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

TRANSCRIPT OF ELECTRONICALLY RECORDED HEARING
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION
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1 TOPIC FOR DISCUSSION: Enhancing Customer Protection
2 and Transparency Through an FCM on U.S. Futures
Markets.

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7 Christine Cochran, Commodity Markets Council

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22 John Lothian, John J. Lothian & Company

23 Sandy McCarthy, FCStone

24 Reggie O'Shields, Federal Home Loan Bank - Atlanta

25 Ross Parke, Barclays Capital

Julie Streit, Country Hedging

Steven Winter, State Street

David Yeres, Clifford Chance LLP

17 MR. WASSERMAN: 30 seconds.

18 MR. BARNETT: Okay. We're without a court
19 reporter but we are taping, so we're -- I'm told
20 we're okay to go. Okay.

21 All right. Welcome back, everyone, to our
22 third panel of today's roundtable. We continue
23 to look at various issues and ways of enhancing
24 customer protection.

25 In this session we're going to look at

1 controls over disbursement of customer funds from
2 Future's accounts, meaning the Section 4D
3 Segregation accounts.

4 The questions could have application in
5 connection with Part 30 secured accounts and
6 cleared swap accounts as well so they cross over,
7 and perhaps tomorrow we'll pick up some strands
8 as well. But that, for the most part, will be
9 what we focus on.

10 I want to start really at the basics. But I
11 heard the prior discussion talk about this a
12 little bit, but not really. I just want to hear
13 a conclusion.

14 I would like to understand, who can tell
15 me, the policies and procedures that most FCMS
16 have currently around Seg. In other words, how
17 do they assure that account class funds are not
18 commingled with other client funds, and that an
19 FCM only withdraws for itself the amount of its
20 residual interest from time to time? How is it
21 currently being done?

22 MS. BURKE: (Indiscernible.)

23 MR. BARNETT: I mean like sort of an
24 operational kind of -- what do we do? What are
25 our typical -- how do we police that currently?

1 MS. BURKE: Okay. So hello everyone. I'm
2 Maureen Burke from Bank of America/Merrill Lynch.
3 I co chair the financial management committee of
4 the FIA. And we spent a great deal of time
5 looking at this. And we had broad representation
6 from the FCM community, clearing houses, and
7 depository banks.

8 As you're aware, the task force was put
9 together by Mike Dawley to look at, you know, our
10 current customer protection rules and the regime
11 as they stand and to see what -- what is done,
12 what are the best practices that are in place
13 today internal controls. And then also look to
14 see, you know, what enhancements could
15 potentially be made.

16 So generally, and just to answer your
17 question, Mr. Barnett.

18 MR. BARNETT: Yes.

19 MS. BURKE: Your question is how do FCMs
20 manage the segregation process today? What type
21 of internal controls are in place to manage that
22 process under the existing regime?

23 MR. BARNETT: Yes.

24 MS. BURKE: Okay. So and we spent a great
25 deal of time on this with the committee members.

1 Generally every -- all the FCMs represented
2 through this group have internal control
3 processes and procedures for managing the
4 computation of the Seg. As we're all aware, that
5 needs to be done by 12 noon daily.

6 In order to ensure that the funds are
7 segregated, the FCM must perform reconciliations
8 on -- you know, there's two sections of the Seg
9 comp. You have your liabilities to your clients
10 and -- well, we'll get to that point.

11 But to prove that the assets are in Seg
12 there's a daily reconciliation that's performed
13 for every asset that's deemed to be in
14 segregation. So a reconciliation is performed to
15 the books and records of the FCM.

16 MR. BARNETT: Excuse me. So -- but what you
17 are doing during the day? I mean, at the end in
18 order to compute what you have, you know, at the
19 end of the day I understand that, but what are we
20 doing to -- what is typically done during the day
21 to make sure that during the operating day --

22 MS. BURKE: You have continual Seg? Well,
23 if you don't mind I'd like to make sure everyone
24 has a level playing field of the knowledge basis.

25 MR. BARNETT: Okay. Go ahead. Thank you.

1 MS. BURKE: So we'll start from the basics
2 and then we can build up from there. So in order
3 to per- -- you start with your Seg comp, which is
4 your -- the Seg comp is required to be computed
5 on T plus 1 by 12 noon the next day. That's your
6 starting point.

