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2

3 MARKET RISK ADVISORY COMMITTEE

4 (MRAC)

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7 Public Meeting

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11 Monday, December 11, 2023

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20 Three Lafayette Centre

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

2 MR. JANOWSKI: Good morning. As the Market

3 Risk Advisory Committee Alternate Designated

4 Federal Officer, it's my pleasure to call this

5 meeting to order. Before we begin this morning's

6 discussion, I would like to turn to the

7 Commissioners for opening remarks. We'll start

8 with Commissioner Kristin Johnson, the sponsor of

9 the Market Risk Advisory Committee, followed by

10 Commissioner Mersinger.

11 Commissioner Johnson?

12 COMMISSIONER JOHNSON: Good morning. Thanks

13 so much, Peter.

14 I'm excited to welcome all of you to the third

15 Market Risk Advisory Committee meeting for 2023.

16 During the first quarter, the first week of March

17 in fact, we held a first-of-its-kind convening in

18 the wake of one of the most concerning cyber

19 attacks in our markets in recent years. The entity

20 at the center of the cyber incident, ION, is not a

21 CFTC-registered market participant. Rather, ION is

22 a mission-critical third-party service provider.

1 This incident and the discussions from the
2 MRAC meeting held by former CFTC Commissioners,
3 White House executive experts, and the presidents
4 and CEOs of the largest industry trade
5 associations, as well as public interest and
6 consumer advocates. In Q2, we led the advisory
7 committee, outlining workstreams for several
8 important subcommittees. And what I'd like to
9 suggest is that we can already begin to see the
10 fruit of our labor.
11 This week, the CFTC will consider a proposed
12 rule that addresses that very issue we launched—
13 last year, March 8, 2023—thinking about. Today,
14 we'll continue the long tradition of this
15 committee's engagement with the Commission and
16 bringing valuable insights into the concerns that
17 shape the stability and integrity of global
18 derivatives markets.
19 It's through this collaborative effort that we
20 can influence industry standards, best practices,
21 the agendas of this agency and others around the
22 world, and provide thought leadership on the most

1 important issues that impact citizens and
2 businesses in every corner of the globe.
3 Today, we have a pretty ambitious meeting
4 planned. Our agenda will begin with presentations
5 on eight topics from seven workstreams currently
6 operating in two of the MRAC subcommittees, CCP
7 Risk and Governance and the Market Structure
8 Subcommittee. Although the final two
9 subcommittees, Climate-Related Market Risk and
10 Future of Finance, will present at the end of the
11 agenda, I think it's worth opening with a preview
12 of the issues that these two subcommittees will
13 begin to explore in 2024.
14 Tomorrow will mark the conclusion of the 2023
15 United Nations Climate Change Conference known as
16 COP28. Notwithstanding the dusting of snow here in
17 Washington, D.C. this morning cooling us off, it's
18 clear that 2023 will end up being the hottest year
19 on record. In fact, according to a recent report
20 from the World Meteorological Society, the past
21 nine years since 2015 have been the warmest nine
22 years on record with mean temperatures now 1.4

1 degrees Celsius above the average from the second
2 half of the 19th century. Concentration of
3 greenhouse gases are at record levels, and the
4 ocean is heated to its highest level in a 65-year
5 observational record.
6 The Biden administration is taking steps to
7 limit climate change. At COP28, Treasury announced
8 a pledge of $3 billion to the Green Climate Fund, a
9 U.N.-based fund designed to help developing
10 countries with adapting to and mitigating climate
11 change. The EPA announced a new rule.
12 It's imperative that we here at the CFTC do
13 our part. So in fact, last week, our chair
14 announced -- and I'm pleased to suggest that I
15 supported -- proposed guidance with respect to the
16 listing of voluntary carbon credit derivatives
17 contracts on designated contract markets.
18 Later in our agenda, Tamika Bent, my Chief
19 Counsel and Designated Federal Officer for the
20 MRAC, will describe the guidance, as well as
21 potential workstreams that might grow for MRAC's
22 Climate-Related Market Risk Subcommittee.

1 There are deep and persistent concerns
2 regarding the integrity, credibility, and lack of
3 visibility in the market for VCCs. I explained
4 recently at a speech at the Dallas Federal Reserve
5 Bank that we must address transparency,
6 additionality, risk of reversal, robust
7 quantification, governance, tracking and double
8 counting, inspections, and sustainable development
9 in these markets. I called on those of us who are
10 willing to be part of a coalition of the willing,
11 that is, market regulators and committed financial
12 market participants. We can play a role in
13 developing and implementing some basic foundational
14 reforms.
15 In addition to thinking about the role next
16 year in 2024 that the Climate-Related Market Risk
17 Subcommittee might undertake, we'll also hear from,
18 at the end of the program, a second subcommittee
19 that will launch additional workstreams. In London
20 last week, I spoke at the Financial Times Crypto
21 and Digital Assets Summit. In fact, there were
22 members of the MRAC here today who joined me for

1 that program. I spoke about vertical integration,
2 corporate governance, and risk management measures,
3 as well as cyber risk and operational resilience.
4 In discussing these topics, I'm hoping that, one,
5 I'm outlining potential workstreams that the
6 subcommittee might take up in 2024, as well as
7 issues that the Commission might begin a rulemaking
8 process to address.
9 Last fall, the Financial Stability Oversight
10 Council called on regulatory agencies to thoroughly
11 analyze the impact of vertical integration and
12 determine whether it is a model that should be
13 supported by existing laws. I look forward to
14 hearing from MRAC members later today as we discuss
15 this very topic.
16 Finally, I'd like to turn to our formal agenda
17 for today because it, too, is very full. Today,
18 we'll begin to explore over the course of several
19 panels the workstreams that have been undertaken by
20 the CCP Risk and Governance Subcommittee and the
21 Market Structure Subcommittee. These workstreams
22 are live, active, and producing potential

1 recommendations as early as the first quarter of
2 2024 for the Commission to undertake.
3 Our agenda begins with a discussion that
4 outlines several of the most critical issues facing
5 global financial markets. In fact, we'll hear from
6 one of the most influential thought leaders in this
7 space, Christopher Hayward, Policy Chair for the
8 City of London Corporation. After Chris' remarks,
9 we'll hear from a panel of discussants, including
10 Mr. Klaus Loeber, Chair of the European Securities
11 and Markets Authority CCP Supervisory Committee,
12 and here at the CFTC, Richard Haynes, Deputy
13 Director of the Risk Surveillance Branch in the
14 Division of Clearing and Risk.
15 Following the presentation by this panel, our
16 subcommittee workstreams will begin to present the
17 issues that they're focused on. Our workstreams
18 include Technology and Operations, Resolution and
19 Recovery, and Margin and Collateral.
20 Following the presentations by the CCP Risk
21 and Governance Subcommittee, we'll hear
22 presentations from the Market Structure

1 Subcommittee workstreams. The Market Structure
2 Subcommittee workstreams include a number of
3 thought leaders who are easily introducing issues
4 that are at the fore of our thinking here at the
5 Commission and for regulators around the world.
6 We'll begin with a presentation by Ashwini Panse,
7 Head of Risk Oversight for ICE Clear Netherlands
8 and Chief Risk Officer for the North American
9 Clearinghouses. She'll present on the results of
10 the workstream's analysis of FCM data and
11 preliminary conclusions on FCM capacity and
12 concentration.
13 Following this presentation, co-chair Ann
14 Battle will provide an update on the workstream's
15 plan to study and prepare potential recommendations
16 related to the U.S. Treasury basis trade. Joining
17 Ann for this discussion is Jennifer Han, Chief
18 Counsel and Head of Global Regulatory Affairs at
19 MFA, and in addition, Sam Schulhofer-Wohl, Senior
20 Vice President and Senior Adviser to the President
21 of the Dallas Federal Reserve Bank. Co-Chair
22 Battle will also give an update on the Block

1 Workstream, focusing on preliminary feedback on a
2 request for analysis on block market participants
3 prepared by the workstream.
4 Finally, for this panel, we'll hear a
5 presentation on the Post-Trade Risk Reduction
6 Workstream.
7 I'm looking forward to hearing from all of our
8 members who have been working tremendously hard to
9 advance these issues. I'm grateful in advance for
10 the hard work of the ADFO and DFO for MRAC, who are
11 my chief counsel and senior counsel here at the
12 CFTC. And in addition to their support, our chair,
13 of course, Alicia Crighton, who also serves as
14 chair of the FIA Board. I'm thankful for my fellow
15 Commissioners who have been able to join and would
16 like to express in advance and in detail later
17 tremendous thanks to the other ADFOs Daniel
18 O'Connell and Parisa Nouri, as well as all of those
19 who support the creation and facilitation of
20 today's meeting.
21 Thanks so much. I'll pause there.
22 MR. JANOWSKI: Thank you, Commissioner

1 Johnson.
2 Now, we'll hear opening remarks from
3 Commissioner Mersinger.
4 MS. MERSINGER: Good morning, everyone, and
5 thank you for being here and fighting this snow to
6 get in. I was not prepared to scrape off my car
7 this morning, so I'm just happy I made it in time.
8 I'm going to keep my remarks short because we
9 do have an aggressive agenda, but all of the topics
10 are so important right now, and they are subjects
11 that we are grappling with at this very moment. So
12 I'm very glad that we are having these discussions.
13 Thank you to Commissioner Johnson for having this
14 meeting and bringing these topics to the forefront.
15 I'm very interested to hear about block trade
16 implementation and any concerns that stakeholders
17 have about the current calculations and how that
18 will impact their businesses. Treasury market
19 reform, CCP risk and governance, all these are
20 important topics. FCM capacity, very happy to see
21 that that's on the agenda because that has been a
22 topic that I think has not gotten enough attention

1 lately, but it's certainly something we need to be
2 focused on.
3 So I'm just excited to hear from everyone
4 today. Thank you all for being here. And with
5 that, I'll just turn it back over to Peter.
6 MR. JANOWSKI: Thank you very much,
7 Commissioner Mersinger.
8 Before starting our discussion, there's just a
9 few logistical items I've been asked to mention to
10 the committee members. Please make sure that your
11 microphone is on when you speak. This meeting is
12 being simultaneously webcast, and it's important
13 that your microphone is on so that the webcast
14 audience can hear you. If you'd like to be
15 recognized during the discussion, please change the
16 position of your place card so that it sits
17 vertically on the table or raise your hand and
18 Chair Crighton will recognize you and give you the
19 floor.
20 If you're participating virtually and would
21 like to be recognized during the discussion for a
22 question or comment or any technical assistance,

1 please message me within the Zoom chat. I will
2 alert Chair Crighton that you would like to speak.
3 Please identify yourself before you begin speaking
4 and signal when you are done speaking. Please
5 speak directly into your microphone for optimal
6 audio quality on the webcast. Please unmute your
7 Zoom video before you speak and mute after you
8 speak. Please only turn on your camera when you're
9 engaging in discussion. And if you're disconnected
10 from Zoom, please close your browser and enter Zoom
11 again using the link previously provided for
12 today's meeting.
13 Before we begin, we'd like to do a roll call
14 of the members participating virtually so we have
15 your attendance on the record. After I say your
16 name, please indicate that you are present and then
17 mute your line.
18 Robert Allen?
19 MR. ALLEN: Present.
20 MR. JANOWSKI: Ruth Arnould?
21 [No response.]
22 MR. JANOWSKI: Richard Berner?

1 [No response.]

2 MR. JANOWSKI: David Bowman?

3 MR. BOWMAN: Present.

4 MR. JANOWSKI: Neil Constable?

5 [No response.]

6 MR. JANOWSKI: Edward Dasso?

7 MR. DASSO: Present.

8 MR. JANOWSKI: Gina-Gail Fletcher?

9 MS. FLETCHER: Present.

10 MR. JANOWSKI: Joseph Garelick?

11 [No response.]

12 MR. JANOWSKI: Lindsay Hopkins?

13 [No response.]

14 MR. JANOWSKI: Demetri Karousos?

15 MR. KAROUSOS: Present.

16 MR. JANOWSKI: Derek Kleinbauer?

17 MR. KLEINBAUER: Present.

18 MR. JANOWSKI: Tim McHenry?

19 MR. MCHENRY: Present.

20 MR. JANOWSKI: Jonathan Levin?

21 MR. LEVIN: Present.

22 MR. JANOWSKI: Craig Messinger?

1 MR. MESSINGER: Present.

2 MR. JANOWSKI: Rajalakshmi Ramanath?

3 MS. RAMANATH: Present.

4 MR. JANOWSKI: Guy Rowcliffe?

5 [No response.]

6 MR. JANOWSKI: Suzanne Sprague?

7 [No response.]

8 MR. JANOWSKI: Viktor Vadasz?

9 MS. SPRAGUE: Present.

10 MR. VADASZ: Present.

11 MR. JANOWSKI: Kevin Werbach?

12 [No response.]

13 MR. JANOWSKI: Nathaniel Wuerffel?

14 MR. WUERFFEL: Present.

15 MR. JANOWSKI: And Huan Zhang?

16 [No response.]

17 MR. JANOWSKI: Thank you all. We'll now hear

18 from the Chair of MRAC, Alicia Crighton.

19 MS. CRIGHTON: Good morning. Nice to see you

20 all.

21 Today, as Commissioner Johnson indicated, we

22 will engage in discussions involving CCP risk and

1 governance, market structure developments, climate-
2 related market risks, as well as host a discussion
3 of issues surrounding the introduction of several
4 emerging technologies and the development of the
5 carbon credit market.
6 Our first series of panels today will present
7 the workstreams of the CCP Risk and Governance
8 Subcommittee. For our first panel, Christopher
9 Hayward, Policy Chairman of the City of London
10 Corporation; Klaus Loeber, Chair of the CCP
11 Supervisory Committee of the European Securities
12 and Markets Authority; and Richard Haynes of the
13 CFTC Division of Clearing and Risk will offer a
14 macroeconomic view of issues that are in the
15 spotlight for U.S. regulators and their
16 counterparts in a number of jurisdictions, as well
17 as multinational market participants in the
18 clearing markets.
19 With that, we'll start with section one and
20 the opening remarks of CCP risk and governance.
21 MR. HAYWARD: It is a pleasure to address the
22 CFTC's Market Risk Advisory Committee. I'm sorry

1 that I can't be with you all in person. I have
2 missed you all by a day as I am currently in New
3 York and will only be traveling to D.C. tomorrow.
4 I'm particularly disappointed to have missed you
5 given that this is a big moment for the City of
6 London Corporation.
7 As many of you well know, we act as a
8 representative of the United Kingdom's financial
9 and professional services sector, an industry that
10 has evolved over the centuries, but one that we are
11 proud still to call the Square Mile home. But we
12 see the FPS sector as much more than a national
13 asset. Indeed, given the global nature of FPS
14 provision and value the worldwide FS delivers as an
15 engine of prosperity, we see the sector as very
16 much an international one.
17 As a statement to this effect, this week, we
18 are announcing the establishment of the City of
19 London Corporation's first-ever U.S. presence. Our
20 objective is to support U.S.-U.K. collaboration
21 across the policy waterfront to both deepen the FPS
22 corridor where possible and promote alignment in

1 our approaches to shared challenges.
2 In these difficult macroeconomic and
3 geopolitical times, this has to be right. I will
4 be in Washington tomorrow introducing our excellent
5 new managing director Ed Price to the D.C. policy
6 community, and I hope all of you will have the
7 opportunity to meet him very soon.
8 One of our core objectives is to ensure U.S.-
9 U.K. alignment in some of the major forward-looking
10 areas of regulation. An area that is front of mind
11 in the U.K. and for Commissioner Johnson is crypto
12 assets. The U.K. Government and regulators are
13 thinking deeply about our approach to this area and
14 is positioning the U.K. as an honest broker, not
15 necessarily at the leading edge, but not leaving a
16 vacuum in this innovative area either.
17 The U.K. Financial Services and Markets Act,
18 concluded this summer, gives regulators the powers
19 to take positive steps. His Majesty's Treasury
20 confirmed plans last month to put in place a
21 regulatory framework for Fiat-backed stablecoins.
22 We are helping regulators think this through, and

1 we'll be responding to the open discussion paper
2 underlining, among other things, that same risk,
3 same regulatory outcome should be an underlying
4 principle.
5 We're also engaging in the proposals to
6 develop the U.K.'s first-ever digital security
7 sandbox to facilitate the testing and adoption of
8 securities across financial markets. We see this
9 as an encouraging development and we think one area
10 where the U.S. and U.K. collaboration may bring
11 benefits.
12 We see opportunities in the U.S. and U.K.
13 exploring how cross-border or multi-jurisdictional
14 sandboxes could help develop interoperable
15 regulatory approaches in response to emerging
16 technologies and potential authorization in
17 multiple jurisdictions, one of the many
18 conversations that we hope our new office may
19 facilitate in the near future.
20 I wish you all well.
21 MR. LOEBER: Hello, I'm Klaus Loeber, the
22 Chair of the CCP Supervisory Committee within ESMA,

1 the European Securities and Markets Authority, and
2 I'm grateful for Commissioner Johnson to have
3 invited me to join this Market Risk Advisory
4 Committee meeting. Unfortunately, I'm unable to
5 join you in person, but I'm very happy to share
6 some thoughts with you and to provide us a bit of
7 background on the supervisory committee and its
8 activities.
9 The CCP Supervisory Committee was established
10 in January 2020 as part of a review of the legal
11 framework supporting European market
12 infrastructures, which is shortly known as EMIR,
13 the legislation governing the central clearing of
14 derivatives and also the requirements of supporting
15 market infrastructure, including central
16 counterparties in the EU.
17 The review of EMIR actually was focusing on
18 two main pillars, first, to enhance the mission of
19 promoting supervisory convergence amongst EU CCPs.
20 For example, we have validations, opinions, and
21 recommendations directed at the national
22 authorities, but also addressing the risks linked

1 to EU counterparty exposures to third-country CCPs.
2 As such, the CCPSC covers 14, soon 15 EU CCPs, and
3 38 third-country CCPs based in 21 foreign
4 jurisdictions. Two out of those 38 third-country
5 CCPs are considered of systemic importance to the
6 EU financial stability and are thus directly
7 supervised by ESMA. These are two CCPs located in
8 the United Kingdom.
9 The CCPSC is quite an original EU setup, which
10 is subject to decision-making processes being
11 responsible to the ESMA Board of Supervisors, but
12 also to the European Parliament. The composition
13 entails representatives from 12 national
14 supervisors of EU CCPs, but also four central banks
15 of issue of the major currencies, two in the
16 European Union and two independent members, plus
17 myself as a chair. It's a quite unique setup that
18 can leverage on the expertise of the national
19 competent authorities, but also the team buildup in
20 ESMA and can thus develop a risk-based supervisory
21 perspective that can cover multiple CCPs and has a
22 perspective on ongoing and emerging risks.

