2 obvious thing, but I'm not sure it's been stated. To the
3 extent that there is an investment loss or a fraud loss
4 it's going to be shared by those folks and not the people
5 who opted into this. So you're just shifting those losses
6 to that pool of people who, for whatever reason, lack of
7 sophistication, or sophisticated and didn't want to do it,
8 or lack of money, whatever, didn't opt into this proposal.
9 You're sifting those kinds of losses to those folks.

10 The -- going back probably an hour now, there
11 was some -- some talk about why would the -- why would a
12 DCO require more margin from a customer in the CIEBA
13 model.

14 And, you know, if we are able to solve all of
15 this and get the FCM in the same position it's in, under
16 current models with respect to its rights, vis-a-vis the
17 customer, I think that's right, that you don't -- you
18 don't change things, but we have all of these issues.
19 Even if there is a lien, is the -- is the FCM in control
20 of the situation? Right? If it's not, then maybe it's
21 more at risk.

22 The more that you put risk onto the FCM, the
23 more the DCO is logically going to think that FCM is not
24 as good a credit. Right? So I need more margin from
25 somebody else.

1 The question of whether the lien makes a
2 customer property or not, I actually do think that the
3 CIEBA model does a very good -- even if there were a lien,
4 that it wouldn't be in so close to the porting issue more,
5 but if we make the FCM more in control of liquidation
6 proceeds, right, in a double default situation, right,
7 those proceeds may, in fact, be at the FCM level, and then
8 the defaulting customer now has defaulting FCM risk.

9 Now, maybe that's something you're not so
10 worried about, but it doesn't entirely solve the customer
11 property risk. And, again, as I said at the outset, there
12 are still issues in my mind about -- is this consistent
13 with what Congress was thinking when it mandated clearing
14 of swaps, made commodity contract a broader definition,
15 and it knew that there was a sharing regime?

16 The last thing I wanted to mention was: In
17 all of this we just need to bear in mind underlying state
18 commercial law, the Uniform Commercial Code, 50 different
19 states. For perfection of security interest, it was
20 drafted with the futures model in mind, accounts at the
21 FCM for the customer, and it's not necessarily an issue
22 with all these things, but just need to, you know, not
23 miss that, going forward.

24 BOB WASSERMAN: Dan?

25 DANIEL MAGUIRE: Thanks.

1 Just to be very brief, it seems, under the GCP
2 model, which definitely has some merit, we're talking
3 customers and turning them into some form of members.

4 So first question is: What do customers or
5 clients lose by being reclassified? Is there any down-
6 side to this?

7 Second thing is: We're saying that somebody
8 has to guarantee the participant in this. To my
9 knowledge -- this is relatively new at the moment in this
10 space is -- is that limited to the FCM's or is that -- it
11 just needs to be a direct clearing member, because that
12 doesn't necessarily mean FCM'S.

13 And, thirdly, just on some of the points that
14 were touched in point as of leakage, when we talked about
15 LSOC there was a -- there was a concern about bringing in
16 any form of optionality, whereas you could have leakage
17 between an LSOC group and a gross omni group, and I've not
18 heard so far, is there any danger of any leakage between
19 the GCP and, let's say, LSOC or gross omni there in terms
20 of the rules and the code would work?

21 BOB WASSERMAN: Joe, then Tim.

22 JOSEPH OTT: Joe Ott, Kansas City Board of
23 Trade.

24 Bob, I just want to address the DCO cost issue
25 real quick. Last week I was on a conference call with

1 other market participants, as well as other DCO's with
2 CIEBA, and the DCO's had expressed some concern about the
3 cost to implement this structure, and the response from
4 CIEBA was: Well, this will be a financial windfall for
5 DCO's once mandatory clearing comes into place.

6 And I guess I wanted to point out that
7 currently each DCO has a limited number of clearing
8 members they deal with on a daily basis, and with this new
9 structure that could increase substantially.