7 In order to ensure that everything's in
8 segregation, the FCMS perform daily
9 reconciliations of their books and records, to
10 the assets that are showing on their books and
11 records, both cash and securities, to the
12 external records to the custodians. The
13 custodians send in those -- we receive the
14 custodial records daily.

15 Any reconciling item at 12 p.m. that we
16 don't have, you know, full resolution by 12 p.m.
17 is taken as a reconciling item and we reduce
18 segregated assets for that amount.

19 If there's any, you know, bad prices in the
20 system, if there's something that's come in as
21 unresolved reconciling item, we will adjust our
22 Seg and that's part of the Seg excess. So that's
23 your starting point.

24 FCMS then, as far as your continual Seg
25 requirement, there's -- there's a flow of funds

1 that occur through the course of the day. In
2 order for any funds coming in to a -- they have
3 to come in to a segregated bank account. And in
4 order for a bank account to be deemed an
5 appropriate segregated bank account the FCM must
6 procure from the counter-party, a custodial
7 provider or a bank depository, an acknowledgement
8 letter that the funds are customer segregated
9 funds, and that they're held on -- that they
10 cannot be used to offset a firm liability. So
11 the flow of funds coming in and out of the FCM
12 always need to flow through an appropriate
13 segregated bank account.

14 If there happen to be any investment of
15 customer's segregated funds where the FCM goes
16 out and takes the customer funds and invests
17 those funds, there's requirements under Reg 125
18 that that must be done on a DVP basis. So that
19 you have a custodial bank account and there's a
20 custodial account, there's a bank account
21 associated with that, a DDA account. In order
22 for the securities, if you're investing cash and
23 bringing in securities, in order for the
24 securities to be brought into the account the
25 cash cannot be released without the securities

1 coming in and it's a DVP transaction.

2 That protects the segregated funds. The
3 cash is in the account awaiting the arrival of
4 the securities, they settle out, and the customer
5 funds are protected all the way along the chain.

6 All the settlements to and from the clearing
7 houses are made in the customer segregated bank
8 account so the funding flow from the clearing
9 house to the FCM flows in and out of the
10 customer's segregated bank account.

11 There's monitoring of deficits with clients.
12 Monitoring of the deficits to see and -- to see
13 that you're not using one client funds to offset
14 another client liability. There's a host of
15 internal controls that go on through the course
16 of the day.

17 MR. BARNETT: Okay. Let me ask a slightly
18 different question, then. Can FCMs accurately
19 compute their residual interest in segregated
20 accounts on a real-time basis or on an intra-day
21 basis?

22 MS. BURKE: Does anyone else want to take
23 that? No?

24 I'll tell you that FCMs go through -- and
25 each FCM is slightly different. They're so --

1 they have their own internal control procedures
2 around monitoring the amount of Seg excess that
3 they need to include in the Seg computation.

4 They also monitor, as I mentioned, the
5 deficits that flow in and out. The payments to
6 and from the clearing house are monitored. The
7 size of the payments, historical information is
8 FCMs have systems in place for monitoring real
9 time, you know, the residual interest.

10 MR. BARNETT: Okay. So can I hear from -- I
11 mean, we've got a number of FCMs on the panel.
12 Can I get a feel from the other FCMs whether they
13 think that the residual interest in Seg accounts
14 can be computed on a real-time basis or on an
15 intra-day basis?

16 MR. KASTENHOLZ: Yeah. This is Steve
17 Kastenholtz. I'm with Newedge. And we do go
18 through a similar process in terms of in what
19 you're really looking for is that the residual --
20 one, that you're always in excess too. And
21 secondly, we look to that we always have a buffer
22 over, obviously, significantly over the minimum
23 requirement.

24 So throughout the day for any withdrawals of
25 excess we'll time stamp that withdrawal excess.

1 And a reason why we believe that we are in excess
2 at that time and that we are significantly above
3 our threshold. So we will do that throughout the
4 day.

5 MR. BARNETT: Uh-huh. Other -- other
6 methods being used?

7 MR. GILMORE: Let me just jump in. My name
8 is Carl Gilmore. I'm from Penson. First, I want
9 to thank the commission for hosting this
10 roundtable. I think it's a good thing for the
11 industry.

12 But I would take the -- excuse me. I would
13 take the question a little bit differently. And
14 so if the question is how do we know that we're
15 properly segregated throughout the day? Can we
16 accurately compute it? I think you have to come
17 take a step back and ask yourself and analyze
18 what kind of things on an inter-day basis can
19 actually cause an FCM to become under segregated.