1 For the tools that we use to set our
2 regulatory and supervisory priorities, we have an
3 annual heatmap where ESMA identifies the most
4 prevailing risks per sector. For CCPs, this means
5 that we discuss amongst the supervisors the key
6 risks which are likely to shape the CCP space, both
7 in terms of impact and likelihood.
8 As part of our 2024 risk map, heatmap, ESMA
9 identified and prioritized a number of risks for
10 its convergence and supervisory activities.
11 Compared to last year, we have actually three types
12 of risk, operational risk, procyclicality and
13 market risk, here, in particular commodities and
14 interest rates, which remain at an all-time high.
15 Given the persisting geopolitical tensions and the
16 requirements -- the developments evidenced by
17 market data. Concentration risk also remains at a
18 high scale within our risks here. For example, the
19 nickel event at the LME has served as a reminder of
20 the challenges in appropriately managing
21 concentration risks.
22 As a result of this year's recalibration, and

1 following some observations we have made across
2 CCPs, ESMA has increased the risk related to
3 governance and controls to medium high, while risk
4 related to recovery plans, which formerly was
5 considered at a higher scale, has been reclassified
6 as medium given the progress made in the EU
7 following the implementation of the CCP recovery
8 and resolution regulation and the development of
9 recovery plans across EU CCPs.
10 A new addition on the risk side is the
11 investment risk, which has come to the forefront
12 following the experiences with the LDI stress
13 events last year and has been categorized as medium
14 next to risks coming from financial innovation.
15 I should also mention for completeness that we
16 also consider a number of risks as inherent, namely
17 membership, due diligence, interdependencies,
18 default management, and liquidity risk in relation
19 to which no additional supervisory work is
20 envisaged beyond the ongoing monitoring activities
21 already conducted.
22 Based on this identification and

1 prioritization, we are conducting at ESMA a number
2 of activities, and I want to share with you some of
3 those in terms of trying to mitigate the potential
4 impact of those risks. As regards the high
5 category risks, for operational, particularly cyber
6 risk, in the EU we have recently adopted the
7 Digital Operational Resilience Act, which is also
8 called DORA, which covers both cyber, but also ICT
9 risk in CCPs and also other supervised entities,
10 but also the risk coming from third parties through
11 outsourcing or different service provisions such as
12 coming from the provision of cloud services, DLT,
13 or, more recently, AI service providers. DORA has
14 entered into force in January this year and will
15 apply as of 2025. And we have quite significant
16 efforts to conclude the detailed technical
17 standards and to make it operational within the
18 timeframes foreseen by the law.
19 We also published last year the results of our
20 fourth EU-wide CCP stress testing exercise, which
21 included for the first time operational risk
22 elements, focusing in particular on the increasing

1 reliance of CCPs on shared third-party providers.
2 We are currently following up on the findings of
3 this stress test and aim to see how the framework
4 could be improved for future iterations here.
5 We are also heavily invested in the work at
6 the international level within the operational
7 resilience group recently established by CPMI-
8 IOSCO, which I have the pleasure to co-chair, which
9 is covering these aspects looking at whether the
10 existing international standards in that field for
11 FMIs are sufficiently granular and calibrated in
12 view of these types of risks.
13 Concerning procyclicality, we have observed in
14 the significant stress events over the past two
15 years that there are certain issues which may
16 require a bit of calibration, in particular, as
17 clearing members exposed to high margin calls will
18 in turn require additional margin from their
19 clients, adding to liquidity strains in the wider
20 clearing ecosystem. This, in the view of ESMA,
21 calls for additional transparency at the level of
22 the CCP, but also at the level of those clearing

1 members providing client clearing services.

2 We were very much looking forward to the

3 publication by the end of the year of the joint

4 Basel Committee CPMI-IOSCO report on the review of

5 margining practices, and we hope that, together

6 with our international colleagues, including the

7 CFTC, we can turn this into meaningful guidance to

8 mitigate the spread of liquidity risk across parts

9 of the financial system.

10 When looking at the other risks very shortly,

11 the CCP Supervisory Committee has planned for next

12 year a peer review on governance and controls in

13 relation to outsourcing of critical operational

14 functions, but also intergroup governance

15 arrangements, including internal controls,

16 functions such as internal audit.

17 For concentration risk, we are following up on

18 the findings of the last stress test, and we will

19 look into whether there is a need for future

20 adaptations of CCP risk models linked to

21 concentration risks, which we'll also focus on in

22 our next stress test exercise that we have just

1 launched.

2 Lastly, and focusing on the planned peer

3 review for next year, we are looking at convergence

4 issues regarding the implementation of new

5 regulatory requirements like investment risks that

6 have been integrated as well in next year's stress

7 test exercise.

8 So let me conclude with a quick look at the

9 new risks that we have identified in relation to

10 financial innovation. Here, the CCP Supervisory

11 Committee will continue monitoring issues resulting

12 from CCPs using new technologies, but also engaging

13 activities related to crypto asset-related products

14 or alterations of their clearing models.

15 I hope this provides you with an overview of

16 what ESMA is conducting in terms of its identified

17 priorities in terms of risks across the CCP sector,

18 and I wish you a very fruitful discussion. And I

19 very much hope that I will be able to engage with

20 you in personal discussions at a future

21 opportunity. Thank you very much.

22 MR. HAYNES: Okay. Hopefully, people can hear

1 me, although I do hear a little bit of an echo, and
2 maybe -- hopefully, maybe that's me. I don't know.
3 We'll see. We'll see.
4 So thank you very much. First, I want to
5 thank Commissioner Johnson, Commissioner Mersinger,
6 Alicia, Peter, and the members of MRAC for the
7 opportunity to briefly discuss a few topics related
8 to cleared markets.
9 Before that, though, I do want to note that my
10 remarks are my own and don't represent those of the
11 CFTC or anyone else at the Commission.
12 So I'm going to dig just a little bit more
13 into actually one of the topics that Klaus
14 mentioned close to the end of his presentation on
15 transparency. But before that, before that, it may
16 be useful to give a short overview of my own team.
17 The risk surveillance branch at the CFTC, RSB, our
18 acronym, is one of the what I will call
19 quantitative arms of the agency with a number of
20 analytical responsibilities, reviewing new and
21 amended DCO margin and risk models, monitoring risk
22 and positions on a daily basis in all cleared

1 derivatives markets, leading or co-leading FCM and
2 FT reviews and engaging in longer-term and more
3 detailed quantitative analysis like our supervisory
4 stress tests, very similar to the supervisory
5 stress test that Klaus also just mentioned.
6 To put it perhaps a little too glibly, if it
7 has a number or equation associated with cleared
8 derivatives markets, guess what? We make sure we
9 understand it. So not surprisingly, this has led
10 us to develop a myriad, 10, 20, what -- of
11 dashboards, automated alerts, and regular reports
12 to better understand the links between key market
13 participants and how these links may be affected by
14 unanticipated and extreme market stress.
15 So to shine some additional light on our work,
16 I will turn to perhaps an obvious theme, stress
17 events in recent years: COVID, the invasion of
18 Ukraine, LME. I could continue. Events like these
19 have given us a much clearer understanding of how
20 CCPs and participants react to an increased need
21 for -- and often an increased cost of -- liquidity.
22 And as importantly, maybe more importantly, they

1 demonstrate how these reactions can differ across
2 markets and entities. Now, public reviews of both
3 early COVID and early invasion periods speak to
4 these differences, whether we focus on funding
5 sources, collateral types, or exposure profiles
6 within our markets.
7 So because of this, paired with the
8 quantitative analysis and the reports, were six
9 related policy themes. Two of these six were
10 potential additional transparency efforts --
11 there's that word -- and potential additional
12 analysis of the size and nature of liquidity
13 demands. Further work in these areas has continued
14 to seek areas where, for instance, more information
15 about potential future liquidity demands and the
16 speed of those demands could aid stress
17 preparations and mitigate any frictions that could
18 occur.
19 This work may be especially important for end
20 users, very common in our markets, who often have
21 fewer and more indirect ways to access liquidity
22 pools. And we saw in 2022, again, another recent

1 event, parts of Europe establishing liquidity
2 facilities to aid end user liquidity needs during
3 periods when pressures were unusually high. Makes
4 sense.
5 So pair these brief thoughts on market
6 transparency with a few on transparency to
7 regulators, to us. I mentioned our dashboards and
8 our reports, which rely on the detailed data we
9 gather daily -- mostly daily, sometimes weekly,
10 sometimes monthly. It is primarily through these
11 that we are able to highlight areas of concern such
12 as unexpected market exposures where we need to
13 seek more information from CCPs or members. And
14 this can often lead to calls or other discussions
15 to ensure that, hey, we fully understand those
16 positions and how they would behave in calm and
17 extreme markets. It goes back to we need to
18 understand every number in every equation.
19 We are able to do this because -- because --
20 of the feedback loop between our data and analysis.
21 And in fact, just this year, we updated and
22 expanded the data we collect in the light of

1 analysis that we wanted to do but that required
2 some data refinement.
3 So my discussion with transparency as one last
4 branch that I'd like to mention before closing, a
5 number of our clearinghouses in recent years have
6 made significant updates to their margin models in
7 cases shifting from what I will admittedly too
8 simply describe as product-level to portfolio-level
9 views. I welcome these changes and the robustness
10 and sophistication of these models, and I
11 anticipate that they will serve us well in future
12 stress events, perhaps similar to ones we've had,
13 perhaps very different from ones we've had.
14 But there is often an inherent and necessary
15 complexity to these new models, so we want to make
16 sure that inherent model sophistication is paired
17 with a full understanding about what this means for
18 behavior during stress periods, not just for the
19 base model, but for other things, again, like Klaus
20 mentioned, for instance, liquidation and
21 concentration costs or concentration add-ons.
22 So we again come to the question about markets

1 and regulator transparency and what this may mean
2 for individual asset classes or participant groups.
3 Unfortunately and -- I mean, I am looking at the
4 clock so perhaps fortunately, I may be
5 disappointing you by not going into further detail
6 here, but I do want to emphasize that this is a
7 theme we have given much thought to in light of the
8 events I have noted.
9 So I will close with a nod to the others on
10 the panel, my esteemed colleagues from around the
11 world. The CFTC has a deep view into many markets
12 and many entities. I've talked about our data
13 briefly, but we still see only a part of the
14 derivatives landscape. The others on the panel
15 have views that overlap in part but also extend far
16 beyond. And so we speak regularly with peers,
17 including ESMA and other international
18 organizations, to share what we can of our own
19 perspectives. So I want to thank those peers for
20 that collaboration and return to the panel title of
21 international perspectives. It is through
22 conversations such as these, such as those that we

1 can gain the knowledge needed to view the market
2 from a truly international perspective.
3 So thank you, and I will pass it back to the
4 moderators.
5 MS. CRIGHTON: Great. Thank you very much
6 Chris, Klaus, and Richard.
7 We'll now turn to the second workstream of the
8 CCP Risk and Governance Subcommittee. We'll now
9 hear from Lee Betsill, Managing Director and Chief
10 Risk Officer of the CME Group. Lee?
11 MR. BETSILL: Thank you. Thank you, Chair
12 Crighton, Commissioner Johnson, and all at the CFTC
13 for supporting the pressing agenda facing the
14 Commission.
15 Our Technology and Operations Workstream also
16 appreciates the contributions from our expert
17 guests and continued interest from many thoughtful
18 and concerned parties within the financial services
19 ecosystem.
20 The Technology and Operations Workstream
21 composition includes Chris Edmonds, who is the
22 subcommittee co-lead and workstream chair for this

1 workstream; Timothy McHenry from the NFA
2 representing the regulator view; Dick Berner from
3 New York University representing an academia view;
4 Graham Harper from DRW representing a client view;
5 and myself.
6 The workstream is proud to offer updates on
7 two important topics during today's meeting. The
8 first will cover the use of legal entity
9 identifiers, followed by a progress update on
10 mission-critical third-party vendors.
11 So during the financial crisis of 2008 and
12 '09, global regulators desired to better understand
13 sources of risk and prioritize these efforts while
14 developing new financial reforms. The European
15 Union adopted the use of legal entity identifiers,
16 or LEIs, and mandated that LEIs be reported during
17 order entry.
18 During the debate surrounding the Dodd-Frank
19 Act, the idea of mandating the use of LEIs was
20 deemed potentially too expensive or operationally
21 burdensome as the complete impact of implementing a
22 new requirement was unknown. The EMIR legislation

1 in the European Union followed the implementation
2 of the Dodd-Frank Act and provided the additional
3 time needed to better assess the impact on market
4 participants.
5 Typically, LEIs are assigned by the GLEIF
6 organization and are only available for corporate
7 accounts. While there's a segment of the domestic
8 trading community not eligible to obtain an LEI,
9 the total risk of these accounts represents less
10 than 5 percent of standing risk, as measured by the
11 collateral on deposit at CME and at ICE.
12 So the workstream discussed the industry
13 response to the ION cyber incident and determined
14 that account recovery and the resumption of
15 reporting could be greatly enhanced if the
16 reconciliation process becomes more efficient. The
17 ability to assign the risk to the beneficial
18 account owner is increased with the use of LEIs.
19 While this path does not represent a 100
20 percent solution, the workstream agreed it is
21 beneficial for the industry to move forward with
22 implementing LEIs at the account level. For such

1 reason, the workstream encourages the full MRAC to
2 recommend a proposed amendment to 39.19(i)(A) to
3 increase the enforceability and usage of legal
4 entity identifiers by requiring all eligible
5 entities as a beneficial account owner to obtain an
6 LEI and to report such identifier to their clearing
7 member.
8 I'll pause there, Alicia, back to you.
9 MS. CRIGHTON: Great. Thanks, Lee.
10 We'll now open the floor for member
11 discussion.
12 [No response.]
13 MS. CRIGHTON: Okay. For our second
14 workstream on third-party risk, we'll first hear
15 from Lee Betsill. Then we'll hear a presentation
16 from Julie Mohr, Deputy Director of the CFTC's
17 Division of Clearing and Risk. And finally, we'll
18 hear from Don Byron, SVP and Head of Global
19 Industry Operations and Execution at the Futures
20 Industry Association.
21 And back to you, Lee.
22 MR. BETSILL: Thank you. So the next topic

1 reviewed by the Technology and Operations
2 Workstream is mission-critical third-party vendors.
3 The workstream members appreciate the limited
4 visibility the Commission and its staff have and to
5 the vast use of service providers by CFTC
6 registrants. The workstream values and seeks to
7 promote the innovation efforts represented by a
8 growing ecosystem of third-party vendors.
9 While the CFTC cannot regulate all direct and
10 indirect operational functions of registrants, it
11 can develop clear definitions and guidelines
12 consistent with its regulations, the Commodity
13 Exchange Act, and relevant U.S. law. There are
14 several U.S. and global regulatory agencies and
15 cross-border efforts seeking to find the right
16 balance of operational oversight and corporate
17 freedom to pursue such innovation.
18 The workstream has developed an inventory
19 covering many of these efforts and reviewed work by
20 trade associations that have published thoughtful
21 work on this topic. Our review of these efforts
22 continues, supplemented by input from market

1 participants and members of the workstream to
2 understand the impact and practical application of
3 such oversight. We will continue our efforts in
4 the coming months with a desire to drive consensus
5 and to report back during the next full MRAC
6 meeting our findings and, where appropriate,
7 recommendations for the MRAC, Commission staff, and
8 Commissioners to consider. Thank you.
9 MS. CRIGHTON: Great, thanks, Lee.
10 And next, we'll hear from Julie.
11 Don, we're actually going to start with you,
12 and then we'll try and circle back to Julie who is
13 having some audio problems.
14 MR. BYRON: Okay, great. Thank you. Thank
15 you, Chair Crighton, Commissioner Johnson, and
16 fellow members on the MRAC. It's an honor to be
17 invited to speak with you today on such an
18 important matter.
19 The March 2023 MRAC meeting, FIA President and
20 CEO Walt Lukken spoke on the importance of
21 strengthening resilience in the global exchange-
22 traded derivatives markets. This came off the back

1 of a ransomware attack on a single-service third-
2 party service provider at the end of January. The
3 ION attack significantly impacted the processing of
4 trades executed on multiple exchanges and CCPs
5 globally, and demonstrated that this type of attack
6 can be particularly disruptive in a highly
7 interconnected ecosystem such as ours.
8 In his remarks, Walt announced the formation
9 of a global FIA cyber risk task force to review the
10 event and develop recommendations for improving the
11 resiliency of our markets. The industry task force
12 consisted of a cross-section of subject matter
13 experts and business leaders within the exchange-
14 traded derivatives and cleared industry, including
15 exchanges, CCPs, clearing firms, third-party
16 vendors, end users, and other financial sector
17 partners.
18 In September 2023, FIA released an after-
19 actions findings report that outlined lessons
20 learned from the event, including six
21 recommendations and findings from the task force
22 for improving the industry's ability to withstand

1 future attacks and outages. Among some of the
2 report highlights I'd like to now outline some of
3 the recommendations and findings in the report.
4 The report identifies the disruptive impacts
5 of a cyber incident, specifically response, which
6 is coping with the immediate breach of an impact.
7 Second is recovery, which is rebuilding and
8 restoring systems and databases. Third is
9 reconnection, which is the reconnection to market
10 infrastructures, service providers, and other
11 organizations.
12 The report highlights that exchanges and CCPs
13 play a critical role in the front-to-back trading
14 and clearing ecosystem of the industry. From an
15 operations and technology perspective, they provide
16 their customers with data and information that is
17 required for, among other things, trade processing,
18 clearing, risk management, and other critical
19 functions. Therefore, exchanges and CCPs are
20 essential when dealing with the disruptive impacts
21 of any outage that affects our ecosystem, and
22 including most cases working with third-party

1 service providers. That being said, the related
2 recommendations were not limited to exchanges and
3 CCPs. Instead, the task force found that they
4 should focus on all market participants, market
5 infrastructures, and third-party service providers
6 within our industry.
7 Next, I'd just like to provide a brief
8 overview of some of the recommendations outlined in
9 the paper starting with the industry alignment with
10 existing reconnection guidelines. The attack
11 demonstrated that the complexities of rebuilding
12 impacted systems and restoring normal service
13 through industry participants required intensive
14 work to gather and process missing trade records
15 and to reconnect systems to the rest of the
16 marketplace. Several financial sector groups have
17 developed guidance and frameworks and tools to
18 guide firms through the process of reconnecting in
19 the aftermath of a cyber incident. These include
20 CMORG in the U.K. and the Financial Services Sector
21 Coordinating Council in the U.S.
22 The task force recommends a review of these

1 connection re-guidelines which could help
2 facilitate a more efficient recovery process for
3 the industry. Therefore, these guidelines should
4 be promoted, reviewed, and practiced during these
5 industry forums, including through FIA.
6 The next recommendation I'd like to highlight
7 is supporting the sharing of information with
8 connected parties regarding contingency plans in
9 the event of a cyber incident or other type of
10 outage. To optimize the success and timeliness of
11 a market recovery after an incident, market
12 participants need to have an ex ante understanding
13 of the reconnection contingency plans of various
14 market participants and third-party service
15 providers. The task force encourages to establish
16 procedures for sharing critical data and other
17 information with their counterparties and clients
18 in a timely manner during a cyber incident. Having
19 a clear understanding of those procedures ahead of
20 an incident can streamline information-sharing
21 during an incident and accelerate the recovery
22 process.

1 Next, improving the risk assessment of third-
2 party service providers is important, as Lee had
3 mentioned, many participants in the global exchange
4 industry rely on these third parties for essential
5 services to their participation in the markets
6 across the industry’s ecosystem. Rather than one
7 set of risk management practices that apply to all
8 third-party service providers and market
9 participants equally, the policy should allow for
10 risk management practices to be calibrated to such
11 factors as the type of service that is provided,
12 the nature of the relationship, and the potential
13 impact of disruption to that service.
14 And then lastly, a few other recommendations
15 that I'd like to discuss from the task force, one
16 is the FIA formation of an industry resilience
17 committee as a standing industrywide group that
18 serves as a trusted forum for key stakeholders to
19 discuss cyber incident management and resilience
20 planning and also recommend best practices for the
21 industry.
22 The recent cyber incidents also showed the FIA

1 itself has an important role in industry
2 communications. This includes not only also
3 functioning as an information clearinghouse during
4 an incident, but also encouraging preparedness
5 across the industry.
6 We've also outlined to engage with sector-wide
7 groups on cyber and operational resilience through
8 the work of FIA. This includes such organizations
9 as the Financial Services Sector Coordinating
10 Council, or FSSCC; and the Securities Industry and
11 Financial Markets Association, SIFMA, which we did
12 during the recent ICBC financial services cyber
13 incident.
14 Lastly, the final recommendation is for
15 participation by the industry in regular cyber
16 preparedness exercises. These exercises include
17 the Hamilton exercises organized by the U.S.
18 Treasury Department and the Quantum Dawn exercises
19 organized by SIFMA. The task force recommends that
20 these exercises should incorporate scenarios
21 related to exchange-traded and cleared derivatives
22 markets.