10 And as an example, let's just say in January a
11 customer puts on a December week calendar swap. The week
12 calendar swaps are marked to the market on a daily basis.
13 Therefore you'd have 250 days of variation margin with the
14 DCO. At \$4 a wire that comes up to around \$1,000 of
15 expense to the DCO, whereas the fees we're going to charge
16 for that swap are \$4.

17 So I don't think there's any guarantee this is
18 going to be a financial windfall for DCO's. In some of
19 the lighter traded swaps it may not make any sense to have
20 this type of structure in place.

21 BOB WASSERMAN: Tim?

22 TIMOTHY DOAR: Tim Doar, CME.

23 You know, I guess to answer one question, you
24 know, we -- it's our expectation that those who guarantee
25 these TCP type of accounts would be clearing from FCM's.

1 That's -- just to be clear about that.

2 Ron, you had mentioned earlier questions
3 around portability. It's our expectation -- we consider
4 it to be a best a practice, particularly with respect to
5 cleared swaps, that clients have relationships with more
6 than one FCM, that would go for a GCP.

7 In the eventuality of an FCM default under
8 LSOC, you know, our expectation would be that we'd be in a
9 position to better ascertain the status of any GCP that
10 goes through the guaranteeing FCM than any client that
11 remains in LSOC.

12 Now, that's not to say that we don't have the
13 ability to assess individual client exposures, to value
14 them, to -- to generally risk manage them. We will know
15 who the likely suspects are, who are causing an FCM
16 default, but we are governed by the portfolio of rights
17 and obligations, in terms of how we administer that
18 default.

19 And I expect that we would have to undergo
20 some pains to assure which client or clients were actually
21 at the source of the default, so that we could then go
22 ahead and -- and do our stuff, and administer the default
23 of that. The point being that there might be different
24 timings associated with when porting could occur for
25 non-defaulting clients within the -- the LSOC pool, if you

1 will.

2 So I offer that up only as some degree of
3 color over the times of distinctions that we would foresee
4 with the utilization of a GCP type construct. If
5 anything, I think that the immediacy of knowing whether a
6 GCP client is the source of the default or not is actually
7 a benefit to the overall construct.

8 MARK SZYCHER: Mark from CIEBA.

9 Ron, with respect to a couple more quick
10 points on portability.

11 No, we absolutely do not have any intention of
12 foisting ourselves upon a clearing member who chooses, as
13 a commercial matter, not to do business with us.

14 But as far as what do we hope to achieve or at
15 least ensure, regarding portability is I think three
16 things, the first of which is the certainty that our
17 positions are maintained, that is, that they're not
18 liquidated, and we, as a large pension fund, and many of
19 our peers, use swaps to hedge very significant inherent
20 risks in our pension plans, interests rate, foreign
21 exchange, and other risks, and we need to be very, very
22 certain that those positions are maintained through any
23 sort of market or other stress.

24 Second of all, a logical followup to that is
25 that there is a mechanism by which we can expeditiously

1 move those positions to an FCM that is, in fact, good --
2 in good standing, so we can make sure our margin payments
3 and other obligations can continue to be maintained as
4 they would otherwise be, again, through no fault of our
5 own something gone awry at the FCM.

6 And last but not least, is to ensure that any
7 margin that we've posted -- initial margin with the FCM,
8 that's having an issue, is, in fact, available to us to
9 move to the new FCM, insofar as then we don't have a
10 double-up situation, that is, we've got a substantial sum
11 that's posted with FCM-A that has a problem. Now FCM-B
12 says, great, you know, we're happy to accept the
13 positions, but now we've got to repost, in essence, that
14 sum again with FCM-B, because FCM-A's -- our margin is
15 tied up with them.

16 DANIEL MAGUIRE: Mark, can I just ask how that
17 differs in the GCP that is LSOC, because our understanding
18 is that under LSOC we'd move the positions and the
19 associated collateral that would be the DCO, as well.