20 And there's a couple of basic flavors.
21 There are cash transactions, money movement.
22 That's relatively easy to compute and I don't
23 know of any FCM that can't accurately compute the
24 amount of money on a cash transaction or
25 investment basis if it goes in and out of a Seg

1 account.

2 But more difficult, one of the other flavors
3 and we shouldn't forget about, is that segregated
4 customer funds with Trading Futures, those are
5 levered instruments. Futures can lose more money
6 than you put up. And so how do you prevent that?
7 Because that is one way that a cus- -- an FCM
8 could become under segregated.

9 And to discuss that, you have to move out of
10 finance, out of cash management, and more into
11 operational risk management. And what do the
12 firms do on an inter-day basis from a market
13 credit and operational risk management standpoint
14 to make sure essentially, very simply, that
15 customer segregated accounts don't lose more than
16 they had when they began the day.

17 So I would say just from an operational and
18 risk management standpoint what you have to do is
19 essentially have systems in place and tools in
20 place and procedures in place that let you look
21 at those customers and look at the trading on a
22 real-time basis to essentially make sure that
23 those accounts don't lose more money than they
24 had when they started.

25 And that is one of the areas in risk

1 management where we made, as an industry,
2 tremendous strides over the last few years. It
3 is with electronic trading we have, as risk
4 managers, much better access to data than we did
5 in the old days. And so if you really -- going
6 back to your original question, Gary.

7 MR. BARNETT: Uh-huh.

8 MR. GILMORE: If you really want to know
9 whether or not you're properly segregated at any
10 time, you have to make sure that you have good
11 risk management that identifies measures and
12 manages your risks in addition to your finance
13 and cash management procedures.

14 MR. BARNETT: Okay. Thank you. And do most
15 FCMs have the tools to do that?

16 MR. GILMORE: I think most FCMs do have the
17 tools. I can't speak for the entire industry
18 certainly. But as there has been a focus on risk
19 management generally over the last five or six
20 years, if there's one good thing that came out of
21 the credit crisis, one golden lining in my view
22 is that the intermediaries, FCMs, exchanges as
23 well have better, more proactive, and more real
24 time risk management tools in place than we ever
25 did before.

1 MR. BARNETT: Okay.

2 MS. BURKE: Yeah. There tools are out there
3 so there are risk management systems with real
4 time feeds of prices to almost 99 percent of the
5 products as well as update of the positions. And
6 I agree, that's part of, you know, I didn't say
7 it quite as eloquently, of the internal controls,
8 procedures, and systems in place for monitoring
9 the risk for customer deficits.

10 MR. BARNETT: Okay. Thanks. One thing,
11 housekeeping, I forgot this at the beginning
12 because we were trying to get things started. So
13 we'll take a break in the middle. We'll see how
14 we're going. We're definitely going to take a
15 break so people shouldn't -- you know, we'll get
16 that done.

17 And then because we don't have the court
18 reporter, but we're taping, it'd be really
19 helpful if everybody, just like the earlier
20 panels, just when you go to speak, announce, you
21 know, your name and you affiliation. And we'll
22 pick it up for the transcript, okay.

23 Okay. And do any other FCMs on the panel
24 have anything they'd like to add or disagree or
25 embellish?

1 MR. WINTER: Steven Winter, State Street.
2 The only thing I would do is reiterate what's
3 already been said. And that's all the FCMs, for
4 the most part, have the tools available today to
5 be able to monitor their Seg and secured
6 calculations. I wouldn't say minute by minute,
7 but during the day to make sure that they're not
8 falling under those Seg requirements whether its
9 through market -- monitoring market activity,
10 trading activity, cash and collateral movement,
11 all of those things, tools are there.

12 If they're running their risk properly, they
13 should be able to ensure themselves to always be
14 in an excess Seg situation. Combined with the
15 buffers that every FCM puts extra money, its own
16 capital, into customer Seg and ensure it that
17 it's always above the minimum requirement.

18 MR. KANNAMBADI: Yeah. Sanjay Kannambadi,
19 (indiscernible). I would add the same thing.
20 Part from that obviously the processes and
21 procedures are from an operations perspective or
22 risk management perspective are crucial to make
23 sure that those systems are monitored and managed
24 appropriately.

25 MR. BARNETT: Okay. Okay. If we can do

1 that, is it -- should an FCM be required to
2 compute its actual residual interest before
3 withdrawing any funds from a Seg account, except
4 for withdrawals that are for the benefit or at
5 the direction of a customer?