1 And lastly, I'd like to conclude and say FIA
2 is committed to working with the broader industry
3 to ensure our markets are resilient against cyber
4 threats and other types of outages. Thank you
5 again for the invitation to speak today on this
6 important matter.
7 MS. CRIGHTON: Thanks, Don. And now we'll
8 hear from Julie.
9 MS. MOHR: All right, just to make sure that
10 you can hear me. Okay.
11 Thank you, Commissioner Johnson, for giving me
12 the opportunity to speak today. I am Julie Mohr,
13 and I manage the CFTC examination program for
14 derivatives clearing organizations, otherwise known
15 as DCOs. I will take the next five minutes to give
16 an overview of the regulations that pertain to the
17 responsibilities of the DCO that outsources
18 clearing responsibilities to third parties, and
19 DCR's examination program on this topic. However,
20 the views that I am about to express are my views,
21 and they do not necessarily reflect the views of
22 the Commission or the chairman.

1 Let's start with the regulations, in
2 particular, it's 39.18(d). It states that the DCO
3 can outsource its responsibilities for its program
4 of risk analysis and oversight with respect to
5 operations and automated services, but if it does
6 this, the DCO must -- and I will quote the
7 regulation here -- "retain complete responsibility
8 for any failure to meet the requirements."
9 And the regulation also states, again I quote,
10 "The DCO must employ personnel with the expertise
11 necessary to enable it to supervise the service
12 provider's delivery of service." This means the
13 DCO must perform due diligence to make sure, one,
14 it understands how the third party will deliver the
15 services; two, how the third party meets minimum
16 information security standards of the DCO; and
17 three, how the third party will meet the standards
18 of the regulation before it enters into a written
19 contractual arrangement with a third party. The
20 regulations also state that the program of risk
21 analysis and oversight must be developed using
22 generally accepted standards and industry best

1 practices, such as NIST.
2 DCR has a program that it follows during the
3 examination of third parties that the DCOs use to
4 complete clearing responsibilities. We are looking
5 for the DCO to know its vendor. I will discuss
6 some of the topics that we may look at during an
7 examination. One, does the DCO have and perform
8 due diligence procedures before entering into a
9 contract with the vendor? Does the DCO look at
10 things like reports, like maybe a SOC report to
11 gain some insight into the vendor’s cybersecurity
12 policies and procedures? And does the DCO ensure
13 minimum cybersecurity standards of the third party
14 that are similar to its own? Does the DCO have
15 procedures that rank the third parties in terms of
16 criticality of the services that the third party
17 will provide? If the service provider is a
18 critical third party, does the DCO perform due
19 diligence activities at the third party on a more
20 frequent basis?
21 Another topic is the cadence of continued
22 assessments and monitoring of the third party and

1 the governance process surrounding the third
2 parties who are responsible for reviewing to ensure
3 that the third-party risk assessments are being
4 completed and that risks are being reviewed and
5 identified.
6 And lastly, how does the DCO monitor third
7 parties that are completing work within its
8 environment? For example, how are events
9 identified and monitored within the SIEM and fed
10 into the DCO cyber defense processes and
11 procedures?
12 So these are just a few of the components of
13 our examination program on third parties. Some
14 third parties potentially play very critical
15 functions for some DCOs such as data center
16 providers or cloud service providers. It is
17 important that the third parties do not bring a
18 large amount of unmitigated risks to the DCO. To
19 this end, DCR examines the processes and programs
20 of the DCO to ensure third-party risk is, one,
21 self-identified, regularly monitored, and governed
22 by the same principles that apply to services

1 produced in house. Thank you.
2 MS. CRIGHTON: Great, thanks, Julie. And
3 thanks to our panelists, Lee, Julie, and Don.
4 We'll now open the floor for member discussion.
5 [No response.]
6 MS. CRIGHTON: Okay. We'll now turn to the
7 third panel of this section, Recovery and
8 Resilience. First, we'll hear from Alessandro
9 Cocco currently on detail as Senior Policy Advisor
10 at the Department of Treasury. Next, we'll hear
11 from Juan Blackwell, Head of Credit and
12 Counterparty Risk Management for the Ontario
13 Teachers' Pension Plan. Finally, we'll hear from
14 Bob Wasserman, Chief Counsel of the CFTC's Division
15 of Clearing and Risk.
16 I'll turn it over to you, Alessandro.
17 MR. COCCO: Thank you. Thank you,
18 Commissioner Johnson, Commissioner Mersinger, Chair
19 Crighton, and CFTC staff for supporting the
20 important work of the Commission in this area. And
21 thank you to MRAC members and guests for being here
22 today.

1 We would like to acknowledge the work of the
2 full membership of the workstream. The other
3 members of the workstream are Ruth Arnould from
4 BofA, Richard Berner from NYU Stern, Lee Betsill
5 from CME, Reggie Griffith from Louis Dreyfus, Paolo
6 Saguato from George Mason University, and Demetri
7 Karousos is from Nodal.
8 I'd like to mention that my remarks are my own
9 and don't represent the views of the U.S. Treasury.
10 So first, we'd like, looking at the first
11 slide 3, to provide a progress update, members of
12 the Recovery and Resolution Workstream plan on
13 issuing a report by the spring of 2024. Today,
14 we'd like to cover some of the key issues that we
15 plan on addressing in the report. We would also
16 like to invite questions and comments on these
17 topics.
18 And I'm looking at slide 14. There it is.
19 In the context of the work leading to the
20 report, we plan to consider public comments
21 received by the CFTC on the proposed rulemaking on
22 DCO recovery and orderly wind-down plans, as well

1 as international developments such as the EU
2 regulations and the FSB financial resources and
3 tools for central counterparty resolution
4 consultation report.
5 So moving over to the next slide, the
6 workstream's first consideration is that, as we
7 think of an effective recovery and resolution
8 regime, the first line of defense is the resilience
9 of the DCOs, FCMs, and clients. Regulations
10 requiring the implementation of recovery tools
11 decrease the likelihood that resolution will be
12 required. The regulations require SIDCOs and
13 Subpart C DCOs who have rules in place to allocate
14 losses and restore a matched book.
15 Clearinghouses are a prime example of the
16 interconnectedness of contemporary financial
17 systems where the connections between participants
18 in financial markets can lead to greater
19 efficiencies but also to the potential for risks to
20 spread more broadly and faster within the global
21 financial system, revealing dependencies that may
22 not be immediately apparent once critical risk

1 thresholds are reached.

2 So it's important to take into consideration

3 the resilience of the whole clearing ecosystem.

4 CCPs are designed to manage risks, but those risks

5 are mutualized among clearing members, and so CCPs

6 rely to a great extent on the ability of clearing

7 members to absorb such risks by providing funded

8 resources and unfunded commitments. Clearing

9 members in turn rely on the ability of clients to

10 meet their financial obligations with respect to

11 cleared contracts. So the ability of a DCO to

12 recover from losses depends on that DCO's risk

13 management but also on the ability of FCMs' clients

14 to recover losses if needed.

15 So turning over to the next slide, it's

16 important to notice that the choice of recovery

17 tools has policy implications, we know that CCPs

18 operate based on the principle of risk

19 mutualization, and CCP shareholders have exposure

20 through skin-in-the-game tranches in the CCP

21 default waterfall. On this point, in July 2021,

22 the CCP Risk and Governance Subcommittee of MRAC

1 published a report on DCO capital and skin in the
2 game. So setting aside losses absorbed by any
3 skin-in-the-game tranches provided by the CCP, if
4 the financial resources provided by the defaulter
5 are insufficient to absorb losses, the loss is
6 mutualized through the guarantee fund, but
7 additional funds may be required to fully absorb
8 the losses. And this is an important policy
9 decision that determines who bears the immediate
10 result of any losses in excess of the financial
11 resources available to the CCP.
12 So looking at the next slide, another factor
13 to consider in the assessment of CCP recovery tools
14 is liquidity. The ability of a CCP to recover from
15 a default scenario from large nondefault losses
16 will be heavily dependent on what supply and demand
17 looks like in terms of liquidity. We plan on
18 taking into account different types of liquidity,
19 so market liquidity and funding liquidity. Market
20 liquidity is a measure of the ability of the CCP to
21 turn an asset into a means of payment. Less liquid
22 assets are those that are more costly to be

1 converted into money. And some of the factors that
2 impact this assessment are the speed and size of
3 the transaction, along with the price impact of
4 converting the asset into money.
5 On the other hand, funding liquidity is the
6 ability to borrow to fund assets held on balance
7 sheet. The analysis of liquidity will depend on
8 the products cleared at the CCP and the risk
9 management tools used by the CCP. For a
10 derivatives CCP, market liquidity can be defined as
11 the ease in which, following a default, the CCP can
12 close an open position, and liquidity can therefore
13 be measured by the bid-ask spread needed to
14 transact, which typically increases during times of
15 uncertainty. The analysis will be different for a
16 repo CCP. A repo CCP would need to have
17 appropriate liquid instruments in place for noncash
18 collateral held as IM by the defaulting clearing
19 member.
20 And with that, I hand it over to Juan
21 Blackwell for the remainder of today's
22 presentation.

1 MR. BLACKWELL: Thank you, Alessandro. Thank
2 you, Commissioner Johnson, Commissioner Mersinger,
3 and Alicia for allowing me to speak here today. I
4 just want to reiterate Alessandro's point on
5 clearing of cash securities. If a CCP enters into
6 recovery or, God forbid, resolution of a cash
7 security clearing mechanism, the amount of
8 liquidity required could enter into a doom loop,
9 meaning that if you're clearing any cash security,
10 particularly for funding purposes, you will end up
11 in a situation where the market might be betting
12 against the ability to continue down that path. So
13 the CCP in question needs undoubted liquidity in
14 order to ensure they can buy the other side. In
15 cash security markets, the CCP no longer has what
16 it needs to settle the trade. So I think that is a
17 very important point for MRAC.
18 I should have started with these comments are
19 my own and not those of Ontario Teachers' Pension
20 Plan.
21 With that, we'll move on to the next slide,
22 please.

1 International harmonization for large
2 organizations and those that need to hedge in
3 multiple markets is absolutely critical. It's
4 necessary to be able to replicate the risks that we
5 take across markets in order to ensure end users
6 have access to hedging tools for the assets that we
7 need in order to, in my particular place, ensure
8 that pensioners actually have funding for their own
9 retirements in the future. Without international
10 harmonization, it becomes more and more difficult
11 to replicate those models across jurisdictions.
12 However, there is one area where the working
13 group will look at harmonization to a point. I am
14 definitely not a lawyer, but you should not get to
15 the point where you try and enforce harmonization
16 where it is no longer applicable due to the legal
17 jurisdiction or the bankruptcy laws in place
18 wherever the CCP is headquartered.
19 With that, we'll move on to transparency.
20 Before diving in, I'd like to acknowledge the work
21 that has been going on between FIA, SIFMA, and CCP
22 Global since approximately 2021. I'd say some of

1 this started in 2019 with a letter that a lot of
2 end users signed and was circulated across the
3 global community in order to ensure that there is
4 transparency first for liquidity models. Most end
5 users that have any sizable position try and
6 replicate their own liquidity of that position to
7 ensure that they can actually close out the
8 position or maintain the position if markets become
9 volatile. Without sufficient transparency, it
10 becomes very, very difficult to do that. It's a
11 guessing game, or worse, you end up being very,
12 very conservative and not deploying capital in its
13 most efficient form.
14 Without transparency, you also cannot justify
15 taking risk in some areas of the world. So this is
16 where more transparency across CCPs, sharing of
17 knowledge is actually a betterment of the financial
18 system for stability.
19 With that, I think we can hand it over to
20 closing remarks and questions. Thank you.
21 MS. CRIGHTON: Thanks, Juan. Bob, over to
22 you.

1 MR. WASSERMAN: Thank you very much. Thank
2 you, Commissioner Johnson, Commissioner Mersinger,
3 and Chair Crighton.
4 First, I will note that the remarks I'm about
5 to give do not necessarily represent those of the
6 Commission or the staff, or even myself if I'm
7 directed to change them.
8 I'm going to discuss two things. First, the
9 FSB's consultation on CCP resources for resolution
10 and the comments on that consultation; and second,
11 the Commission's proposed rulemaking for DCO
12 recovery and orderly wind down.
13 So FSB issued the consultation in September,
14 and comments were due on November 20. The main
15 point of the consultation is that resolution
16 authorities for systemically important CCPs should
17 have access to a set of resolution-specific
18 resources and tools that meet certain dimensions.
19 And they should be chosen from a set that includes
20 bail-in bonds, equity, resolution cash calls, and
21 variation margin gains haircutting.
22 There were 10 comments from industry

1 participants, including eight from the CCP side and
2 two from the market participants' side, one from
3 ISDA, FIA, IIF, and one from ICI, as well as a few
4 others. While the industry participants took
5 positions that broadly reflected their relative
6 contrasting perspectives, there were a number of
7 broad common points of agreement, one of which is
8 the importance of flexibility in implementing
9 resolution and of looking holistically across
10 recovery through resolution. There was also broad
11 agreement that further quantitative analysis is
12 necessary.
13 I would note that in 2022, FSB, CPMI, and
14 IOSCO undertook a quantitative analysis that found
15 very little impact on the 15 CCP service lines
16 studied from the default loss side either from
17 taking the CCPs' worst historical credit loss
18 scenario, multiplying by 1.4 and applying cover for
19 it, or looking at liquidity through the use of
20 maximum cash calls and 100 percent VMGH.
21 Nonetheless, the report noted some limitations
22 in the analysis and concluded that FSB should

1 continue to review the sufficiency of the existing
2 toolkit for CCP resolution, focusing in particular
3 on non-default loss scenarios. However, the 2023
4 consultation eschewed quantitative analysis, a
5 deficit that a number of commenters on both sides
6 criticized.
7 Both sides also oppose the use of the VMGH for
8 non-default losses, with commentaries noting that
9 the guidance should avoid tools that would
10 undermine close-out netting for bank capital
11 purposes. I would note that the VMGH for NDLs may
12 well be just such a tool.
13 Commentaries on the CCP side expressed that
14 resolution-specific resources and tools for default
15 losses could weaken or remove the incentive for
16 participants to effectively support default
17 management recovery. Quote, "Consultation
18 disregards the outcomes of the March 2022 report
19 because the consultation lacks supporting data and
20 quantitative analysis. While ignoring
21 contradictory data in the public sphere, it may not
22 provide relevant regulatory authorities and local

1 jurisdictions sufficient basis to implement any of
2 the proposals." Indeed, one commenter pointedly
3 stated that if the CFTC were to undertake a
4 rulemaking to adopt the consultation's proposals,
5 without adequate database analysis regarding
6 relevant costs and benefits involved, its
7 rulemaking could face a legal challenge.
8 By contrast, market participants were of the
9 view that, quote, "A greater balance of loss
10 allocation towards CCPs, relative to clearing
11 members and participants, looking across recovery
12 and resolution, would better align risk management
13 incentives and promote better outcomes from a
14 resilience, financial stability, incentives, and
15 market confidence perspective." They were
16 generally opposed to VMGH for default losses,
17 although they acknowledge it could be used with
18 strict limitations.
19 Turning to the recovery and wind-down
20 rulemaking, on June 7, the Commission approved a
21 rule proposal that would revise the existing
22 requirements for DCO recovery and wind-down plans.

1 It was broadly designed to accomplish three goals:
2 First, to codify existing staff guidance on
3 recovery and wind-down planning for SIDCOs and
4 Subpart C DCOs. Guidance is informative but not
5 binding. Regulations are binding.
6 Second, it would newly establish wind-down
7 requirements for all other DCOs. Some of these are
8 foreign-based and so already have wind-down plans
9 pursuant to their home country legal framework.
10 Others are U.S.-based, and the intent is to ensure
11 that they have orderly wind-down plans.
12 Now, just a few years ago, the Commission
13 approved amendments to our Part 190 bankruptcy
14 regulations that would explicitly cover a DCO
15 bankruptcy. I've observed before that in a
16 bankruptcy the only parties that make out well are
17 the lawyers and other professionals. In light of
18 new DCOs, including those whose members are retail
19 participants, it seems essential to have orderly
20 wind-down plans as an alternative to bankruptcy.
21 However, the requirements for these DCOs were
22 proposed to be intentionally less rigorous than

1 those for SIDCOs and Subpart C DCOs. In addition
2 to not requiring recovery plans, the requirements
3 here would be more focused on making sure that the
4 wind-down plan is credible and that the tools can
5 effectively be used. And the third function was to
6 obtain information for resolution planning.
7 Now, as background, our current regulations
8 require plans that identify scenarios that may
9 potentially prevent the DCO from meeting its
10 obligations and providing critical operations and
11 services as a going concern and to assess the
12 effectiveness of a full range of options for
13 recovery and orderly wind down. As a result of
14 supervision and developments in international
15 guidance, in 2016, DCR issued the current staff
16 guidance, letter number 16-61. Much of this
17 rulemaking incorporates the substantive elements of
18 letter 16-61. Although, to be frank, the proposal
19 does indeed go beyond them. The proposal is fairly
20 detailed, arguably prescriptive with respect to the
21 recovery and wind-down planning processes.
22 However, it seeks to be non-prescriptive and leave

1 DCOs considerable discretion with respect to the
2 decisions they make about the content of the plans
3 and with respect to the decisions DCOs take in
4 executing those plans.
5 The proposal would require analyses for
6 recovery and wind-down plans that are similar to
7 those identified in 16-61. For instance, the DCO
8 must identify wind-down triggers, scenarios, and
9 tools. However, the proposal goes somewhat
10 further, requiring the DCO to identify its
11 financial and operational interconnections and
12 interdependencies, plans for resilient staffing
13 arrangements, governance structures, and contracts
14 or agreements subject to alteration in the event of
15 wind down, as well as the service providers relied
16 on for critical operational services; and,
17 contrastingly, any critical operations or services
18 it provides to other financial entities; and
19 finally, obstacles to the success of the plan.
20 16-61 covered plans for regular testing, and
21 the proposal would require the testing of recovery
22 and wind-down plans on at least an annual basis.