20 So I'm trying to understand what is the
21 difference there.

22 MARK SZYCHER: I think -- I think in -- Danny,
23 I think in principle you're -- you're absolutely right,
24 and I think on paper it should work that way. We just
25 have -- I think we would just derive a great deal more

1 comfort if, in essence, we were holding or at least the
2 FCM wasn't holding any collateral, and we were in a better
3 position to, I guess, have fewer entanglements and -- and
4 have fewer steps that we would need to go through, I mean,
5 in order to extricate ourselves from an FCM situation, and
6 as described with the GCP model, we believe, if we've
7 structured it correctly, legally and operationally, in
8 essence we're doing nothing more than replacing the
9 guarantor with another guarantor, a solvent guarantor,
10 which should, in principle, be easier than again the --
11 the extrication from a -- from a more stringent as --

12 (Participants talking at the same time)

13 DANIEL MAGUIRE: I guess the only point I want
14 to say is that the FCM under LSOC doesn't hold the
15 collateral like the DCO does. Again, different models,
16 but ...

17 BOB WASSERMAN: Christine, does that --

18 CHRISTINE AYOTTE-BRENNAN: Yeah. So I just
19 wanted to add a couple of things. I mean, I think the
20 question on portability, Mark tried to, you know,
21 answered, but I just wanted to say from Fidelity's point
22 of view we are worried about the portability, but at the
23 end of the day what we are worried about the most is
24 segregation, and -- and really protecting the customer
25 collateral.

1 Excuse me. There was a point made, I think,
2 earlier -- in the earlier panel that we wouldn't be here
3 but for MF Global, and what we're really focused on is
4 futures, because we didn't really worry about that
5 segregation in the swaps market. Not true.

6 You know, we're required, by the '40 Act,
7 obviously, to segregate our collateral. We've been doing
8 it, you know, since 1940. So it's something that we're
9 focused on. It's something that we think our customers
10 deserve.

11 We agree with Tim that there is a difference
12 between the swaps and futures, you know, markets, and
13 we've -- we've argued that from the beginning which is why
14 we think we do need increased protections in the swaps
15 market.

16 And at the end of the day, when we think about
17 it, we see -- you know, we hear: If you want to increase
18 protection, it's going to cost you more, and we can't give
19 up a lien, and -- you know, it -- when we look at it, we
20 see the customer is the one who's bearing most of the
21 burdens here: The increased costs, the reduced
22 segregation protections, and I'm not sure that's the way
23 this was intended to go.

24 When I sit and think about how to solve this,
25 because I've heard all of the concerns and all of the

1 proposals, I don't know what the right answer is, but it
2 seems to me that we keep going round and round, because we
3 need a lien, but that makes the customer property, and we
4 have severe bankruptcy issues.

5 I realize that we're going to talk about 190
6 later on today and that tomorrow there's going to be some
7 more bankruptcy discussion, but I really think that in
8 order to solve almost all of the issue that we've all
9 brought up here, we really have to focus on a bankruptcy
10 fix.

11 BOB WASSERMAN: Chris.

12 CHRIS PERKINS: Getting back to portability,
13 we think the key to portability is ensuring that guarantee
14 funds size is not too large, because if you think of the
15 perspective of the FCM, to whom the positions are ported,
16 if they have to post a guarantee fund for a port, not only
17 do they have to fund it during a period of market stress,
18 it's also subject to mutualization.

19 So getting back to my earlier point on the
20 defaulter-pays model, we believe that it's very important
21 to ensure seamless portability, and thus understand
22 segregation is incredibly important, but if portability is
23 successful, you don't even have to get to segregation. So
24 we believe it's equally important.

25 BOB WASSERMAN: Christine.

1 CHRISTINE COCHRAN: I'd like to piggyback on
2 what Christine was saying, as well.

3 Again, Christine Cochran with the Commodity
4 Markets Council.

5 I really appreciate CIEBA. They have been
6 very kind to us as an organization, and spending a lot of
7 time walking through their proposal, because, as I said
8 earlier today, you know, we represent a wide variety of
9 market participants.

10 And what I would just like to -- what we are
11 taking from this right now is that this is -- this is a
12 very thoughtful proposal. It addresses a lot of concerns
13 that a number of market participants share.