6 Should the results of the calculation be
7 certified? Now, I saw the FIA's -- I just got it
8 last night very late -- but I saw stuff about
9 policies and procedures. But it wasn't
10 developed, I don't know exactly how far they were
11 going. But should there be -- so it's a specific
12 question, I guess.

13 So if we're able to track it pretty well
14 moment to moment, then should an FCM be required
15 to compute it before withdrawing any funds from a
16 Seg account if it's not for the benefit of the
17 customer?

18 And then the second question following that,
19 should those results be certified in writing as
20 accurate?

21 MS. BURKE: Well, I mean, the committee's
22 recommending in that regard that, yes, you should
23 know if you're going to withdraw your residual
24 financial interest and you're looking as the
25 targeted residual financial interest -- because

1 the number does change based upon all the moving
2 parts that occur through the course of the day.
3 But the clearing house has direct debit authority
4 against your customer's segregated account bank
5 account.

6 But to the extent -- twofold. First of all,
7 the committee's recommending there should be
8 written policies and procedures that the FCMs
9 develop with regard to the residual targeted
10 financial interest. They should be written so
11 they can be audited by the DSROs, you know,
12 through the course of the year on an annual
13 basis.

14 And then second to that, if, in fact, you're
15 -- the FCM is going to change or withdraw the
16 residual targeted financial interest, then that
17 should be certified. Should be signed off by the
18 chief financial officer or a delegate or the
19 appropriate personnel for the area that's
20 performing that calculation. And there should be
21 a proper separation of duties so that if, in
22 fact, you're going to change your targeted amount
23 -- because each firm may have a different
24 targeted amount based upon their internal set up,
25 the controls they have, the systems they have in

1 place, so we're not making it extremely
2 prescriptive because each FCM is slightly
3 different.

4 But we're recommending that there should be
5 someone held accountable to sign off. That if
6 you're going to change a targeted amount, that
7 you know at that point in time that you're going
8 to withdraw your residual interest knowingly.
9 You should know that you're not putting the Seg
10 comp into a deficiency.

11 MR. BARNETT: Okay. Yes?

12 MR. SMITH: May I follow up on that for a
13 moment?

14 MR. BARNETT: Sure.

15 MR. SMITH: I just want to make sure I
16 understand one part of this. So risk management
17 is looking at, okay, what is the standard offer
18 that any firm wants to have in segregation and
19 monitoring that and the ability also to look at
20 market moves and customers who may be go into a
21 deficit or margin call situation so it doesn't
22 expose the firm to risk. But on top of that is
23 the daily withdrawals of customer's cash in and
24 out of the account that's happening on -- all
25 day long.

1 Is there an ability -- which I don't know if
2 I understand here from the discussion -- is there
3 an ability on a real-time basis for the FCM to
4 truly know where it stands with respect to its
5 residual interest in the accounts.

6 Or are you really focusing on what is the
7 expected buffer? What do we traditionally run as
8 a buffer and what impact it may have on that.
9 But do we really know to a certain degree of
10 precision how much funds are in there that are
11 residual funds?

12 MS. BURKE: You know, based upon historical
13 information and the systems and tools that you
14 have to say an exact point in time do you have
15 all the information updated? Have you received
16 all your real-time feeds from your custodial
17 banks? Have you received all your real-time
18 feeds from your bank depositories? Have you
19 updated every one of the -- in order to produce
20 the Seg computation, which is produced overnight,
21 the full blown Seg to know exactly what the
22 residual interest is. Maybe some firms have it.
23 But there's quite a bit to be done there to have
24 that exact precise amount. And that is why there
25 is a buffer and there's, you know, cushions.

1 The other tools are used to augment to know
2 that this buffer is accurate. You know, it's an
3 appropriate buffer. And that's why we feel that
4 it's important for each FCM that if they targeted
5 a buffer to just not change it, you know, based
6 upon some other need, a liquidity need elsewhere
7 or something along that line that may or may not
8 have happened. Which we'll --

9 MR. BARNETT: All right. So I want -- let
10 me push on it a little bit, okay. So would it be
11 possible, for instance -- and we heard the
12 earlier discussion about direct posting the FCM
13 take- -- not having contact with cash. Not
14 talking about DCO posting, but just talking about
15 our existing structure.

16 Could you run, for instance, a lock box
17 structure with client Seg in essentially a lock
18 box where the FCM only had the right to instruct
19 the application of client Seg? It had excess
20 running in a parallel account. But do you know
21 client Seg well enough to run it in sort of a
22 lock box structure?