1 And additionally, SIDCOs and Subpart C DCOs would
2 conduct the testing with the participation of
3 clearing members where the plan depends upon that
4 participation.
5 The rulemaking enumerates certain non-default
6 loss scenarios that the DCO would be required to
7 address but only if they're applicable. These
8 include settlement and custodian or depository bank
9 failures, investment risk, and legal liability
10 unrelated to the DCO’s business as a DCO.
11 One lesson we've recently relearned is that it
12 is important to avoid conflating low risk with no
13 risk. For instance, many used to consider the
14 default of a regulated bank as an irrelevant
15 scenario since large banks don't fail. That
16 assumption fell last March.
17 The proposal would also require that the DCO
18 consider any combination of at least two scenarios
19 involving multiple failures especially relevant to
20 the DCO’s business and that the plans address cyber
21 risk for malicious actors.
22 The Commission has received a set of detailed

1 and very well-thought-out comments. Some
2 commenters want the Commission to go further and
3 impose requirements on the substance of the plans.
4 Others say that the proposal was far too detailed.
5 And some commenters pointed out places where the
6 language used in the proposed rules might lead to
7 unintended consequences.
8 Now, our colleagues at the SEC are in parallel
9 going through their own rulemaking on clearing
10 agency recovery and orderly wind-down plans. We've
11 been in contact with and have coordinated with our
12 SEC colleagues. I will observe that while the rule
13 text of their proposal would seem to be far less
14 detailed than ours, given the fact that the SEC has
15 a process for approving such plans in advance as
16 rule filings, and the points the SEC made in their
17 preamble as to their expectations with respect to
18 those plans, I would submit that both proposals get
19 to the same end place, though by different routes.
20 We're still in internal discussions to
21 determine what the specifics of the final rule
22 proposed to the Commission might be, though I will

1 note that at the very least, staff will be paying
2 close attention to concerns about how the proposed
3 rules might be adjusted or redrafted to avoid
4 unintended consequences. Thank you.
5 MS. CRIGHTON: Great. Thanks, Bob. And
6 thanks to our speakers.
7 I'll open it up to the floor for comments.
8 [No response.]
9 MS. CRIGHTON: Okay. We'll now turn to the
10 fourth panel of this section, which discusses
11 margin and collateral. First, we'll hear from
12 Dmitrij Senko, Chief Risk Officer of Eurex Clearing
13 AG. Dmitrij?
14 MR. SENKO: Thank you, Chair Crighton. Thank
15 you, Commissioner Johnson, Commissioner Mersinger,
16 and CFTC staff who helped to organize and for the
17 possibility to share the progress update of the
18 workstream Margin and Collateral Guidelines.
19 The workstream participants are people
20 representing different parts of the derivatives
21 industry. We have Joseph Garelick from BlackRock.
22 We have David Horner from LCH. We have Raj

1 Ramanath from JP Morgan and myself from Eurex
2 Clearing. We worked on a prioritized set of
3 topics, and I will outline them one by one.
4 So we worked on the topics transparency for
5 margin, second one is anti-procyclicality, third
6 one is margin period of risk, fourth is collateral
7 margin calls. Today is only the progress update as
8 we planned for the work to -- before providing
9 recommendations, we looked into what happened since
10 the last report was presented in '21, what market
11 developments happened since then, how industry
12 practice evolved, and what are the known viewpoints
13 on the topics. As you can see, the topics were
14 already with us for a few years, so we looked at
15 whether an update of the recommendation from the
16 last report is needed, but we want to do it on a
17 reasonable analysis that is performed before that.
18 So, currently, where we are now, we looked at
19 all that, and we are currently assessing the
20 discussion landscape before we progress to
21 recommendation, which we will work out in the next
22 few months and present to you next time.

1 On margin transparency, a few words were
2 mentioned today already. We looked into
3 recommendation last time in '21, and this
4 acknowledged already the importance of the topic
5 and referring that further work will be conducted
6 separately.
7 The overall goal here is to enable market
8 participants' liquidity planning and risk
9 management by providing information on margin model
10 reaction on certain market conditions, including
11 how margin calls work, resulting out of the market
12 developments. In the workstream, we discussed
13 different viewpoints on that topic, one being that
14 a lot of things are already in place. That's one
15 viewpoint. Another viewpoint is that still more
16 enhancements can be done, and all those ideas for
17 what to be enhanced can be split into different
18 categories, descriptive aspects, empirical aspects,
19 and operational aspects.
20 As for descriptive aspects of transparency, it
21 could be enhanced the description of how the margin
22 model works, including the add-ons and margin

1 parameters, et cetera. All in all, it's a
2 qualitative description but could allow replication
3 of the margin model on a standalone basis.
4 As for empirical aspects of transparency, CCPs
5 could extend quantitative disclosures of margin-
6 related metrics, including breakdowns into base
7 margin add-ons and, for example, margin backtesting
8 performance. CCPs could provide the tools for
9 members to facilitate understanding of these
10 breakdowns also, including potential "what if"
11 analysis, what happens if the portfolio changes and
12 new positions come into the portfolio?
13 As for operational aspects of transparency,
14 CCPs could disclose procedures for intraday risk
15 monitoring, including triggers, thresholds, for
16 example, how much margin erosion is tolerated
17 before margin calls are done.
18 In addition to those three types of aspects --
19 empirical, descriptive, and operational -- we
20 discussed also to whom which information should be
21 disclosed, so who are the recipients, and maybe a
22 stratified approach is necessary or whether it is

1 necessary or not: all members and clients,
2 individual members, individual clients, supervisory
3 authorities, could be different groups or subgroups
4 and how disclosures are made, publicly, privately,
5 tool-supported, et cetera.
6 Coming to the second topic we looked at, anti-
7 procyclicality, we pre-discussed that there are
8 several factors for cyclicality both of variation
9 margin effect, initial margin effect, and the
10 bigger one is probably the VM effect. But we
11 focused our discussion on IM effect, so IM
12 procyclicality only. Comparing to recommendations
13 in '21, we agreed that CCP should retain the
14 ability to choose the appropriate means of
15 mitigating procyclicality.
16 Further, we discussed that there is room for
17 standardization of procyclicality metrics, and just
18 to -- and we discussed the flavor on the different
19 dimensions that are relevant there: one is called
20 the short-term metrics, long-term metrics, and also
21 we discussed ideas about metrics that are relating
22 to some model-free measure of volatility.

1 In terms of aggregation level, it's also
2 important to differentiate that it doesn't make
3 sense or there is some precautions to be known if
4 looking at portfolio-level measures where portfolio
5 is changing over time so their procyclicality
6 metrics may be not giving the full analysis. So
7 procyclicality assessment on product level or on
8 some fixed strategies could be necessary to
9 understand the dynamics.
10 Further, we discussed the necessity to
11 strengthen the cyclicality in terms of governance
12 and framework around it. For example, disclosure
13 of the framework, how CCP strikes the balance
14 between margin stability and backtesting
15 performance, there is some tradeoff there. Stable
16 margin can result into low backtesting results,
17 and CCPs could outline the details of chosen
18 procyclicality metrics, target levels of these
19 metrics, and what thresholds are there and what
20 investigation CCP would perform if some of the
21 metrics are exceeded.
22 In addition to discussing these backward-

1 looking procyclicality measures, we discussed the
2 forward-looking procyclicality disclosures that
3 could be done by, for example, replaying or doing a
4 what-if, what can happen if crisis repeats or some
5 crisis situation evolves, so what would be the
6 moderate reaction?
7 We also discussed the -- in order to achieve
8 the overall goal of overall financial stability,
9 there is a value of understanding the cyclicality
10 developments also in uncleared space and the
11 interplay of what happens in cleared and uncleared
12 together.
13 In terms of margin period of risk, we compared
14 also here with a recommendation in '21, their
15 outlined criteria are mainly still valid. Since
16 then, we observed a few more crisis and notable
17 events happened with increased attention on the
18 issue of margin, so considering those few
19 additional data points and perspectives, we
20 discussed whether further recommendation or making
21 it more precise, whether it is needed.
22 In the workstream, we discussed the competing

1 viewpoints and the tradeoffs on the MPOR, on the
2 one hand, the importance of MPOR to enhance the
3 risk management, providing more time to react in
4 adverse market conditions, and on the other hand,
5 implications on economics of trading where
6 excessive margins may stifle trading activity and
7 lead to market inefficiencies.
8 Also, we discussed if this should be viewed as
9 a product-specific approach, so, for example,
10 addressing margin period of risk for, you know,
11 only energy or commodity space or a general
12 liquidity-based argument, which is true across
13 different asset classes.
14 Initial margin should cover losses faced by
15 CCP during the default management or until CCP
16 returns to matched book following member default.
17 And there are two primary sources of this loss.
18 It's market risk between the last successful margin
19 collection and until CCP is balanced and the
20 liquidity concentration risk that can materialize
21 when additional price pressure comes when
22 liquidating a big position.

1 So noting we discussed as well that porting is
2 also part of one element, one instrument that helps
3 CCPs to return to matched book, whether different
4 approaches should be applied to MPOR, considering
5 that there is porting approach with different
6 mechanics from the liquidation approach where
7 potentially auctioning happens, whereas in porting
8 it's ported and maybe less than market impact is
9 happening. So that's the discussion we had.
10 We also discussed different alternatives to
11 ensure appropriate of margins, such as one is
12 requiring a minimum of two days MPOR or
13 appropriateness of a more differentiated approach
14 where level of concentration margins for larger
15 portfolios is sufficiently adjusted to reflect a
16 shorter holding period.
17 Further, we discussed different perspectives
18 on margins with respect to margining practices and
19 the role they play in CCP risk management vis-à-vis
20 clearing members and risk management between
21 members and clients. In that respect, in the
22 latter respect, the margins are not only there to

1 protect CCPs from surviving participants in case of
2 clearing member defaults, but also used by clearing
3 members to manage client risk.
4 Coming to the last point on margin calls, we
5 discussed that, beyond the core purpose of margins
6 to act as a first line of defense to collateralize
7 cleared exposures, margin calls can influence
8 procyclicality. The previous report in '21 on that
9 elaborated on many aspects and recommendations, and
10 they are still valid. In the workstream, we
11 discussed different types of margin call processes,
12 scheduled event-driven and ad hoc, differentiating
13 between event-driven and ad hoc, two different
14 ones. We discussed one subdimension is whether
15 margin calls require or don't require VM
16 passthrough and implications if VM passthrough is,
17 for example, not possible, if noncash collateral
18 only collected. If cash is not collected, then VM
19 passthrough is not possible.
20 We noted also the known tradeoff between
21 lowering of frequency of margin calls and the level
22 of tolerable margin erosion, so the less frequent

1 margin calls are done, the more margin erosion can
2 happen in between those calls. In addition, we
3 discussed the margin practice along the overall
4 chain between CCP members and clients and different
5 velocity of margin movements along this chain.
6 Further, interrelation with other topics like anti-
7 procyclicality and margin transparency may require
8 that we combine this topic with the other ones.
9 So with that, that's the progress update so
10 far, and we hope that in the next few months we are
11 coming up with more recommendations. And with
12 that, I hand it back over to the organizers.
13 MS. CRIGHTON: Great. Thanks very much,
14 Dmitrij.
15 Before we transition to the Market Structure
16 Subcommittee, I'll pause for any member comments as
17 we close out the CCP risk and governance. I
18 recognize Jennifer Han.
19 MS. HAN: Sure. Can you explain a little bit
20 more with respect to client collateral and margin,
21 is that segregated? And then maybe to Bob's
22 previous discussion, in a default, where does that

1 fall? Is that at the top of the waterfall, or is
2 that at the general default fund?
3 MR. SENKO: So let's take a few points there.
4 Margins and for different client access models,
5 there are different client access models,
6 individually segregated or gross omnibus
7 segregated. And that's omnibus segregated, so
8 that's just to mention how much margin and where it
9 is held and what's the risk to your peer clients is
10 different in those different models.
11 In terms of where margin sits in the
12 waterfall, that's unchanged. Margin is first line
13 of defense in the waterfall. Then comes -- if
14 that's not sufficient, then it's skin in the game
15 of the CCP. If that is not sufficient, then it
16 goes before is a default fund contribution of the
17 defaulted members. And after skin in the game,
18 it's default fund of the remaining clearing
19 members. So that's pretty similar across CCPs.
20 MS. HAN: On what you said, so when you say
21 margin is the first line of defense, is that the
22 client that is in deficit, or is that also if you

1 are another client? So like would my margin be at
2 risk if another client is in deficit? Like would
3 my margin be taken to use to fill a gap due to
4 another client's?
5 MR. SENKO: So yes, we are coming to mechanics
6 of default measure when one clearing member is in
7 default, then the question is posing, can clients
8 be ported or not? And if they are, let's say,
9 segregated from each other, say an individual is
10 segregated, then what's the situation with their
11 backup clearing member? Are they going to be
12 accepted in that phase? It's not allowed.
13 Spillover is not allowed between individually
14 segregated clients.
15 But coming to another example, in Europe there
16 is net omnibus account structure there. Kind of
17 it's not transparent to CCP who are the clients,
18 and they are treated as one account. So there some
19 customers are subject to peer client risk if you
20 want. Unless the individual is segregated, if
21 porting can happen, then that's the best outcome.
22 If porting cannot happen, then such client

1 positions, portfolios are liquidated. And then
2 also there is no spillover possible to the other,
3 so everyone is liquidated, and the margin is held
4 against what are the proceeds from the liquidation
5 of the single account. So in that respect,
6 individually segregated setup is most, you know,
7 protected from peer client risk.
8 MS. HAN: Thank you.
9 MS. CRIGHTON: Bob, we'll turn to you.
10 MR. WASSERMAN: Yeah, to your point, in the
11 U.S. of course on the futures side, you do face
12 fellow customer risk because, as mentioned, it is
13 one account on the omnibus. However, of course, on
14 the cleared swaps side we have LSOC, which means
15 you would not be facing fellow customer risk,
16 although, again, if the margin has gone missing,
17 then there would be risk there.
18 MS. CRIGHTON: I recognize Marnie Rosenberg.
19 MS. ROSENBERG: Thanks, Alicia.
20 Thank you, Commissioner Johnson, for your
21 continued sponsorship of the MRAC and Alicia as the
22 MRAC chair for the continued focus and support of

1 the CFTC's CCP Risk and Governance Subcommittee on
2 enhancing CCP risk management.
3 And, Dmitrij, we welcome the priority areas
4 identified by the Margin and Collateral Workstream,
5 which we're involved in, ensuring transparency and
6 predictability of margin models, evaluating impact
7 of margin call processes, determining metrics for
8 measuring and addressing margin procyclicality, and
9 revisiting the impact of different margin periods
10 of risk and assessing alternatives to ensuring
11 adequate margin.
12 It's encouraging to hear that the workstream
13 is building upon the prior work and the
14 recommendations that several of us worked on from
15 2020 to 2021. We look forward to also reviewing
16 the recommendations from the group.
17 I also wanted to voice our support for the
18 important work being done in the recovering
19 resolution in the Tech and Ops Workstream, which
20 tie into the valuable global work in this arena.
21 So we look forward to really focus on these
22 recommendations once each of the workstreams is

1 prepared to share it with the full MRAC. And
2 thanks, Alessandro and Chris Edmonds, for leading
3 this subcommittee. We look forward to seeing all
4 the recommendations from across the workstreams in
5 the coming months. That's all.
6 MS. CRIGHTON: Great. Thanks, Marnie.
7 Any other comments in the room or on Zoom?
8 Oh, sorry. Juan?
9 MR. BLACKWELL: Thank you. I just wanted to
10 expand on Jennifer's comments.
11 With respect to -- so, Bob, you mentioned
12 LSOC, and we're very thankful as end users. For
13 the mandatorily cleared products LSOC was created.
14 However, if IM does not remain sacrosanct, and
15 we're aware of the fellow customer risk, I do not
16 believe recovery or resolution for a CCP can work
17 because, as you move further down the waterfall, it
18 requires those of us that manage money for other
19 people to go to our board or the people who have
20 given us the mandates and ask them if they're
21 willing to put good money behind bad. That's a
22 very difficult ask.

1 MS. CRIGHTON: Alessandro?
2 MR. COCCO: Thank you, Alicia.
3 And still building on what Juan mentioned, so,
4 Jennifer, I guess the question, as mentioned, you
5 need to look at, you know, what model of
6 segregation you have depending on the type of
7 product and the region where you're trading , and
8 then when you get to the end of the waterfall,
9 that's when you want to really understand what
10 happens in a recovery or resolution scenario
11 because, depending on the model, you may have
12 variation margin haircutting. So even though
13 you're the winning party, you know, the party that
14 has a gain, and you're not the defaulter and your
15 clearing member is okay, there may still be,
16 depending on the choices that are made, a shortfall
17 that then will require you to speak to your board
18 and to your investors, so I think that
19 understanding those models.
20 And something that Bob mentioned to me, the
21 fact that something is low risk does not mean you
22 don't have to prepare for it and have a clear

1 understanding of what happens because especially in
2 the context where you have mandatory clearing, you
3 have to make sure that the service continues. And
4 there are, again, those policy choices that I
5 mentioned earlier in terms of who bears losses in
6 in a recovery and resolution situation. Thank you.
7 MS. CRIGHTON: Great. Thanks, Alessandro.
8 And if I may, Jennifer, just on one of your
9 points regarding margin being the first line of
10 defense, I think the reason why we focus on that
11 and really kind of think about that as, you know,
12 one of the overarching themes and really part of
13 the advocacy of so many folks in this room is, you
14 know, we want to ensure that margin is
15 appropriately calibrated and customers have enough
16 on deposit in much more of a uniform fashion,
17 right? Margin shouldn't be sort of a competitive
18 advantage across firms or CCPs. So ensuring that
19 it's appropriately calibrated by asset class and by
20 product is one of the things that we focus on the
21 most. And ensuring that calibration, ensuring the
22 robustness of that initial margin regime we think

1 really, in that context, that's how it's the first
2 line of defense, making sure that there's enough
3 collateral on deposit to withstand the risks that
4 we have seen and continue to see.
5 MS. HAN: Great, thank you.
6 MS. CRIGHTON: Lee?
7 MR. BETSILL: Thanks, Alicia.
8 Following on the same point, I did want to
9 reiterate that in a clearing member default at CCP,
10 one of our first priorities is to look to port
11 clients, to non-defaulting clearing members. The
12 CFTC regime, which has customer gross margining,
13 has bulk transfer rules is one which is set up to
14 support porting, and we have successfully done that
15 in the past. And that is putting positions to non-
16 defaulting clearing members along with associated
17 collateral. So we are set up to be successful. We
18 can't guarantee it, obviously, but we are set up to
19 be successful for that in the CFTC regime.
20 MS. CRIGHTON: Thanks, Lee. Bob?
21 MR. WASSERMAN: To Lee's point, of course, in
22 order to have successful porting, you need to have

1 willing transferees. And, as Lee mentioned, we
2 have been very successful in the past that it's
3 becoming increasingly tenuous given the reduced
4 number of FCMs we have. And indeed, to the extent
5 that bank capital rules make such porting less
6 attractive to potential transferees or indeed
7 potentially damaging, it makes life that much more
8 difficult. Thank you.
9 MS. CRIGHTON: Thanks, Bob.
10 As the Commissioner just said, that's actually
11 a perfect segue into the Market Structure
12 Subcommittee. So for our first panel of this
13 section, Ashwini Panse, Head of Risk Oversight for
14 ICE Clear Netherlands and Chief Risk Officer for
15 the North American Clearinghouses. Ashwini?
16 MS. PANSE: Thank you, Chair Crighton,
17 Commissioner Johnson, Commissioner Mersinger, and
18 CFTC staff for the opportunity to speak today on
19 the topic of FCM capacity.
20 I would like to acknowledge all the members of
21 the workstream and the Market Structure
22 Subcommittee members for all the active discussion

1 that we've had on the topic, the feedback, and the
2 valuable input that has helped round our views.
3 The FCM Capacity Workstream analyzed 20 years
4 of FCM data published on the CFTC website. The
5 data looks at trends relating to the number of
6 FCMs, activity over the years, client margins, and
7 capital requirements. The headline is, one, there
8 has indeed been some consolidation of FCMs overall,
9 but there is still adequate competition and
10 capacity from what we can tell. So the system
11 still works.
12 Two, costs in the form of capital compliance,
13 cyber technology are high and growing, so we need
14 to be thoughtful about how we balance risk with
15 reward so new entrants can come to the market,
16 existing players stay in the market, and costs are
17 kept manageable as they are ultimately passed in
18 some form back to the consumer.
19 Today, I will focus on our top observations
20 included on the first two slides. The remaining
21 slides contain supportive data and charts. With
22 respect to the number of FCMs, the futures industry