14 However, we are hesitant to pass judgment on
15 it in a vacuum. We are still waiting for the MF Global
16 bankruptcy -- or MF Global investigation to be complete.
17 You know, there are a matrix of solutions to be
18 considered, and this is what I think Christine did a very
19 nice job articulating, whether they are back-office
20 solutions, like reporting, and disclosure requirements,
21 whether they are bankruptcy changes or these more
22 structural changes, I don't think we can consider any
23 single one in a vacuum. We have to look at them together,
24 how they inter -- interact within each other, and the cost
25 and benefits across all markets participants, because we

1 need to be very careful that we're not choosing solutions
2 that benefit one class of market participants any more or
3 less than any other class of market participants.

4 TIMOTHY DOAR: Tim Doar, CME.

5 You know, I think underlying the tone of many
6 of the comments here is the idea that when we talk about
7 swaps perhaps you're talking about interest rate swaps or
8 credit default swaps, but there is the 8515 rule, for
9 instance, which promises to recast many products that are
10 currently cleared as futures, particularly in the energy
11 space.

12 But honestly I don't know what the bounds of
13 this 8515 process will be. So -- okay. Apparently nobody
14 does, but many products --

15 BOB WASSERMAN: Some of my colleagues who
16 focus on that do, but I'm just -- that's not my --

17 TIMOTHY DOAR: All right. Sorry. I didn't
18 mean to make a metaphor here, but I think we do take a
19 different view to the types of record keeping requirements
20 that are associated with LSOC, due to our station in the
21 world.

22 We do offer clearing services for interest
23 rates swaps, obviously, and for credit default swaps, as
24 well, but with the workings of the 8515 rule, many
25 products that are currently classed as being futures, as

1 many as 600, our last estimation, will be reclassified as
2 swaps. So that means that if you are an FCM, and you have
3 any kind of activity on ClearPort, for instance, you are
4 going to have to get very used to LSOC standards, your
5 requirements under LSOC's methodology, and the reporting
6 requirements thereunder, which is perfectly fine, but
7 it's -- you know, it strikes us that it's a -- it's a
8 place to exercise some degree of caution for the reasons
9 that I tried to articulate earlier.

10 Many of the accounts that were put in place to
11 service business under ClearPort were developed within a
12 futures context. At least in swaps, when we're talking
13 about rates and credit, we are at the beginning of things,
14 and we can set the accounts up in a way that they can be
15 optimized with respect to whatever the end regulatory
16 requirements become.

17 Within the context of a -- of a futures --
18 traditional futures FCM, and its back-office business
19 infrastructure, accounts have been set up for a variety of
20 purposes, for a variety of reasons. Related accounts do
21 exist in this world. You know, knowing which account or
22 set of accounts to report under, in an LSOC methodology
23 may not be problem, but it might be, you know.

24 So that the disposition of the portfolio of
25 rights and obligations report, going up against the broad

1 class of products that will be classed as swaps is not a
2 trivial issue in my mind. I may be alone on this, but I
3 wouldn't trivialize the issue.

4 There are issues that we are going to have to
5 delve into, as this regulation finds its face, and it will
6 have an impact on our FCM's, as well.

7 BOB WASSERMAN: Byron?

8 BRYON BALDWIN: Obviously in terms of
9 portability, in terms of Eurex's individual segregation,
10 portability clauses come into use in the agreement, but
11 also Eurex will have an interim participant facility. So
12 in the event of an FCM default a buy site firm can make
13 margin direct to Eurex Clearing for a five-day period,
14 which gives that buy site time to switch to another
15 clearer. So that -- that's a part of Eurex's cleared
16 swaps offering.

17 BOB WASSERMAN: I'd ask to let that be the
18 last comment. I apologize. I think this is the sort of
19 topic one could spend all day talking about, and I would
20 much enjoy that. But we only have 45 minutes for lunch.
21 We are going to be starting very promptly at 1:30. There
22 are a number of places to get sandwiches or salads, both
23 in this building and within a one-block radius. And so I
24 look forward to seeing you all in 45 minutes.

25 (Proceedings recessed for lunch)

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