23 Carl, what do you think? I see your brow
24 frowed up.

25 MR. GILMORE: It's a good question. And the

1 real answer is ultimately, Gary, is maybe. But
2 again, let's go back to the original question
3 which was does an FCM have the ability to perform
4 a Seg computation on an inter-day basis?

5 A full-blown segregation calculation on an
6 inter-day basis, probably not. There's a reason
7 that you get until noon the next day because
8 there are a lot of components.

9 But as a practical matter, let's think about
10 the things again that can affect your segregation
11 position. Customer takes money out. That's not
12 going to affect your residual unless that
13 customer didn't have the money to take out in the
14 first place, right. That's easily tracked. I
15 don't know of any FCM in this room that can't
16 easily track that. Customers have positions on,
17 markets are volatile, they haven't lost more
18 money than they put up at the beginning of the
19 day or whatever your starting point is, that
20 won't affect your residual.

21 So ultimately what I would say is a
22 practical matter, I don't know if an FCM can
23 actually do a full-blown inter-day segregation
24 calculation. But an FCM ought to be able to
25 estimate, with some reasonableness, that taking

1 money from the residual, out of their Seg excess,
2 won't cause them to be under segregated if those
3 things are in place.

4 You don't let a customer take money out that
5 he didn't have. You don't have a customer that's
6 run a debit. You haven't moved money out
7 obviously of segregation for any other reason.
8 If those three fairly simple things are in place,
9 you ought to be able to reasonably estimate that
10 withdraw of whatever your residual interest was
11 at the beginning of the day isn't going to cause
12 you to be under segregated.

13 But again, I don't think you can do a
14 full-blown segregation calculation inter-day.
15 There's just too many moving parts and it takes
16 too long. I would advocate for some sort of
17 reasonable basis before you take it out, which is
18 what I think as a practical matter the firms are
19 doing now.

20 MR. BARNETT: Uh-huh. Other thoughts?

21 MR. FILLER: Gary, first, thanks for you
22 inviting me. But I want to commend the
23 Commission. I don't know if anyone is aware of
24 it, but your new financial data for FCM report
25 has added two new columns. Basically what I call

1 the buffer you call it residual interest. It now
2 lists the buffer amount for Seg and for 30.7.
3 And I don't think the commission's gotten enough
4 publicity to -- and I think this is a great new
5 disclosure for -- for the end users understand
6 how much perspective FCM.

7 And so when you were able to see that
8 obviously the FCM is giving you that data on
9 their 1FR or focus reports or whatever. So
10 they're able to calculate that, maybe if only on
11 the month end date.

12 But I have a suggestion. I think I know
13 where you're coming from and we all know what the
14 issue with MF Global. They took money out of the
15 customer account which they thought was house
16 funds. And they probably took more than they
17 should have.

18 And I have an easy solution, I think, that
19 can work to satisfy the concerns from the
20 commission's perspective as well as -- as well as
21 address the operational issues from an FCM
22 perspective.

23 When I was at Lehman we had between 200 and
24 \$600 million in what I call the residual or
25 buffer amount. And a lot of the times as Maureen

1 and others have talked about, it had clients
2 trading in Asia and it would take 24 to 48 hours
3 for that money to come back and forth. We had
4 clients who would port trades in and the
5 positions come in day one, but the monies don't
6 come in for days two or three.

7 And my recommendation is for the Commission
8 or for the group to think about talking about is
9 let's create a separate account. Let's call it
10 FCM customer segregated account, so it's
11 calculated to make sure there's no shortfall for
12 the FCMs residual interest or buffer or whatever.

13 And I'll use Lehman. If I have \$400
14 million, I'll put that \$400 million in that
15 account separate and apart from your normal Seg
16 account. Anyone can therefore account for that.
17 If money comes out of that residual account, it
18 can only come out of this special account. You
19 can never transfer monies out of the customer
20 account to the house account. So you can label
21 it as a customer segregated account but the only
22 assets that sit in that account is the, quote,
23 "residual interest" or buffer.

24 And, therefore, is an FCM wants to take
25 money out -- I know there are issues whether

1 custodial bank should get some kind of
2 acknowledgement or certification. You now have
3 an accounting, clear accounting, because the only
4 money sitting in this special account is the
5 residual interest. You call it customer Seg
6 because it's used impart to make sure there's no
7 shortfall. You don't comingle it with the
8 traditional customer segregated accounts that are
9 opened by the FCM.