1 has experienced a significant FCM consolidation
2 over the period 2002 through 2023. We have
3 observed a 70 percent decline in the total number
4 of FCMs, primarily led by the exit of many
5 independent FCMs who are neither duly registered as
6 broker-dealers, nor affiliated with banks or bank
7 holding companies.
8 However, the decline is attributable to not
9 only the departure of many shell FCMs, i.e., FCMs
10 conducting only retail for its business, and non-
11 carrying FCMs, i.e., FCMs that hold no customer
12 funds, but also to the shrinkage of an important
13 group of FCMs who hold customer funds intended for
14 futures trading carrying FCMs. We're seeing a
15 decline of 91 percent of non-carrying FCMs, 58
16 percent of carrying FCMs, and as of today, only
17 four shell FCMs remain.
18 A succession of increases in minimum capital
19 requirements has resulted in the near elimination
20 of the shell FCMs. When we look at firms doing
21 cleared swap business, the number of firms have
22 reduced from 23 in 2014 to only 17 in 2023. We

1 have observed exits and downsizing by some notable
2 firms in recent years, including BNY Mellon, State
3 Street, Jefferies, Nomura, RBS Securities, and
4 NewEdge, who exited the cleared swap business in
5 2015, followed by Deutsche Bank Securities in 2017.
6 And Credit Suisse, as you all are aware, had begun
7 reducing the client activity even prior to the
8 sale.
9 Let me jump to the two essential primary
10 financial safeguards. First, segregation of
11 customer funds from proprietary funds and trading
12 activities of the FCM; second, maintenance of
13 minimum capital given FCM's capital provides a
14 backup layer and an added layer of protection to an
15 FCM's customer base from potential large trading
16 losses of a customer, which could exhaust the
17 customer assets and potentially expose other
18 customers of the FCM to the risk of losing their
19 own funds.
20 Let us look at the growth in customer funds
21 and adjusted net capital across firms. During the
22 same period of 20 years where we observed a decline

1 in the number of FCMs, even as a swap clearing
2 requirement went into effect, we are seeing a
3 rising demand for clearing. We observed a 700-
4 plus-percent increase in the holding of customer
5 funds. Going back 20 years ago when the part of
6 client margin requirements aggregated to $60 plus
7 billion, in 2023 the highest we have seen the
8 requirements rise to was north of $500-plus billion
9 U.S.
10 Today, the remaining FCMs are dominated by the
11 larger FCM brokers who now hold all top 10 industry
12 positions in terms of holdings of customer funds,
13 and these 10 FCMs account for 80-plus percent of
14 all customer funds. Similarly, we have observed an
15 increase of 296 percent in firms' adjusted net
16 capital. Going back 20 years across the firm's
17 adjusted net capital was $45-plus billion U.S. In
18 2023, it is north of $179 billion U.S.
19 As a whole, the remaining FCMs are well-
20 capitalized and most hold significant excess
21 capital relative to the CFTC minimum requirements
22 with the FCM broker-dealers and the bank-affiliated

1 FCMs holding significantly greater levels of excess
2 capital than independent FCMs primarily due to the
3 fact they need to adhere to other more stringent
4 regulatory or jurisdictional capital requirements.
5 Excess capital that FCMs are maintaining
6 support FCMs' financial solvency, reduce systemic
7 risk, and enable them to meet the rising costs
8 stemming from regulatory requirements and
9 technological advances. However, in our review of
10 the data and our conversation with the dealers, our
11 initial analysis has also attempted to rationalize
12 why there are fewer new entrants.
13 Providing FCM services has become an
14 increasingly high fixed-cost business with the cost
15 of infrastructure and regulatory compliance
16 climbing materially post-Dodd-Frank. This makes
17 scale critical to running a successful FCM, in many
18 cases, with firms taking a more holistic view of
19 their largest clients across their franchise, i.e.,
20 not just clearing, but associated businesses such
21 as prime, repo, execution, et cetera.
22 As a result, smaller FCMs may not be able to

1 generate enough money to justify the cost of
2 infrastructure and regulatory compliance. And what
3 we have seen is that the clients have been
4 gravitating to the biggest providers generally, all
5 banks.
6 However, data also remains supportive of the
7 fact that, overall, FCM business continues to be
8 very competitive. FCMs across the board have been
9 able to absorb the growth in client activity and
10 meet margin requirements, including in periods when
11 margin levels increase sharply due to market
12 volatility. That being said, it is critical that
13 capital rules remain risk-sensitive, incentivized
14 clearing and additional burdens not be placed on
15 firms providing the service.
16 There are some instances where the big bank
17 FCMs have become more restricted on offering the
18 service, particularly post-SA-CCR rollout, when
19 these products became disproportionately expensive.
20 While we have seen some smaller non-bank FCMs step
21 in aggressively in these instances, it is also the
22 case that some of this business was taken OTC, and

1 some market makers exited the markets when the
2 capital requirements became too punitive, impacting
3 liquidity and therefore the cost of hedging for
4 commercial participants.
5 We have seen recently as a result of
6 heightened volatility in certain energy markets and
7 large increases in margin requirements during that
8 period meant that many commercial participants
9 using cleared markets to hedge commercial price
10 risk hit various thresholds, including some capital
11 thresholds with their FCMs, the result of which was
12 that they either took these hedges OTC or in some
13 cases took the hedges off altogether.
14 Tying up too much capital has the effect of
15 reducing the headroom for when the market stresses
16 occur. FCM concentration, coupled with new capital
17 rules, may make the possibility of porting more
18 challenging. When Lehman happened, Barclays took
19 all the clients. If the same scenario were to
20 occur again and one of the larger clearing members
21 took a hit, I think the regulators in the industry
22 should really be concerned about how likely is it

1 that another clearing member will step forward to
2 take on all those clients if that member is already
3 at capacity with the proposed capital rules.
4 If we go to the next slide, for instance, the
5 more recently proposed capital rules like the G-SIB
6 surcharge and Basel III Endgame can impact client
7 clearing and have the potential to further reduce
8 capacity in cleared markets.
9 It is important to bear in mind that uplift in
10 capital have real impact on the business that banks
11 do on a desk-by-desk basis and on a business-by-
12 business basis. As the hurdle rates change for
13 those businesses, banks will have to make decisions
14 about where to grow and invest relative to where to
15 reduce or eliminate certain activity that they do.
16 The G-SIB buffer is supposed to disincentivize
17 activity that is seen as systemically risky.
18 The proposal to include OTC client-cleared leg
19 to the complexity and the interconnectedness
20 indicators of the G-SIB surcharge is
21 counterintuitive because it is well proven that
22 clearing reduces complexity and interconnectedness.

1 The inclusion does not align with the actual risk
2 presented by this activity. It departs from the
3 existing framework without adequate explanation,
4 may reduce capacity and willingness of banks to
5 intermediate client clearing and contravenes the
6 longstanding public policy objective to promote
7 central clearing.
8 If we look at the Basel III Endgame proposal
9 with the capital stacks being restructured, the
10 impact of trading activities will be quite
11 significant. For instance, the services component
12 of the operational risk capital relating to the
13 fee- and commission-based revenue is widely
14 acknowledged to be punitive in nature and
15 essentially attacks on revenue, which is very
16 difficult to optimize around.
17 If we look at the credit value adjustment
18 capital charge, inclusion of client clearing is
19 unnecessary as the only client-related credit risk
20 that the clearing member faces is the risk of
21 client default, which is already captured in the
22 existing counterparty credit risk framework. Also,

1 it is worth discussing equivalency of U.S.
2 implementation with what we see in other major
3 jurisdictions like the U.K. and the EU where
4 exemptions are in place.
5 Another element of the new proposal penalizes
6 exposures to foreign banks with higher risk rates
7 and charges more capital for counterparties that
8 are investment grade, highly creditworthy, but do
9 not have publicly traded securities.
10 I will close my remarks by saying that we
11 recognize that there's a need to make sure that
12 derivatives activity is appropriately capitalized,
13 but that needs to be done in a way that recognizes
14 existing risk mitigants in the system and in a way
15 that's consistent with broader policy objectives.
16 We could see changes in types of participants,
17 participation, which could present a different type
18 of systemic risk and something we should all
19 carefully think about if we want to incentivize.
20 Separately, we also believe it is critical to
21 ensure that the proposed capital rules do not
22 impede implementation of potential clearing

1 requirements for the U.S. Treasury securities
2 transactions if the SEC finalizes its proposed rule
3 on this issue.
4 With that said, I would like to invite
5 feedback from the full MRAC to ensure we have input
6 and consensus around the workstream's observations
7 prior to considering any potential recommendations.
8 Thank you.
9 MS. CRIGHTON: I appreciate it, Ashwini.
10 Thanks very much. Maybe I'll start with a few
11 brief comments, and then we'll open it up to the
12 floor for discussion.
13 I'll primarily focus just on the capital
14 comments in the materials that you just reviewed.
15 I think while we have highlighted there are really
16 a number of concerns, the kind of top list is here.
17 I think we'll really focus on probably the two most
18 concerning aspects, which is the inclusion of the
19 CVA charge for client-cleared derivatives, as well
20 as the inclusion of the notional of the client-
21 cleared leg in the G-SIB calculation.
22 The CVA is intended to capture mark-to-market

1 losses or counterparty deterioration absent a
2 client default. These types of losses do not exist
3 in the client-cleared model. Counterparty default
4 risk does exist. However, we are capitalizing for
5 that already, as you indicated in the SA-CCR
6 framework. These proposed changes to G-SIB were
7 discussed and ultimately not implemented in 2017
8 with the view that significant impacts to the
9 client-cleared model and to the FCM capital
10 footprint would disincentivize clearing.
11 Post-Dodd-Frank, goals in the clearing
12 mandates were to simplify and standardize, and
13 markets have rightly benefited from that. However,
14 we're reaching a new tension in the system with a
15 concentrated pool of FCMs offering much-needed
16 capacity to the client-cleared ecosystem. The
17 consequences if the proposals are implemented as
18 drafted will be significant and will exacerbate the
19 FCM concentration issues we're already experiencing
20 and likely have a second-order risk impact of
21 introducing new participants into the mutualized
22 pool. We urge regulators to focus on these issues,

1 and thanks for your time.
2 I'll open it up to the floor for more feedback
3 and comments. Sorry, Andrew?
4 MR. NASH: Thank you. I echo Alicia's
5 comments but also, Ashwini, I thought that was a
6 very well-done presentation. It's very data-
7 driven, and it's taking a 20-year time horizon for
8 perspective, which is a nice way to see it.
9 I would just call out some of the trends that
10 you highlighted both in terms of the concentration
11 of the number of FCMs and the rising balances at
12 those FCMs. And to tie it back to Bob's comments
13 from the prior panel, ultimately, the question is
14 what is the impact on portability and the impact on
15 customer access to clearing services. That might
16 be an area for further investigation by the
17 subcommittee in the coming year.
18 And then to amplify two other points that have
19 been alluded to, what's, I think, interesting about
20 this topic is the intersection with two other
21 regulatory regimes. Insofar as the FCMs are
22 largely subsidiaries of large U.S. bank holding

1 companies, you have this top-of-the-house fed
2 capital rulemaking structure that is then pushing
3 down capital requirements to these business
4 activities so outside of the Commission's direct
5 purview.
6 The second, which has also been alluded to, is
7 that oftentimes, the FCMs are dual-registered with
8 the SEC as a broker-dealer. And so the SEC has
9 announced on Wednesday of this week it's intending
10 to adopt a final rule to mandate clearing in U.S.
11 Treasury securities. One might expect, all else
12 being equal, that those Treasury clearing services
13 will be conducted out of the same entities and will
14 put further capacity pressure on the entities that
15 are offering both Commission-regulated clearing
16 services, as well as those for Treasury. So the
17 issues become more amplified for all the reasons
18 that you previously highlighted.
19 Alicia, I think, did a nice job summarizing
20 the obstacles on CVA issues so I won't call out
21 those any further.
22 My last observation would be just in terms of

1 future work that the subcommittee might do or might
2 consider. I think that this presentation did a
3 wonderful job of summarizing the data trends for
4 the FCM specifically. Another perspective of it
5 might be trends we've seen with clearinghouses and
6 whether the relative market share of clearinghouses
7 and the products that they're clearing have changed
8 or in what ways have they changed over a similarly
9 long time horizon so that you could see both the
10 FCM and the clearing side of the equation. Thank
11 you.
12 MS. CRIGHTON: Thanks, Andrew. That's
13 helpful.
14 Tyson?
15 MR. SLOCUM: Thank you very much. Excellent
16 presentation. So I was really interested in the
17 chart on page 24 of the handout that we've all been
18 given. And it seems like it's documenting the 70
19 percent decline in the total number of FCMs. And
20 it looks like there's a couple of key data points
21 here. One appears to correspond with the 2008
22 financial crisis, and the other appears to be in

1 2014, 2015, and since then, it's sort of leveled
2 off.
3 And so I'm just wondering if the committee is
4 looking at whether or not mergers and acquisitions
5 have played a role in this concentration, and
6 particularly, you noted the significant barriers to
7 entry for new participants, the infrastructure
8 needs, whether or not mergers and consolidations
9 have contributed to those barriers to entry, and
10 therefore, removing some competitiveness perhaps.
11 Thank you.
12 MS. PANSE: Just to highlight, I think, you
13 know, in the back pages of this presentation, we've
14 looked at, you know, every five years who's
15 remaining, and you're right, you know, we have seen
16 a lot of consolidation happening over the years,
17 which has contributed to -- and then I think that
18 combined with, you know, the 2008 crisis that
19 happened and then the new capital rules and
20 requirements that came into play, I think it's a
21 combination that we've observed where we've seen a
22 lot of, you know, FCM capacity, number of FCMs

1 declining.

2 As you see, clearing is still -- you know,

3 there's a high demand for clearing, and so that

4 hasn't stopped. There's a rise in, you know,

5 customer funds, that has, you know, with time only

6 increased. So the demand hasn't gone down. We've

7 just seen some consolidation. And I think that's,

8 like you said, mergers and acquisitions, plus some

9 of the members have just exited because of the

10 capital rules.

11 MR. SLOCUM: Thank you.

12 MS. CRIGHTON: Marnie?

13 MS. ROSENBERG: Thank you, Alicia. Yes, some

14 of my remarks will be similar to what Alicia and

15 Andrew said, which we would support as well.

16 So first, thank you, Ashwini, for the detailed

17 presentation on trends and FCM capacity over the

18 last two decades. I think it's really helpful for

19 folks to see that.

20 I guess looking forward, we are concerned that

21 the proposed Basel III Endgame capital rules and

22 amendments to the methodology for the G-SIB buffer

1 could further disincentivize bank-affiliated FCMs
2 for providing client clearing services. I think
3 that's a general comment that several others have
4 made.
5 We're particularly concerned with the proposed
6 inclusion of agency-cleared notionals and the
7 complexity and interconnectedness components of G-
8 SIB. It's counterintuitive since central clearing
9 reduces complexity through the standardization of
10 derivative contracts and reduces interconnectedness
11 by replacing bilateral exposures with a central
12 counterparty. Rather than encouraging central
13 clearing, the proposed changes would effectively
14 normalize the treatment of uncleared and cleared
15 derivatives in G-SIB, undermining the longstanding
16 policy goal to increase central clearing.
17 Ultimately, this could act as a disincentive for
18 banks to offer to continue to invest in a client
19 clearing service would reduce the likelihood of
20 successful porting of client trades in a stress
21 event and limit the opportunities for a client to
22 change clear even absent a member default, so in

1 kind of business-as-usual circumstances.
2 While we acknowledge the need to ensure that
3 risks arising from the banks' cleared derivatives
4 activity is properly capitalized, it is critical
5 that this is done in a way that recognizes the
6 significant existing risk mitigants such as the
7 exchange of margin, the CCP waterfall on default
8 fund contributions and doesn't undermine the
9 broader policy objectives to support and encourage
10 the use of cleared derivatives to manage risk.
11 And I think this is particularly significant
12 in the context of the analysis that Ashwini
13 presented today, so thank you.
14 MS. CRIGHTON: Okay. Thanks, Marnie.
15 Okay. Seeing no other comments, we'll turn to
16 the second panel of section 3, Treasury market
17 reform. First, we'll hear from Sam Schulhofer-
18 Wohl, Senior Vice President and Senior Adviser to
19 the President of the Federal Reserve Bank of
20 Dallas. Next, we'll hear from Anne Battle, Senior
21 Counsel, Market Transitions and Head of Benchmark
22 Reform for the International Swaps and Derivatives

1 Association. And finally, we'll hear from Jennifer
2 Han, Chief Counsel and Head of Global Regulatory
3 Affairs of the Managed Funds Association.
4 Sam, please begin.
5 MR. SCHULHOFER-WOHL: Thank you, Chair
6 Crighton and Commissioners Johnson and Mersinger.
7 My name is Sam Schulhofer-Wohl. As Chair Crighton
8 mentioned, I'm Senior Vice President and Senior
9 Advisor to the President at the Dallas Fed. I've
10 been closely involved in work to support the
11 resilience of Treasury markets, including through
12 collaborating with the interagency working group
13 for Treasury market surveillance.
14 Today, I'll review the state of play as I see
15 it in efforts to enhance the resilience of the
16 Treasury markets. I'll then take a deeper dive
17 into one dimension of those efforts, possibilities
18 for expanded central clearing and how clearing
19 relates to the cash futures basis trade. My
20 remarks represent my views and not necessarily
21 those of the Dallas Fed, Federal Reserve System, or
22 any other organization.

1 Because today falls in the communications
2 blackout period ahead of an FOMC meeting, I will
3 not comment on current or prospective economic and
4 financial conditions or the Fed's policies and
5 tools. No inference should be drawn from my
6 silence on these matters.
7 The history of the Treasury markets, including
8 those for cash securities, repos, and futures, has
9 been one of ongoing evolution crucial to ensuring
10 that these markets can continue to reliably serve
11 their vital purposes. I date the current chapter
12 of the market's evolution to the stresses in repo
13 markets in September 2019 and the dash for cash at
14 the onset of the pandemic in March 2020. Following
15 those episodes, experts began examining how to
16 mitigate the vulnerabilities they revealed.
17 The IAWG, which consists of staff from the
18 Treasury, Federal Reserve Board, New York Fed, SEC,
19 and CFTC launched workstreams to evaluate policy
20 issues and options in five areas. Significant
21 progress has been made across all of them, and I'd
22 highlight in particular the numerous enhancements

1 to data collection and publication, the Treasury's
2 announcement of a buyback program, and the SEC's
3 proposal for broader central clearing which the
4 Commission will take up this Wednesday.
5 But the policy framework that the IAWG has
6 established may be as important in the long run as
7 any of the specific steps. In 2021, the IAWG
8 staffs proposed six principles to guide public
9 policy in the Treasury markets. They are, first,
10 resilient and elastic liquidity; second,
11 transparency that fosters public confidence, fair
12 trading, and a liquid market; third, prices that
13 reflect prevailing and expected economic and
14 financial conditions; fourth, economic integration
15 across cash funding and derivatives markets; fifth,
16 financing that does not pose a significant threat
17 to financial stability; and sixth, infrastructure
18 that operates effectively and efficiently.
19 The benefits of a principles-based approach to
20 public policy are familiar to the CFTC and
21 participants in the markets it regulates, in
22 particular, the way that principles-based

1 regulation can provide flexibility to adjust to
2 changing conditions, alongside clarity about
3 desired outcomes. While the IAWG principles do not
4 have the force of law or regulation, I hope they'll
5 offer some of the same benefits in Treasury
6 markets.
7 I'll now discuss in more depth the potential
8 for expanded central clearing and basis trade in
9 light of the IAWG's principles. A substantial
10 share of Treasury transactions is already centrally
11 cleared. However, a significant set is not,
12 including typical dealer-to-customer transactions
13 and trade legs with principal trading firms on
14 interdealer broker platforms.
15 Several of the IAWG's principles provide
16 useful frameworks for assessing the implications of
17 broader clearing: first, resilient and elastic
18 liquidity. During stress episodes, market
19 liquidity has sometimes come under strain because
20 balance sheet costs or constraints discouraged
21 intermediaries from expanding the supply of
22 intermediation. Central clearing allows for

1 multilateral netting, which reduces the balance
2 sheet intensity of intermediation and may permit
3 dealers to more significantly increase
4 intermediation when demand rises.
5 Second, transparency. Because centrally
6 cleared transactions are reported to the CCP,
7 collecting data on them is straightforward. By
8 contrast, collecting data on bilaterally cleared
9 transactions has proven challenging. There still
10 is no routine data collection for the $2 trillion
11 noncentrally cleared bilateral repo market, though
12 the OFR has proposed to close this gap. Broader
13 central clearing would support more efficient data
14 collection that could enhance transparency.
15 Third, infrastructure that operates
16 efficiently and effectively. The hybrid clearing
17 model for transactions on IDB platforms poses a
18 contagion risk to the CCP, which lacks visibility
19 into noncentrally cleared trade legs. Moving all
20 IDB transactions into central clearing should
21 enable more effective risk management at the CCP.
22 Finally, I'll take these two principles

1 together: economic integration and financing that
2 does not pose a significant threat to financial
3 stability. In the Treasury markets the economic
4 integration trade par excellence is the cash
5 futures basis trade. Market participants' ability
6 to buy a cash security, finance it in the repo
7 market, and short the corresponding future helps
8 ensure two tight links between the prices of cash
9 securities and futures and between the implied
10 financing rates in repo and futures markets.
11 A trader who puts on a cash futures basis
12 position faces a couple main risks that could lead
13 to deleveraging in the face of a shock. If the
14 repo funding is overnight, it must be rolled until
15 expiry and may become expensive or scarce. And
16 although the trade has a defined return if financed
17 with term repo and held until expiry, it can
18 generate margin calls in the interim.
19 Broader central clearing could mitigate both
20 risks. It could support a more robust term repo
21 market by efficiently centralizing risk management
22 at the CCP. And, if combined with an efficient and

1 broadly available cross-margining arrangement,
2 broader clearing could reduce margin calls on basis
3 positions as margins would be based on the net risk
4 of these positions, which is much smaller than the
5 gross risk.
6 Work beyond adoption of the SEC's clearing
7 proposal would be needed to fully achieve these
8 benefits. Most notably, the new fixed CME cross-
9 margining agreement still covers only clearing
10 member portfolios, not customer portfolios, but one
11 shouldn't take this or other current challenges to
12 customer clearing as given. Importantly, the SEC's
13 proposal would modify rule 15c3-3 on segregation of
14 customer funds. This change would open a path to
15 lower costs of customer clearing.
16 Under current rules, a clearing member at a
17 security CCP must post its own funds, not the
18 customer's, as collateral for customer trades.
19 This increases the costs of customer clearing, as
20 I've documented my research. From a derivatives
21 perspective, it may seem surprising that customer
22 funds can't currently be posted as collateral for

1 cleared customer trades in the Treasury market.
2 And I'm mindful of the deep dive we just took into
3 the nuances of different modes of customer
4 segregation in derivatives.
5 You know, and as we've discussed, separate
6 margining of customer positions is standard
7 practice in the markets that the CFTC regulates.
8 But in the SEC's markets it's different, and I'm
9 encouraged that the SEC has proposed to allow
10 clearing members of a Treasury securities clearing
11 agency to post customer funds as collateral for
12 customer trades.
13 Another way broader central clearing can
14 support financing that does not threaten financial
15 stability is by providing for uniformly strong risk
16 management of repos. The OFR's pilot collection of
17 non-centrally cleared bilateral repos found that 74
18 percent of such transactions against Treasury
19 collateral are done with a zero haircut. While in
20 some cases the cash investor may be protected by
21 portfolio level margining, the data also show
22 transactions that are simply unmargined.

1 For example, with netted packages, repos and
2 reverse repos collateralized by different
3 securities as part of a relative value trade, it's
4 common to set a zero haircut on the theory that the
5 collateral perfectly offsets, but that doesn't
6 account for the risk of a change in the two
7 securities' relative value, which is the reason for
8 the trade in the first place. Broader central
9 clearing would apply the CCPs' strong risk
10 management standards to the market more uniformly.
11 Lest you think I'm a total Pollyanna, I do
12 want to acknowledge that broader central clearing
13 has potential costs such as costs for market
14 participants to meet the CCPs' risk management
15 requirements and knock-on effects on market
16 liquidity from market participants' higher costs.
17 But as the IAWG has discussed, it is important
18 to distinguish between private and social costs.
19 When a market participant chooses not to centrally
20 clear a trade, that participant may reap the
21 savings from lighter-weight risk management. But
22 the market and society as a whole bear the cost of

1 stresses when inadequately managed risks emerge.
2 So while broader central clearing could have some
3 costs for individual market participants and for
4 market liquidity at normal times, those costs must
5 be weighed against the market-wide benefits,
6 especially at times of stress.
7 Thank you. I look forward to today's
8 discussion and to ongoing engagement with all of
9 you.
10 MS. CRIGHTON: Thanks, Sam. Ann?
11 MS. BATTLE: Thank you, Chair Crighton. Also
12 thank you to Commissioner Johnson.
13 So I'm going to give an update on the Treasury
14 Reform Workstream of the Market Structure
15 Subcommittee. This workstream is led by Nate
16 Wuerffel from BNY Mellon. He's not able to be here
17 today, so I'm speaking on his behalf. Thanks to
18 him, the workstream members for their work, and
19 also to my co-chair of the Market Structure
20 Subcommittee Bis Chatterjee.
21 So the Treasury Reform Workstream has reviewed
22 current topics related to U.S. Treasury reform with

1 a focus on the work underway in the IAWG that Sam
2 just described on which the CFTC sits. We have
3 specifically focused on topics that affect the
4 derivatives industry, including the significant
5 Treasury futures market at the CME.
6 As a result of these discussions, the
7 workstream has decided to focus on the Treasury
8 cash futures basis trade in our work over the next
9 six to nine months. As part of our work, we expect
10 to produce a detailed presentation or discussion
11 with the MRAC during the first quarter of next year
12 and potentially follow up with recommendations
13 and/or best practices for risk management of the
14 basis trading.
15 In light of recent media attention on the role
16 of asset managers and levered market participants
17 participating in this trade, the workstream
18 specifically hopes to put the size of the basis
19 position in the context of the growing market;
20 understand the motivations for those positions,
21 which do introduce the opportunity for arbitrage
22 between economically similar instruments, but also

1 include trading objectives completely unrelated to
2 arbitrage; and finally, review how the positions
3 have performed in times of stress.
4 We welcome feedback from the MRAC on how the
5 workstream should structure its presentation, and
6 we're currently considering, first, a description
7 of the basis trade, an explanation of what creates
8 the basis with a focus on the long asset manager
9 buy side position, and motivations for that
10 position; an explanation of the role of liquidity
11 providers in hedge funds in the short position, and
12 the degree to which that position is levered using
13 repo funding; a general review of the role of
14 leverage in past episodes of illiquidity, potential
15 risks of the basis trade, including for all the
16 different players, that is the futures position,
17 the cash position, and the repo financing leg; and
18 finally, specific examples of how the different
19 players currently risk manage those positions.
20 And, as noted, we ultimately hope to expand on this
21 last point to propose recommendations and/or best
22 practices later in 2024.

1 The workstream expects to analyze these issues
2 under current market and regulatory conditions, but
3 we will also consider the implications of recent
4 proposals, including the SEC's proposal on
5 additional Treasury clearing, which it expects to
6 finalize this week and which Sam also mentioned, as
7 well as the SEC's dealer registration proposal, and
8 recent regulatory announcements related to cash
9 futures margining.
10 Our next step is to host discussions with
11 asset managers, hedge funds, and dealers, many of
12 which sit on the workstream and the Market
13 Structure Subcommittee, regarding their trading
14 objectives and risk management practices. We
15 welcome feedback on these next steps and what we've
16 covered today and look forward to presenting our
17 findings early next year. Thank you.
18 MS. CRIGHTON: Thanks, Ann.
19 Jennifer?
20 MS. HAN: Great, thank you. Thank you,
21 Commissioner Johnson, Commissioner Mersinger, Chair
22 Crighton, and staff for organizing the meeting

1 today and for my invitation to participate here to
2 present on the Treasury basis trade.
3 And so I have a number of slides, and if we
4 can start with 38. And this just sets the scene
5 really. As you can see from the graph -- and we've
6 all known Treasury markets are the largest and most
7 liquid in government bond markets in the world.
8 And as you can see from the graph, you know, since
9 2000, the supply of Treasuries has grown
10 significantly to export the expanding U.S.
11 Government debt. And so I put this here really to
12 help, again, emphasize that these markets, I think,
13 as we all know, are significant. And to start
14 imposing various rule changes without really
15 understanding potential consequences for the
16 modifications could severely disrupt these markets.
17 And so I think also, turning to the next
18 slide, another key part of these markets is that
19 they're very diverse. You have a lot of different
20 market participants, and this really helps support
21 a robust and healthy market. And so when you look
22 at it, it's a number of different types of

1 entities. You have, you know, the foreign
2 entities, mutual funds, depository institutions,
3 state and local governments, hedge funds, private
4 and public pensions, insurance companies, and U.S.
5 savings bonds.
6 So we really think that, as we look at
7 potential changes, thinking about the composition
8 of market participants and keeping this diversity
9 is really key. I think it really helps support a
10 robust market. When you start decreasing the
11 number of market participants, the categories, you
12 risk bringing a lot of fragility to market,
13 especially when you have extreme volatility or
14 market shocks.
15 So turning to the next slide, and again, you
16 know, thank you to Sam and Ann for setting the
17 stage on the Treasury basis. There have been a
18 number of articles, it feels like every week, every
19 day, we see articles about the basis trade in U.S.
20 Treasury markets, what is really a routine trade
21 becoming frontline news and a lot of financial news
22 sources, I think, can be quite concerning. And so

1 we at MFA put together a primer to help demystify
2 this a little bit and to really help frame the
3 issues as we think that sometimes the financial
4 media is making this a little more interesting and
5 sexy than it really is.
6 And, again, I think it's a pleasure speaking
7 to such a sophisticated group that already has a
8 lot of understanding of the basis trade and, of
9 course, how this works in futures markets where
10 it's very, very common.
11 So, many investors, you have mutual funds,
12 pensions, and others, and really, they rely
13 strongly on the Treasury futures market. It's an
14 efficient way for them to manage risks. There are
15 also regulatory reasons that they prefer to
16 transact in the Treasury futures market. And so
17 this is a number of the participants who are buying
18 Treasury futures. And so, obviously, you need a
19 seller as well.
20 Hedge funds have been highlighted in the news
21 as the ones providing the bonds, who are buying
22 from the cash markets and selling into the futures.

1 And again, as many are aware, with futures market,
2 you have a price disparity between the spot markets
3 and the futures market, and so this is a common
4 arbitrage trade, the basis trade, which takes place
5 and has a lot of important features to it. By
6 providing this arbitrage, you have a lot of
7 benefits in the sense that, you know, hedge funds
8 are increasing liquidity in the market. They're
9 dampening volatility, they're reducing the bid-ask
10 spreads, really lowering the cost of government
11 borrowing. I think that is a really key part of
12 this.
13 I know that, as Sam had mentioned, if you
14 think of what are all the costs, and I know you
15 mentioned the costs of everyone as to significant
16 disruptions. But also another cost that everybody
17 bears is the increased cost of government
18 borrowing. And as our debt continues to expand, I
19 think that it really cannot be lost upon us to
20 really calculate and analyze what this cost means
21 to the government, to taxpayers, and to the broader
22 economy.

1 Turning to the next slide, so, again, we've
2 seen a lot of articles, reports on
3 collateralization of the basis trade. And so one
4 of the key aspects, the price differences are
5 small, and so oftentimes what happens is that
6 market participants engaged in this trade may use
7 leverage to make the trade economically viable.
8 The collateral is posted in connection with the
9 basis trade, includes both margin posted on the
10 futures leg of the trade and any haircuts on the
11 repo transaction to finance a cashed leg of the
12 trade.
13 I think looking at the OFR data, you only see
14 one leg of it, and so that has resulted in a lot of
15 alarming headlines about zero margin on one leg of
16 it. And so I think really in looking at and
17 understanding this trade, you really need to
18 understand or think of it with both legs. And so
19 when you look at just the futures leg for the basis
20 trade, market participants see it as
21 overcollateralized because it's only one direction,
22 right? And so CME margins the futures, the short

1 futures position as an outright directional
2 position, and it doesn't account for the other side
3 of it, which, again, if you separate out, you might
4 see a zero, but really, a counterparty is looking
5 at it with both legs and so is offsetting risk.
6 And so that's why you may see zero percent haircut
7 because of the collateral on the futures leg. So I
8 think it's really important to look at this as a
9 single trade as opposed to breaking it up.
10 The low haircuts for repo financing are really
11 due to the master netting agreements between a
12 dealer or prime broker who recognizes it's a
13 package trade. And I think that that's one of the
14 things that's oftentimes lost when people are
15 looking at the zero margin on the repo side.
16 So turning to the next one, again, as we look
17 at solutions, and we've heard of a number of
18 proposals to address risk management, and I think
19 that there are already a number of rules in place,
20 a lot of oversight which does address leverage.
21 You know, it's not without regulatory oversight
22 right now, so counterparty banks through their own

1 risk management protocols will determine the margin
2 requirements on hedge fund financing arrangements.
3 Also, bank regulators are working with banks
4 to ensure that there's appropriate counterparty
5 risk management on the bank side. Also, the
6 Federal Reserve has noted that, you know, imposing
7 additional limits could have negative impacts on
8 the Treasury market. So again, I think important
9 to look at the impact without just thinking of the
10 trades separately, but looking at them as a whole
11 because I think knowing that a lot of the market
12 participants providing liquidity into these markets
13 right now, a number of hedge funds and others.
14 So I think also looking at the broader
15 markets, what we know is that central banks have
16 been net sellers of it. You have the mutual funds,
17 pensions, and others who prefer to be in the
18 Treasury futures, and so you have a number of
19 market participants. There are banks, and then
20 there are hedge funds and other market participants
21 who are really providing this liquidity. And
22 again, I think there's adequate oversight seeing

1 both trades, and they are the ones really buying
2 the bonds and selling the futures right now. So I
3 think proposals that address these changes need to
4 consider also the liquidity implications.
5 So adding to some of the oversight already,
6 turning to the next slide, really there are a
7 number of things already happening which provides
8 oversight and transparency. And so regulators
9 right now, there are cash transactions reported to
10 FINRA through TRACE. The Treasury futures are
11 subject to CFTC regulation. Centrally cleared repo
12 data is being collected by OFR, and we know there
13 are additional changes which we support and also
14 noncentrally cleared tri-party repo market data is
15 collected by BONY, which is under the supervision
16 of the Federal Reserve Board.
17 So, you know, there are reporting mechanisms
18 already providing important information. Hedge
19 funds are also providing a lot of systemic risk
20 data to the SEC, FSOC, and others, and this is just
21 filtered through -- SEC also has oversight of the
22 fund, their investments, and use of leverage

1 through Form PF.

2 So I think just to emphasize that there is

3 oversight and regulation, we're not in the wild

4 west here, and so also putting this all into the

5 framework when you're looking at the proposals out

6 there and how various entities are regulated

7 already.

8 So going to the next slide, some of the

9 proposals -- and I think -- coming out whether from

10 the SEC or others, again, you hear, in addition to,

11 you know, zero percent haircuts, you also hear

12 proposals . . . the SEC is looking at a number that

13 would address Treasury market structure. And

14 certainly while we support modernization to

15 Treasury market structure, and we've been engaged a

16 lot, I think there are some real potential

17 downsides to Treasury market and the broader

18 economy through the current dealer proposal and the

19 Treasury clearing proposals.

20 So the dealer one, again, these ones,

21 expanding the scope of who is a dealer, and so not

22 to get too detailed into the securities law

1 framework, but we think that this is really
2 statutorily based as to who is a dealer. The
3 proposal right now is very broad, would bring in a
4 lot of market participants, including hedge funds
5 and other proprietary traders who, in our view, are
6 not acting as dealers making markets in these
7 various markets.
8 I think the concern you have there is that you
9 would be fundamentally changing business
10 structures, so a lot of these entities, the actual
11 hedge fund, as opposed to the advisor, in many
12 cases will not be able to register as a dealer.
13 And what that really means is backing away from
14 that Treasury basis trade, and so I think that that
15 will certainly have an impact on Treasury
16 liquidity.
17 Similarly, with Treasury clearing, we
18 certainly welcome enhanced client clearing. I
19 think that there are a number of steps that need to
20 happen before a mandate for clearing across the
21 board for Treasurys. And so again, looking at the
22 proposal, I think there are a number of things that

1 would need to happen. And one of the things I know
2 mentioned is the customer cross-marginalization.
3 So that is a framework that I think also needs to
4 be addressed.
5 Some of the FICC rules, which currently in our
6 view are anti-competitive and would actually reduce
7 the number of market participants in this area,
8 would, in our view, add fragility to the market
9 rather than increase it. And so I think for a
10 number of reasons, looking at the Treasury clearing
11 proposal, as drafted by the SEC, would actually
12 increase risk to the system, decreasing liquidity,
13 decreasing the number of market participants
14 engaged in this, and really increasing the cost of
15 government borrowing. And so that is for
16 taxpayers, but also, if you look at pensions,
17 corporations, and others, mutual funds who are
18 using Treasury futures, it's going to make it more
19 expensive as well.
20 As I mentioned, we certainly think that there
21 could be a number of steps to modernize and
22 improve, enhance the Treasury markets. And so top

1 of those, improving data collection through TRACE,
2 expanding the use of voluntary central clearing in
3 the dealer-to-customer segment. I think that's one
4 thing that we've been advocating for a number of
5 years now, which is increasing dealer-to-customer
6 client clearing there.
7 Another key aspect -- and I think for those
8 familiar with the CFTC swaps rules, in this
9 context, it is requiring clearing members of FICC
10 to accept done-away trades. And I think with the
11 swaps rule, you have a model already for give-ups.
12 And the rules that you have with respect to SEFs, I
13 think those have worked well and could be used as a
14 model because, again, this is one key component
15 which I think would really decrease the number of
16 market participants and potentially add to market
17 fragility, providing for segregation of customer
18 margin at FICC.
19 And I think this fits in nicely with some of
20 the things discussed earlier with respect to
21 bankruptcy issues. And so one key component here,
22 segregation of customer margin at FICC, I think

1 that that would provide a lot of protection for
2 investors because otherwise, you know, facing
3 another layer and level of risk right now, if
4 you're engaged in the trade, you are faced with
5 counterparty risk. And if the segregation of
6 customer margin is not addressed appropriately,
7 then really, when you get into this mandatory
8 clearing, your risk actually increases because you
9 have counterparty risk, but then also, you are
10 facing risk of other market participants, dealers
11 as well.
12 And finally, as I had mentioned, introducing
13 the cross-margining for end users for Treasury
14 futures and cash Treasury transactions, we think
15 that that is really critical to preserving market
16 liquidity. Without that component, I think a
17 number of market participants will not be able to
18 trade at the same level. And so a few things will
19 happen. The cost of the trade will increase. The
20 number of market participants providing or engaging
21 in the basis trade is likely to decrease. It is
22 going to increase the spread, increase the costs

1 for pensions, mutual funds, corporations using
2 Treasury futures, and overall, the cost of
3 government borrowing. So this is a key piece we
4 think is really important to get right before any
5 type of mandatory clearing is required for
6 Treasuries.
7 MS. CRIGHTON: Great. Thank you very much.
8 Thanks to our panelists.
9 I'll open it up to the floor for feedback and
10 comment.
11 [No response.]
12 MS. CRIGHTON: Okay, great. Just being
13 mindful of time, we're going to just push through
14 rather than stopping for a break.
15 So we'll turn to the third panel of section 3,
16 discussing the block implementation rule, and I'll
17 turn the floor back to Ann.
18 MS. BATTLE: Thank you, Alicia. I'm going to
19 jump right in in the interest of time, but many
20 thanks, of course, to the members of this
21 workstream and Elizabeth Kirby, who has chaired it.
22 The Market Structure Subcommittee has

1 previously noted that incorrectly set block size
2 would adversely impact the ability of market
3 participants to efficiently execute large-size swap
4 transactions, unnecessarily impeding their ability
5 to hedge risk through swaps. We strongly support
6 the CFTC's recent extension of the new block
7 thresholds from December 4 of this year to July 1,
8 2024, next year.
9 In an effort to better understand the volume
10 and trading of market participants currently
11 trading blocks and the implications that the new
12 block sizes could have on this population, this
13 workstream recently developed a set of questions
14 for trading venues and data repositories. The
15 questions focused on two datasets in particular:
16 10-year U.S. dollar rate swaps and five years CDX.
17 The questions, which are available in the
18 materials for today, are not designed to assess the
19 suitability of the new thresholds or any impacts
20 they may have on market liquidity. However, they
21 are intended to define datasets and study and
22 understand the number of market participants

1 trading blocks and how that could change.