10 I don't know whether that's -- is creating
11 another account another layer? But I think one
12 more account where you can easily do the
13 accounting and calculations and provide -- if you
14 wanted a report on a daily basis -- I know that
15 later on today we're going to talk about what
16 kind of reports FCMs should provide. This type
17 of report you could provide it on a daily basis
18 because all you've got to do to do is look on the
19 online statement to see how much money is in that
20 one particular account from that perspective.

21 MR. BARNETT: Let's see what other people
22 think. But first I want to respond to your
23 beginning statement by saying that -- I should
24 have put the disclaimer out there immediately at
25 the beginning -- we can't engage -- the CFTC

1 staff can't engage in a discussion concerning
2 matters involving MF Global in light of our
3 division of enforcement's ongoing investigation.
4 And we ask participants to respect our request
5 that such specifics not be injected into the
6 discussion here today.

7 MR. FILLER: We can.

8 MR. BARNETT: But beyond that is when this
9 whole process -- I spoke to a number of people a
10 month ago when the different committees started.
11 I would talk to Mike Dawley, I talked to others,
12 and early on there was discussion about complete
13 Seg. And people were actually talking -- from
14 the industry, were talking about trying to get to
15 complete Seg. But then what I'm seeing coming
16 out are things more like business conduct rules
17 around it.

18 And so we're trying to gauge what the
19 industry was thinking. What do you think is
20 possible and why is it sort of like different
21 from where, you know, what's coming out is
22 slightly different from where you -- well, maybe
23 significantly different from what you thought
24 might be possible.

25 Because that's important to start figure

1 out. When we start thinking about what rules and
2 procedures to build around it, you've got to
3 start with what's possible. So I just wanted you
4 to know that that's what sparked it. And this is
5 not a discussion about the unmentionable, okay.

6 Any thoughts about -- go ahead. Go ahead.

7 MS. STREIT: Julie Streit from Country
8 Hedging. As a matter of practice, our client
9 base is particularly heavy in agriculture
10 cooperatives, farmer producers. It's very common
11 for them to pay by check or ACH because they're
12 small - small accounts. So it's -- essentially,
13 us as an FCM, are paying the clearing houses or
14 the clearing FCMS that we're working with in
15 advance of receiving those funds. So we're
16 really, we're front -- you know, we're really
17 fronting our excess funds on behalf of those
18 customers.

19 So I think, you know, to Ron's question, I
20 think it would be that adds an extra layer of
21 logistical complexity to having that second
22 account. I can see where you're coming from.
23 But as a matter of practice it may be
24 challenging.

25 MR. BARNETT: Other thoughts about Ron's

1 thought or other models? Dan?

2 MR. DRISCOLL: I'm Dan Driscoll from NFA.
3 The type of account that Ron is suggesting here
4 you could do it and it would work. When it
5 wouldn't work, though, is if not withstanding the
6 \$400 million that's in there, but in your real
7 customer accounts you're short \$500 million.

8 So it -- it doesn't -- it might make the, in
9 some ways, accounting for it easier and things
10 like that. And it would probably preclude you
11 from using that as a short-term funding mechanism
12 for other parts of your business. But it
13 wouldn't necessarily ensure that you would always
14 be properly segregated.

15 MR. BARNETT: Right. Right.

16 (Indiscernible).

17 MR. WINTER: I guess I just want to make
18 sure we're clear on one thing. And that's that
19 typically in a large FCM, FCMs don't typically
20 draw out their residual excess Seg funds. That
21 generally remains pretty constant. So and that's
22 the important issue here.

23 And so in reality, if there's a concern
24 about withdrawing it, you can always implement
25 rules that are similar to a broker dealer. When

1 you put capital into a broker dealer you can't
2 withdraw it without certain notice periods. You
3 can put similar rules into effect that would
4 create the same safeguard.

5 MR. BARNETT: Okay.

6 MS. MCCARTHY: This is Sandy McCarthy with
7 FCStone. Our firm actually sweeps all house
8 funds into Seg every day. So for you to say we
9 couldn't then draw it out would be a major
10 problem and we would not continue that practice.

11 Because if a market -- let's say corn moves
12 40 cents and the margin's 20 cents, we're going
13 to -- and that's our biggest player is corn
14 because we're soliciting Ag business, then we're
15 going to have a huge deficit. Our customers are
16 going to be in a one-day deficit situation.
17 That's why we sweep all excess house funds into
18 Seg.