2 So, second, there are questions intended to
3 determine the scale and concentration of the block
4 participants and their trading needs. We asked a
5 question on recalibration of swap data to check the
6 relevance and materiality of the difference between
7 block sizes being used by the market today versus
8 under 67 percent and 75 percent calculations.

9 Next, we asked questions on recalibration of
10 the scale and concentration of the number of block
11 participants and their trading needs if the 67
12 percent and 75 percent calculated block sizes were
13 to be used.

14 Next, we asked questions designed to identify
15 how the trading profile and reliance on block
16 trading changes in volatile market conditions with
17 a lack of liquidity, specifically using the first
18 three months of global lockdown during the COVID-19
19 pandemic in 2020.

20 And finally, we asked a question designed to
21 compute SOFR block sizes and compare those to LIBOR
22 block sizes. Two SEF members of the Market

1 Structure Subcommittee participate on this
2 workstream, and graciously, as part of their
3 participation, provided responses to certain of
4 these questions. The workstream recently analyzed
5 those responses and can note that most swap dealers
6 currently trade blocks for the datasets mentioned,
7 and a meaningful number of non-swap dealers do as
8 well, particularly in the case of five-year CDX.
9 Of those entities, in most cases, blocks make up
10 less than 25 percent of their respective total
11 trades, but in some cases, blocks make up more than
12 75 percent of an entity's total trades.
13 2022 data for 10-year U.S. dollar rates is not
14 reflective of what future trading will look like
15 because there was a general prohibition on trading
16 LIBOR during that year. But at the same time,
17 SOFR, the identified alternative to LIBOR to which
18 future block thresholds will apply, was not yet MAT
19 in 2022. Market dynamics like these can materially
20 impact the number of entities trading blocks, and
21 therefore, it is critical to ensure that the
22 dataset used to set block thresholds remains

1 reflective of the market conditions in which those
2 thresholds will apply.
3 Similarly, data for the second quarter of
4 2020, again, the first three months of the global
5 lockdown during the COVID-19 pandemic, indicates
6 that volatile market conditions with low liquidity
7 do in fact affect the number of market participants
8 trading blocks. And again, it is critical to
9 account for market dynamics during such periods of
10 volatility when considering how to appropriately
11 implement block thresholds.
12 The MRAC Market Structure Subcommittee and the
13 Block Workstream acknowledge the recommendations on
14 these issues recently approved by the CFTC GMAC,
15 and we support coordination as appropriate across
16 the MRAC and the GMAC, as well as with industry
17 groups that continue to advocate for appropriate
18 block thresholds.
19 It is likely that analysis of trading volumes
20 and other data for certain products will be
21 required as the industry works to understand the
22 impacts that higher block thresholds would have on

1 market structure and liquidity. The Market
2 Structure Subcommittee will continue to support
3 this work and is committed to streamlining any
4 future requests of trading venues and data
5 repositories in order to facilitate broad
6 understanding of these critical issues in the most
7 efficient manner possible. Thank you.
8 MS. CRIGHTON: Thanks, Ann.
9 I'll open it up to the floor for comments.
10 [No response.]
11 MS. CRIGHTON: Okay. We'll turn to the fourth
12 panel of section 3 on post-trade risk reduction.
13 To discuss the update from the workstream, we'll
14 turn to Guy Rowcliffe, Co-CEO and Chief Commercial
15 Officer of OSTTRA. Guy, please go ahead.
16 MR. ROWCLIFFE: Thank you Chair Crighton. Can
17 I just check you can hear me?
18 MS. CRIGHTON: We can.
19 MR. ROWCLIFFE: Okay, great. So thank you,
20 Chair Crighton, Commissioner Johnson, Commissioner
21 Mersinger.
22 I will present to you today the update of the

1 work from the Market Structure Subcommittee on
2 post-trade risk reduction. I know we're pushed for
3 time, so I will attempt to just stick to the
4 highlights for now. This is not a finalized
5 recommendation. It's near final. We anticipate
6 completing the work and voting on the finalized
7 version for early January and submission following
8 that, so some of the material I will skip over
9 today and leave for the final submission.
10 But going straight to the point, what we are
11 anticipating is a recommendation for further
12 examination on providing certain exemptions from
13 the Commodity Exchange Act and Commission
14 regulations to enable market participants to use
15 post-trade risk reduction services more efficiently
16 and optimally.
17 So the issue we focused on is the efficient
18 and optimal operation and usage of post-trade risk
19 reduction services. Today's post-trade risk
20 reduction services include compression, risk
21 rebalancing, and risk mitigation. They optimize
22 bilateral and cleared derivatives portfolios in

1 order to minimize the buildup of notional amounts,
2 trade count, basis risk, and counterparty risk,
3 which in turn reduces overall systemic risk.
4 These services often involve the creation of
5 new non-price-forming transactions in order to
6 fulfill the purpose of the risk-reducing exercise.
7 The non-price-forming nature of the transactions
8 means they are administrative and do not change the
9 directional first-order market risk of the
10 derivatives portfolios concerned, but rather reduce
11 either counterparty, operational, basis, or
12 systemic risks of the existing derivatives
13 portfolios.
14 Current requirements under the Commodity
15 Exchange Act and certain U.S. CFTC regulations can
16 make it difficult for market participants to
17 efficiently use certain post-trade risk reduction
18 services or for post-trade risk reduction service
19 solutions to be structured in the most efficient
20 way.
21 Under the CEA and Commission regulations, some
22 of the resulting administrative transactions are

1 currently subject to mandatory clearing at a
2 derivatives clearing organization, mandatory trade
3 execution on a swap execution facility, and real-
4 time public reporting.
5 As we'll explain in more detail in our
6 submission, market participants will be able to
7 utilize these PTRR services more efficiently and
8 therefore reduce a greater amount of risk in their
9 portfolios if the administrative trades generated
10 as part of those services were exempt from the
11 three requirements I've just mentioned.
12 In addition, for similar reasons, we believe
13 the Commission should also consider exempting
14 providers of these post-trade risk reduction
15 services from the SEF registration requirements or,
16 at a minimum, clarify that PTRR services do not
17 meet the trading system or platform requirement
18 under the SEF definition in CFTC regulations when
19 they prearrange transactions between multiple
20 participants for the purpose of conducting these
21 risk-reducing exercises.
22 So the subcommittee recommendation is likely

1 to be that in the view of the issues raised so far,
2 we will recommend that the Commission considers
3 adopting exemptions from the CFTC clearing
4 obligation, from the trade execution requirements,
5 and from real-time reporting requirements for swap
6 transactions that are created in order to complete
7 post-trade risk reduction services, and, most
8 importantly, meet all of the following criteria.
9 Firstly, the exercise does not change the
10 directional risk of covered portfolios except for
11 some de minimis risk for portfolio compression and
12 second-order risks for basis risk mitigation.
13 Secondly, participants in the exercise are not
14 able to post bids or offers, there is no price
15 negotiation that takes place, and transactions can
16 be recorded away from market prices on stale curves
17 and stale prices where applicable.
18 Thirdly, the exercise does not allow for
19 taking directional market positions.
20 Fourthly, the exercise's runs or cycles take
21 place according to pre-established schedules
22 defined by the post-trade risk reduction providers.

1 Next, the service provider's preset algorithm
2 determines the overall risk reduction
3 opportunities, nobody else. Also, the exercise is
4 binding on an all-or-nothing basis across each
5 exercise participant.
6 And finally, the exercise is performed by a
7 service provider independent of the participating
8 entities.
9 In addition, we believe the Commission should
10 also exempt PTRR services from the SEF-registration
11 requirement, as I mentioned earlier, or, at a
12 minimum, clarify that they do not meet the
13 definition of a trading system or platform under
14 the SEF definition in CFTC regulations.
15 In discussing these findings, we based it on
16 the belief that there is a need for market
17 participants to have access to efficient risk
18 reduction techniques, and that that has been
19 reinforced by recent market volatility and the need
20 for participants to mitigate both counterparty risk
21 and liquidity stress and volatile margin demands
22 that we have seen, particularly in the last year.

1 There are three broad types of post-trade risk
2 reduction services. I won't go into each one, but
3 to highlight, it's portfolio compression, portfolio
4 rebalancing, and basis risk mitigation. In each
5 case, the common characteristic is that those risk
6 reduction services create new swap transactions in
7 order to perform the respective risk-reducing
8 exercise. These new administrative transactions,
9 as I've mentioned, are non-price-forming, they are
10 market-risk-neutral, and are entered into for the
11 sole purpose of reducing portfolio risk and
12 exposures. And therefore, the exemptions we are
13 proposing we feel appropriate.
14 There'll be more detail on each exemption in
15 the final submission, but, as I mentioned, it's the
16 exemption from a clearing requirement, exemption
17 from a trade execution requirement, exemption from
18 definition of a SEF, and lastly, exemption from
19 real-time reporting. The first three exemptions
20 will all add to the efficiency and optimal
21 provision and usage of those services.
22 The last exemption from real-time reporting

1 isn't really relevant to the efficiency of the
2 services, but it's relevant because the
3 administrative swap transactions that are created
4 in order to complete those services are non-price-
5 forming events. And, as a result, the requirement
6 to publicly disseminate such swaps does not advance
7 price transparency policy objectives, nor
8 contribute to price discovery due to the execution
9 on stale curve or prices.
10 Absent an exemption from all of these
11 requirements, post-trade risk reduction service
12 providers cannot perform the PTRR exercises as
13 efficiently as possible because they must create
14 new swaps that are not subject to the clearing and
15 trading obligations in order to reduce risks and
16 exposures. Today, post-trade risk reduction
17 services providers use more complex products than
18 are necessary -- for example, swaptions instead of
19 plain vanilla IRS -- and enabling post-trade risk
20 reduction service providers to use the most
21 efficient means to conduct risk-reduction exercises
22 would not only make the process simpler but, more

1 importantly, lower the risk even further.

2 So with that, I will conclude the findings of

3 the subcommittee for now and save the rest until

4 the full recommendation in early January.

5 MS. CRIGHTON: Great. Thanks very much, Guy.

6 I'll open the floor to MRAC members for

7 discussion. Tyson?

8 MR. SLOCUM: Thank you. I'm just going to

9 admit that I don't fully understand post-trade risk

10 reduction services markets, so please forgive me in

11 advance for asking potentially very dumb questions.

12 So you describe it as an administrative

13 function and doesn't have any impact on price

14 formation. Has the subcommittee determined how the

15 participants would go about asking for the

16 exemption? Is that by the market participants

17 declaring this is a post-trade risk reduction

18 service transaction, and therefore, it's subject to

19 the exemption? Is it the independent service

20 provider that would be handling this? How would

21 the exemption requests be handled? Is it something

22 where it's on a case-by-case basis, or it's just

1 excluding this whole set of transactions?

2 MR. ROWCLIFFE: It would be around the

3 characteristics of the type of trade output as

4 defined in those six or seven points that I

5 mentioned earlier. They are unique characteristics

6 to the trade output from any type of these risk-

7 reduction exercises. They can be clearly

8 identified and clearly flagged to relate them to

9 the provision of the service, and it would be via

10 rulemaking.

11 MR. SLOCUM: Okay. Thank you.

12 MS. CRIGHTON: Okay. No other questions or

13 comments, we'll move on to our fourth section of

14 the day, which will cover matters relevant to

15 climate-related market risks.

16 To begin the discussion, it's my pleasure to

17 introduce to Tamika Bent, Chief Counsel to

18 Commissioner Kristin Johnson and MRAC Designated

19 Federal Officer, as well as Kerstin Mathias

20 Director of Policy and Innovation for the City of

21 London Corporation, who will share remarks.

22 Tamika, go ahead.

1 MS. BENT: Thank you.
2 As many of you might have seen last Monday,
3 the CFTC issued a proposed guidance regarding the
4 listing of voluntary carbon credit derivative
5 transactions. That guidance follows more than two
6 years of CFTC engagement examining carbon markets
7 and the impacts of climate on financial markets.
8 I'm going to provide you with a very brief sort of
9 summary of the guidance.
10 So the Commission has provided the guidance
11 which sets out certain factors a DCM should
12 consider when addressing requirements of the CEA
13 and the CFTC regulations that are relevant to the
14 contract design and listing process. Specifically,
15 DCMs are required to comply with core principles.
16 Core Principle 3 requires a DCM to demonstrate that
17 listed contracts are not readily susceptible to
18 manipulation. Core Principle 4 requires a DCM to
19 prevent manipulation, price distortion, and
20 disruptions of the physical delivery or cash
21 settlement process through market surveillance,
22 compliance, and enforcement practices and

1 procedures.

2 DCMs are required to submit products for

3 listing to the CFTC either by self-certification or

4 by seeking Commission approval. Through this

5 process, the Commission reviews the product

6 specifications, including information about the

7 underlying assets, which, in this case, we're

8 talking about voluntary carbon credits.

9 The guidance sets out a number of factors, and

10 I'm going to give you a very brief overview. So,

11 for example, a DCM should consider factors

12 including transparency, additionality, permanency,

13 and risk of reversal, as well as robust

14 quantification in connection with the underlying

15 VCC. Additionally, the governance framework and

16 tracking mechanisms of the crediting program for

17 the underlying VCCs and the crediting program's

18 measures to prevent double counting are all

19 additional factors a DCM should consider.

20 Inspection or certification provisions should

21 be specified in a DCM's contract terms and

22 conditions. DCMs should actively monitor the terms

1 and conditions of VCC derivative contracts to
2 ensure conformity with current standards and should
3 require their market participants to keep records
4 of their trading, including activity in the
5 underlying spot market.
6 Finally, a DCM is required to submit to the
7 Commission the contract terms and conditions and
8 any contract amendments, and must also provide an
9 explanation and analysis of the contract and its
10 compliance with applicable CEA provisions. In the
11 guidance, the Commission noted that SEFs that list
12 swaps on VCCs should also consider the factors that
13 are laid out in the guidance.
14 In a supporting statement, Commissioner
15 Johnson noted that the proposed guidance may help
16 to improve the integrity of the VCC markets, yet
17 there may be additional and significant areas that
18 the proposed guidance does not address. One area
19 that is worth noting is that there is a significant
20 part of the environmental commodity market that
21 trades as forwards or spots or other types of
22 commercial contracts where commercial participants

1 intend to take delivery of the underlying physical
2 commodity.
3 Under the CEA, a forward on an environmental
4 commodity that satisfies the forward exclusion to
5 the swap definition would not be subject to the
6 full range of the swaps regime. And so generally,
7 those markets are not traded on an exchange.
8 They're not cleared through a regulated
9 clearinghouse or reported to a regulated trade
10 repository, and there may even be intermediaries
11 that trade in those contracts that are not required
12 to be registered with the CFTC. And so for those
13 markets, there may be vulnerabilities that
14 potentially may require additional Commission
15 action to address those concerns. I think Kerstin
16 is next?
17 MS. CRIGHTON: Yes, that's right. Thanks,
18 Tamika. Now, we'll hear from Kerstin.
19 MS. MATHIAS: Great. Good afternoon,
20 everybody, and thank you very much to Commissioner
21 Johnson and Chair Crighton for the invitation to
22 speak here today.

1 My name is Kerstin Mathias. I lead the City
2 of London's Global Financial Services Policy and
3 Innovation work, and I have been invited to provide
4 a view from London on our sustainability priorities
5 here today. Apologies I cannot be with you in
6 person.
7 In the interest of time, I will focus on three
8 main areas. I appreciate not all of them actually
9 sit within areas of responsibility with the CFTC,
10 but they do, I believe, provide some useful lessons
11 from wider work that the CFTC might be considering.
12 So I would like to start with the work of the
13 ISSB and the wider lessons we can learn about the
14 risk of misaligned approaches to sustainability
15 standards and the need for mutual recognition
16 mechanisms. We very much believe that 2022 was the
17 year of disclosures, and we really welcome U.K.
18 Government and other governments' support for the
19 development of international standards for
20 disclosures, sustainability-related information.
21 We also agree with the U.K. Government that
22 the provision of globally comparable

1 sustainability-related information is vital for the
2 effective functioning of capital markets. We
3 believe that building an effective international
4 framework for sustainability-related disclosures
5 will avoid fragmentation and regulatory arbitrage,
6 promote greater transparency, consistency,
7 comparability of disclosures, and reporting costs
8 and operational burdens. This approach, we
9 believe, could be applied to other areas of current
10 and future of policy and regulation and
11 sustainability.
12 On this occasion, we believe that
13 jurisdictional approaches as much as possible to
14 sustainability information should indeed converge
15 around the work that the ISSB has done in setting a
16 global baseline. And this could form the basis for
17 counterparty information required to meet
18 sustainability disclosure requirements for
19 international companies.
20 We therefore consider integrating all aspects
21 of the ISSB standards into the U.K.'s domestic
22 reporting and disclosure framework to be of vital

1 importance for the London ecosystem. We advocate
2 for U.K.-U.S. collaboration as the U.K. consults on
3 the implementation of these standards, and indeed,
4 enhances and strengthens dialogue between U.K. and
5 the U.S. Government and regulators and all global
6 standard-setting bodies in this space.
7 The second issue I would like to talk about is
8 transition planning, which has very much been a
9 priority in this year 2023. There the global
10 momentum for standards surrounding private sector
11 transition plans and their vital role in supporting
12 the global shift to net zero both in the financial
13 sector and also in the wider economy. Clarity of
14 transition pathways will make it easier for
15 entities to measure and assess their climate risk
16 exposures, and it will allow banks and insurers and
17 other actors to gather better data and
18 counterparties' transition plans and their evolving
19 climate exposures. This will support financial
20 institutions to incorporate climate risk exposures
21 into their own risk management processes.
22 You might be familiar with the work of the

1 U.K.'s Transition Plan Task Force in this space.
2 In October of this year, they released their final
3 disclosure framework and implementation guidance
4 for U.K. by U.K. businesses. We welcomed the
5 effort of this Transition Plan Task Force to
6 incorporate a disclosure framework within the wider
7 sustainability and general purpose reporting
8 landscape. Again, another example where a national
9 approach is looking for as much alignment as
10 possible with the work that is happening
11 internationally, which we applaud.
12 The TPT framework has been designed to align
13 with the transition planning guidance developed by
14 the Glasgow Financial Alliance for Net Zero and to
15 be consistent and build on the reporting standards
16 developed by the ISSB.
17 We believe that the U.K. has an opportunity
18 here to use its first mover advantage to promote
19 its transition planning approach to international
20 peers, and so I'm delighted to have the ability to
21 talk about it here to you today because, again,
22 this might help to reduce fragmentation and

1 increase global interoperability for entities
2 operating in multiple jurisdictions as those
3 jurisdictions continue to consider how they
4 approach sections addressing transition plans.
5 We hear from firms in the U.K. that it may be
6 useful to consider providing additional guidance
7 and clarity on the application of these standards
8 in relation to transition plans for both preparers
9 and users of transition plan.
10 We believe that we need to develop market
11 tools, standards, and incentives to scale financing
12 for credible transition of hard-to-abate sectors in
13 particular, and we need to give confidence to
14 capital providers that they can credibly support
15 financing the transition without harming their own
16 net zero or [inaudible] targets where they exist.
17 The U.K. has commissioned a condition finance
18 market review to support the government and
19 industry to address some of these questions, and we
20 are delighted at the City of London Corporation to
21 be hosting the secretariat that will support this
22 work, and we'll be happy to discuss this work with

1 any of the attendants in the audience today.