19 MR. BARNETT: Got it.

20 MR. WASSERMAN: Just a quick question to
21 interject on that, which is if you have an
22 account which is essentially isolated and
23 essentially this account is residual interest, do
24 you create any uncertainty as to whether that
25 account constitutes customer property in the

1 event that, as Dan pointed out, it turns out you
2 need it.

3 MR. BARNETT: I knew you were going to ask
4 that, actually. Earlier when he was talking
5 about it I knew you were thinking about that,
6 yeah.

7 MR. FILLER: If you're asking me, I think
8 the answer is yes because it's labeled as a
9 customer segregated account. What's the
10 difference in whether I put my 400 million in
11 account one or in the commingled segregated
12 account if -- as long as we properly label it as
13 a customer segregated account. And to answer
14 Dan's point, whether the 400 million is in the
15 big account or the separate account, if you lose
16 \$500 million you're going to have a shortfall no
17 matter what.

18 So I just think from an accounting point of
19 view for transfers -- if FCStone sends money out
20 every day just to do it -- you have a proper
21 record of what these transactions or deposits
22 coming in or transfers going out so if the CFTC
23 or the DSRO or whomever wants to audit the FCMs,
24 you can just focus on that account.

25 I -- I've always been concerned that you

1 take money out of customers to send it to the
2 firm. And I agree with Maureen, that's the way
3 it happens. But you have to then document it,
4 get certified, get the proper people to approve
5 it within treasury or whatever the department is
6 at the firm. And, to me, I think it's -- you're
7 still taking money out of Seg. There's 400
8 million. Let's say you take 100 million out but
9 you have a separate record of it.

10 MR. BARNETT: Right.

11 MR. FILLER: It's distinct and separate.
12 And that's just my -- I'm just trying to come up
13 with an easy accounting calculation perspective.

14 MR. BARNETT: That's helpful. And there is
15 -- we can work on legal issues later. But it's
16 helpful. Let's shift if -- you have a -- go
17 ahead.

18 MR. YERES: Yes. I'm David Yeres. I'm from
19 Clifford Chance and I'm here on behalf of CIEBA
20 which, as you know, represents the benefit plans
21 and a fiduciary for plans. And as mentioned in
22 the last panel, as you know, CIEBA was proposing
23 a full Seg model.

24 And just to make the record clear, while
25 CIEBA acknowledges the work that the FCMs do, the

1 systems that they put in place, and some of the
2 improvements that are being proposed here by the
3 FIA, it continues to think that this is not a
4 substitute for the full Seg model that it has
5 proposed. And that putting into place more
6 audits, more paper requirements while they're
7 good, don't ultimately protect the funds in the
8 same way segregation does.

9 Just to mention -- I won't mention MF Global
10 for now. It's only six years ago that Refco
11 folded. A very big firm. Had \$500 million
12 apparently in losses which weren't detected for
13 years and years and years despite the fact it
14 went through audits, it was a public company, et
15 cetera. So with all do regard for people's
16 efforts, it is probably only by a structural
17 change, perhaps the one CIEBA and CMA are talking
18 about perhaps another change, that full
19 protection can occur.

20 MR. BARNETT: Okay. Can I -- I want to --
21 I'll come back. But moving from the location and
22 earmarked for it, what about going back to this
23 thing about being able to reconcile by, like,
24 noon of the following day. What if we limited
25 the -- whether it's from a source or just in

1 general -- the withdrawal of excess to a time of
2 the day when the computations and reconciliations
3 have occurred? Is that -- is that helpful or
4 not?

5 I mean, one thought is you've done the
6 reconciliations and you should know what's there.
7 But what also comes to mind immediately is we're
8 halfway through the second day and I also don't
9 know if trading has been going on all night or,
10 you know, whether markets moves continue.

11 So what do you think operationally about the
12 benefits of limiting withdrawals of excess to
13 after you've run your computations instead of any
14 time inter-day?

15 MR. KASTENHOLZ: And again, Steve Kastenholz
16 from Newedge. Like Sandy mentioned at FCStone,
17 we have, since the unmentioned bankruptcy, have
18 moved a considerable amount of our excess house
19 liquidity into our pool just as another matter of
20 safety.