2 Finally, I will conclude with a few thoughts
3 on voluntary carbon markets, which I know has been
4 a huge priority for Commissioner Johnson and the
5 CFTC more generally. Carbon credits have emerged
6 as a powerful and cost-effective mechanism which
7 can enable immediate climate action. While they
8 are not standalone solutions for emissions
9 abatement, together with other decarbonization
10 efforts, carbon credits can deliver market-led
11 carbon pricing.

12 Carbon credits enable responsible businesses
13 to act today on climate action. If 1,700 of the
14 world's highest-emitting companies compensated for
15 just 10 percent of their emissions through carbon
16 market investments, more than $1 trillion of
17 investment could be mobilized by 2030. Carbon
18 credits get rapid climate finance to the global
19 sales on its terms today, something we urgently
20 need to work on. We also know that companies that
21 purchase carbon credits decarbonize twice as fast
22 as those who do not, so we can see that the VCM has

1 a huge role to play in supporting us to reach net
2 zero.
3 Despite this, carbon credits are frequently
4 accused of allowing firms to greenwash their
5 environmental impact. While there have been
6 instances of scandal and misrepresentation of
7 course in this market, these examples should not be
8 used to undermine the benefits of carbon credits.
9 To overcome reputational concerns, all
10 elements of the carbon credit supply chain have a
11 role to play in building a high integrity market.
12 Over the past four years, the work of the Voluntary
13 Carbon Markets and Integrity Initiative and the
14 Integrity Council for the voluntary carbon market
15 have developed some standards to address these
16 concerns and help to promote market integrity.
17 While these are voluntary standards, we really
18 believe that they should be the foundations to use,
19 and any further work should build on them,
20 including from regulators in the U.K. and the U.S.
21 and more widely.
22 In addition to integrity, we must also look to

1 enhance the infrastructure to support the scaling
2 of voluntary carbon markets such as innovative
3 measurements, reporting and verification,
4 technology, and a supportive legal, regulatory, and
5 policy environment. From COP28 where I have just
6 returned, which is now in its stages of conclusion,
7 we hope to see progress from the negotiations on
8 the technical aspects of Article 6, which will
9 facilitate country-to-country trade of ITMOs. And
10 progress here will be hugely supportive for the
11 scaling of international markets.
12 There are many other issues on the horizon,
13 which we would love to collaborate with the CFTC
14 and other U.S. stakeholders on, but in the interest
15 of time, I will leave it here. Thank you very
16 much.
17 MS. CRIGHTON: Great, thanks so much, Kerstin.
18 Thanks to both of you. I'll open it up to the MRAC
19 members for discussion.
20 [No response.]
21 MS. CRIGHTON: Okay. We'll now begin our
22 fifth and final section of the day on matters

1 relevant to the Future of Finance Subcommittee.
2 I'd like to ask Jai Massari, Co-Founder and Chief
3 Legal Officer of Lightspark, to begin the
4 discussion. And following Jai's remarks, Kevin
5 Werbach. Liem Sioe Liong First Pacific Company
6 Professor, Professor of legal studies and business
7 ethics, and Department Chair at the Wharton School
8 at the University of Pennsylvania will provide a
9 few remarks, followed by an open discussion on the
10 future of finance.
11 Please begin.
12 MS. MASSARI: Thank you, Commissioner Johnson,
13 Chair Crighton and CFTC staff for asking me to
14 present today. I'm Jai Massari, a Co-Founder and
15 the CLO of Lightspark, a U.S. company building
16 enterprise-grade payments on the Bitcoin Lightning
17 Network. I'm also a fellow at the Berkeley Center
18 for Business and Law at the University of
19 California Berkeley Law School. Before Lightspark,
20 I was a partner in the Financial Institutions group
21 at Davis Polk, with the early years of my career
22 spent on Dodd-Frank Title VII implementation. It's

1 nice to see many known faces from that work around
2 the room.
3 Our conversation today is meant to further
4 inform the work of the Future of Finance
5 Subcommittee. The topic, the future of finance, is
6 ambitious, and the subcommittee's work could take
7 many directions. Before focusing on four specific
8 topics that the subcommittee could consider
9 further, I'll make an obvious observation. It is
10 very difficult to accurately predict the future,
11 particularly when the future involves new
12 technologies and the attendant implications.
13 History is replete with examples of society
14 misjudging the impact of a particular new
15 technology. Examples include the internet and
16 smartphones, each of which have changed much about
17 our lives, for the good, mostly.
18 But some new technologies have not and will
19 not change the world. It can be difficult to tell
20 apart the ones that will from the ones that won't.
21 Part of the work of the MRAC and the subcommittee
22 is to try to understand these developments and

1 ensure that the CFTC is well-positioned to address
2 those that are likely to be widely adopted and to
3 change the world, at least the world of CFTC-
4 regulated markets.
5 I'll turn to four topics that, in my view, are
6 good candidates for further exploration for the
7 subcommittee. First, vertical integration. The
8 CFTC and its staff have been deeply engaged on this
9 topic for some time, and rightly so. Fundamental
10 changes to market structure are rare given that
11 market structure is in effect written in stone
12 through legislation, regulations, and supervisory
13 structures.
14 Accordingly, the vertical integration
15 discussion arose first from centralized spot crypto
16 exchanges that were regulated as payment
17 intermediaries, not financial trading markets. To
18 be clear, this development is not
19 disintermediation. As the term vertical
20 integration more correctly implies, it is a
21 different configuration of intermediated functions.
22 This may have benefits for markets and market

1 participants, but it also raises different
2 considerations for risks, conflicts of interest,
3 and governance.
4 As was discussed during the last MRAC meeting,
5 many of these considerations are not in themselves
6 new. And we have policy, regulatory, and
7 supervisory tools to address them, informed and
8 directed by the work already underway at the CFTC.
9 The Future of Finance Subcommittee is well-
10 positioned to analyze and make recommendations on
11 how existing laws and regulations could be applied
12 to this different market structure, taking into
13 account its benefits and risks. For example, some
14 aspects of the market structure reduce counterparty
15 and settlement risk because trades are prefunded
16 and settlement is instant.
17 Other aspects, namely integrated custody
18 services and conflicts of interest from the full
19 range of services provided by crypto exchanges,
20 brokerage, dealing, order book operations,
21 settlement, clearing, and custody, plus other
22 ancillary services, just as in traditional finance,

1 need to be carefully assessed and addressed as
2 necessary, including by applying the existing
3 policy toolkit in this different context.
4 Next, risk management and governance.
5 Innovations in market structure necessarily require
6 innovations in risk management and governance. For
7 example, clear guidance on risk management and
8 governance expectations for new types of services
9 or those using new technologies would help market
10 participants better manage risk, and it would
11 enable regulators to recognize the role of auditors
12 and insurance providers and risk management.
13 Indeed, further guidance on risk frameworks
14 and governance approaches could benefit both
15 incumbents who need direction on how to engage in
16 new types of activities, and also ensure new market
17 participants operate safely. The subcommittee can
18 play an important role in identifying areas in
19 which this type of guidance would be useful and can
20 help inform that guidance.
21 Third, cyber resilience. While predicting the
22 future is hard, it is easy to predict our

1 increasing reliance on technology in financial
2 services, whether for consumer or user-facing
3 applications or core infrastructure in our
4 financial markets. As these services evolve, so
5 will the tactics and approaches of those trying to
6 exploit them.
7 The CFTC and the National Futures Association
8 have been forward-leaning in developing standards
9 for technological resilience for regulated
10 intermediaries. This work is essential and should
11 continue as new technologies are used in CFTC-
12 regulated markets, whether those are blockchain-
13 based systems, smart contracts, or user-facing
14 applications that allow the use of those
15 technologies. Understanding new risks posed by new
16 technologies used in CFTC-regulated markets and
17 directing the development of new audit standards
18 and cybersecurity resilience measures is a useful
19 and impactful focus for the committee.
20 Finally, decentralized or digital IDs and
21 verified credentials. The concept of a
22 decentralized or digital ID is a powerful one. It

1 is a form of identification that is digitally
2 native, a digitally issued driver's license, or
3 some form of nongovernmental ID. It is owned and
4 controlled by the holder of the ID and can be used
5 as a credential without needing to be separately
6 verified, and without revealing unnecessary
7 information.
8 The promise of this technology is one of data
9 ownership and minimization. We need not share
10 volumes of personal information with each one of
11 our service providers to prove our identity or
12 other key characteristics. We're still in the
13 early days of DIDs and VCs. They hold great
14 promise to improve data security and privacy,
15 enhance interoperability and competition, and to
16 streamline compliance processes.
17 There, of course, is no panacea for illicit
18 finance, but DIDs and VCs present new opportunities
19 to combat it in ways that existing systems cannot.
20 It will take effort on the part of issuers of these
21 IDs, those that use them, those that accept them,
22 and from policymakers and regulators to understand

1 their uses, their benefits, and where they cannot
2 address existing gaps. The subcommittee could seek
3 to better understand the possible benefits of DIDs
4 and VCs, the potential risks and, if appropriate,
5 how best to support their adoption.
6 I look forward to any discussion we have.
7 MS. CRIGHTON: Great, thanks, Jai. Kevin?
8 MR. WERBACH: Thank you very much for the
9 opportunity. Given the time, I will try to be
10 quite brief. I'm going to talk about two
11 particular areas that I think the Future of Finance
12 Subcommittee should engage in, which are blockchain
13 and AI and a little bit briefly at the very end
14 about how they might come together. There's some
15 of the things I'll say that overlap very much with
16 the excellent presentation you just heard from Jai.
17 With regard to blockchain and digital assets,
18 we're in a very different place, of course, than we
19 were a year and a half ago, but activity and
20 trading continues, and with developments such as
21 the Binance settlement, we seem to be moving
22 towards a regulated environment for digital asset

1 trading, and in particular, digital asset commodity
2 trading under the oversight of the CFTC.
3 There are two particular areas with regard to
4 the scope of the MRAC that I think are worthy of
5 discussion by the subcommittee. One is the
6 mechanisms for risk management. And this is
7 different from what Jai was talking about in terms
8 of risk management frameworks, although related.
9 The digital asset industry has developed an array
10 of sophisticated technical solutions for the
11 various risks that have developed in the sector in
12 some cases as a matter of necessity because of the
13 paucity of regulation, in some cases in order to
14 provide the necessary trust, given the different
15 technical and operational and business dynamics of
16 digital asset platforms relative to traditional
17 trading mechanisms.
18 The Blockchain and Digital Asset Project at
19 the Wharton School, which I led earlier this year,
20 did a survey, found more than 30 startups that were
21 just focused on these kinds of issues, as well as a
22 number of larger companies. I'm talking about

1 solutions for things like cybersecurity, fraud
2 detection, risk analytics, smart contract audits,
3 various kinds of custody technologies, including
4 advanced cryptographic solutions for key management
5 and multi-party computation, compliance solutions
6 for things like the Travel Rule and KYC, detecting
7 market manipulation, and addressing some of the
8 distinctive risks that arise with regard to digital
9 assets and DeFi things like oracle risk of outside
10 data feeds, and issues around miner extractable
11 value and the activities of block validators with
12 regard to the trading activity on top.
13 All of these are relevant to understanding
14 what the capabilities are to address the risks that
15 are very real. I think investigation of these
16 issues would be helpful both for the CFTC in its
17 mission with regard to digital asset trading, but
18 also more broadly in terms of understanding
19 evolving regulatory technology or RegTech
20 capabilities that may well be applicable to trading
21 in other areas.
22 The second category put under blockchain is

1 what I will call technology-informed regulation.
2 LabCFTC has been in existence for a number of years
3 and is a valuable asset for the agency, but its
4 capabilities are limited. Various regulators, most
5 notably the Bank for International Settlements and
6 the Monetary Authority of Singapore, have developed
7 extensive capabilities within the regulatory agency
8 to directly engage in technology trials, technology
9 development, in having actual computer scientists
10 and engineers and technologists who are able to
11 develop proofs of concepts, to engage with the
12 industry, to identify the capabilities and
13 potential of experimental new digital asset
14 platforms.
15 This may or may not go along with regulatory
16 forbearance mechanisms such as sandboxes, but given
17 the novelty and potential and complexity of
18 emerging digital asset platforms and DeFi
19 mechanisms, gaining that ability to truly
20 understand the technology in a hands-on way would
21 be extremely valuable, and I think it would be
22 worth the MRAC examining what that potential would

1 be within our area.

2 Second broad category is AI. Obviously, this
3 is an area of tremendous excitement right now
4 across the board. It is not just hype. We are
5 seeing explosive adoption of generative AI
6 technologies on top of already very substantial
7 adoption of other kinds of AI technologies. And
8 it's particularly important to understand that with
9 the growth of foundation models like GPT-4, which
10 are platforms that can then be used by lots of
11 different companies and individuals to build
12 different kinds of solutions, as well as the
13 release of open-source foundation models, like the
14 Meta Llama model, the spread and implementation of
15 generative AI is going to be much broader than just
16 what you see from the large, high-profile
17 platforms. A survey earlier this year found that
18 68 percent of people using ChatGPT at work have not
19 told their bosses, so the spread and adoption of
20 these technologies is even broader than it seems.

21 Three areas I think are worthy of
22 consideration in the Future of Finance

1 Subcommittee, one is with generative AI, the
2 potential for leakage of private data through the
3 queries. If you, for example, want to use ChatGPT
4 or another generative AI tool to develop a trading
5 strategy, what you are typing in goes to the
6 company that is providing that foundation model.
7 It might be something that they have access to,
8 which raises various kinds of confidentiality
9 compliance issues, which a number of firms have
10 been trying to address. It might be something that
11 gets put into the training data or to the fine-
12 tuning data that is used in the models, so a set of
13 issues that are important to consider in terms of a
14 new class of risks that we haven't previously seen
15 that the generative AI technology brings to them.
16 The second one is simply the risks issues that
17 come up with these AI systems being used in
18 trading. Obviously, automated trading is not a new
19 thing, but with AI, the possibility of automated
20 trading bots becomes increasingly sophisticated.
21 And we're seeing rapid development of agent-type
22 systems, systems that have a great deal of

1 autonomy, that can talk to each other, plug into
2 these foundation models and other tools and, with a
3 tremendous amount of independence, engage in very
4 sophisticated activities. That raises a whole
5 series of risk issues that are poorly understood
6 and which deserve some consideration.
7 Third one is systemic risk. Chair Gensler at
8 the SEC has spoken on this. Even if there is
9 decentralization of the use of AI technologies,
10 with these foundation models, which require massive
11 amounts of computation that only a limited number
12 of companies have the resources to develop, it is
13 entirely possible that there may be seemingly
14 independent traders and others who are using at
15 bottom the same foundation model, which may lead to
16 correlated and systemic risks, again, something
17 that is, at this point, a hypothetical, but one
18 that I think deserves consideration in terms of
19 future financial risks.
20 And then the final one is, at some point, how
21 might these two areas of AI and blockchain come
22 together? To the extent that one would imagine an

1 AI-based trading bot that is operating on a DAO, a
2 decentralized autonomous organization, where it is
3 entirely coded through smart contracts on a
4 blockchain, powered by digital asset transactions,
5 difficult to have any centralized point of control
6 for it raises the same sorts of issues that have
7 already come up with things like Tornado Cash, but
8 not necessarily used for illicit purposes, but used
9 for purposes that may still raise very serious risk
10 issues.
11 Again, this is not something that we are at
12 today, but now is the time to try and think about
13 what the potential is of that convergence of AI and
14 blockchain, what the risks are that it raises, and
15 how they might be addressed.
16 MS. CRIGHTON: Great. Thanks, Kevin. And
17 thanks to you both.
18 I'll open it up to the broader committee for
19 discussion. Okay. I'm sorry, Chip. I keep
20 missing. Apologies.
21 MR. LOWRY: Thank you. First of all, thanks
22 to the CFTC and the whole team for a really

1 excellent and thought-provoking day. This has
2 really been tremendous. Thank you.
3 The first part of your presentation reminded
4 me a lot of the parallels with the foreign exchange
5 market, especially around vertical integration risk
6 management. A little over 10 years ago, the FX
7 market went through its own set of issues and came
8 up with the FX Global Code that was created with
9 input and led by the central banks around the world
10 and major banks around the world as well and other
11 industry participants. And most of the industry
12 now operates under the Global Code, and it consists
13 of six leading principles including ethics,
14 governance, execution, information-sharing, risk
15 management compliance, and settlement and
16 confirmation. And it might be helpful to inform
17 you of things that you might be thinking of. So if
18 it's helpful to you, I'd be more than happy to have
19 the FXPA arrange for the subcommittee a
20 presentation on the FX Global Code to see if it has
21 any value in your input. Thank you.
22 MS. CRIGHTON: Great. Well, we made it. So

1 that concludes our meeting today. I'd like to
2 express our thanks for the insights of our guest
3 speakers, as well as the contributions from our
4 MRAC members. Commissioner, do you have any last
5 remarks?
6 COMMISSIONER JOHNSON: Very quickly, I just
7 want to thank everyone who's here and remained. We
8 apologize that we're over time, but I have to on
9 the record acknowledge Chair Crighton's tremendous
10 support for the MRAC, her participation not only in
11 leadership here at the front, just, you know, at
12 the dais if you will, in terms of leading MRAC is
13 valuable, but she's also now supporting a
14 subcommittee and acting as a co-chair alongside
15 Alessandro Cocco and currently Chris Edmonds from
16 ICE. And so I'd like to thank her, her co-chairs
17 for the Subcommittee for CCP Risk and Governance.
18 I'd also like to thank Ann Battle and Bis
19 Chatterje for their leadership of the Market
20 Structure Subcommittee.
21 Finally, I would be remiss if I didn't say a
22 tremendous thanks to Peter Janowski and Tamika

1 Bent, who are here with us also at the front of the
2 room. And my newest senior counsel Julia Welch,
3 who's not with us today but will be with us the
4 very next MRAC meeting.
5 I acknowledged at the outset of the meeting
6 and will acknowledge again Daniel O'Connell and
7 Parisa Nouri of the Division of Clearing and Risk
8 who support the subcommittees that did so much of
9 the work for today's meeting.
10 I also want to acknowledge the folks in IT who
11 managed to figuratively keep the lights on or at
12 least keep systems flowing and working in
13 particular in the context of hybrid meetings,
14 Altonio Downing, Monae Mills, Andy Brighton, Keane
15 McBride, Venise Raphael-Constant, Margie Yates,
16 Jean Cespedes, Pete Santos, Ty Poole, and Phyllis
17 Campbell of my office for all of their very hard
18 work over last week and the weekend. Thank you all
19 so much.
20 MR. JANOWSKI: Thank you, Commissioner and
21 Chair Crighton.
22 I want to thank everyone for attending our

1 final MRAC meeting of 2023. The meeting is
2 adjourned.
3   [Whereupon, at 12:56 p.m. EST, the meeting was
4 adjourned.]
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