21 If we're going to go down to the fact that
22 we're just going to say, well, all of that we
23 need. You know, there's the rules and
24 regulations to get that money back to fund our
25 internal operations. All that is going to do,

1 from my perspective, it's going to bring down the
2 level that we're comfortable putting in excess.
3 Which may be fine. And then we'll just live
4 within that targeted excess but we won't go above
5 that excess then.

6 And I think from my perspective we've put a
7 significant amount of our own liquidity and
8 capital into these pools just as another added
9 level of security, and if we were to somehow
10 restrict that ability to move all of that, I'm
11 not arguing some portion of that, but restrict
12 our ability to move some of that I think we'll
13 have -- we would be forced to bring our excesses
14 down.

15 MR. GILMORE: Carl Gilmore again from
16 Penson. Sorry. Just quickly, I think that's
17 right. There's a real risk of a lot of
18 unintended consequences there. That if you say
19 you make your calculation, you know what your
20 residual interest is, you can take it out at that
21 time and then you can't do it again, Steve is
22 right. What will inevitably happen is
23 participants will take out as much as they can
24 and you'll end up with less excesses than you
25 might otherwise if you let the FCMs make

1 additional withdrawals if they're reasonably
2 confident that they're not under segregated.

3 MR. BARNETT: Go ahead.

4 MR. FERRIS: Yeah. I very much appreciate
5 your focus on what can be done by the people
6 sitting at this table. And I have no doubt that
7 -- and I applaud a lot of things that have been
8 said about what is being done and what can be
9 done. I think the CFO certification I applaud
10 very much. I think that's really very helpful.

11 But one thing you've got to understand is
12 there are a lot of FCMs. And they may have the
13 best rules and procedures in the world. And I
14 was an expert witness in a case where the rules
15 and procedures were wonderful, but the following
16 the practice of those rules and procedures were
17 not there. And when were they not there? Not
18 even what I would call an emergency where the FCM
19 thinks if I don't get my hands on some money for
20 my own collateral, we will go down. But just to
21 sort of make customers happy the rules are often
22 not followed in practice.

23 I know I've been involved in situations
24 where margin is not collected within five
25 business days because the FCM wants to keep a

1 customer who's trading a lot happy and give them
2 a little more time to cover. I think customer
3 funds can be gone into not only when the ship is
4 going to go down, but whenever it happens to be,
5 and this is not going to be on a day-to-day
6 basis, but it happens more often than they'd
7 like. It just is more convenient to temporarily
8 take customer funds and use it for your own
9 purposes before the auditors can catch up with
10 you.

11 What does that -- what does that mean? That
12 means that there is -- I applaud and we need to
13 get better rules and procedures and perfect the
14 system. But the system needs to be better
15 audited by the SRO. And the CFTC cannot -- I
16 know you guys got funding problems and maybe this
17 is a way we can help you get around it, but the
18 CFTC, in terms of transparency, oversight, you
19 must not assume that because the rule book is
20 good everything that is happening is good.

21 And I also would agree that you cannot
22 separate the segregation policy from the back
23 office perfection policy. One doesn't substitute
24 for the other. They go together. You both have
25 to worry about whether you're using LSOC for

1 Futures or whatever. And, as FIA appears to be
2 doing, you have to improve back office
3 procedures.

4 And for that matter, if back office
5 procedures are improved so that you don't have
6 this fear about dipping into customer accounts,
7 all the cost of following LSOC or whatever is
8 reduced because there's much more of a confidence
9 that the back office will protect the system.

10 And I think that also goes, you know,
11 somewhere in here -- and I'm sure we will discuss
12 insurance, I know Ken is very anxious to talk
13 about it -- but if there is an insurance
14 resolution to the extent the back offices are
15 properly audited so that when it's convenient for
16 the FCM -- and I'm not talking about FCMs at this
17 table. I'm talking there are a lot of FCMs out
18 there who I think have problematic practices,
19 that they can cover quickly. When they can't
20 cover it is when the ship is going to go down and
21 they think they're borrowing a little money until
22 they think they can get more money to write the
23 ship and that doesn't -- doesn't happen.

24 Also I just want to say when we talk about
25 moral hazard, the moral hazard of protecting the

1 customer too much and, therefore, the customer
2 doesn't make intelligent decisions about where to
3 place their money, a lot of these customers, even
4 their representatives, don't have the ability to
5 make those intelligent decisions. If there is a
6 moral hazard problem here now, it is the moral
7 hazard that the customers have lost faith in the
8 system. And the system is in trouble.

9 And with more problems of the kind that
10 we've seen, especially if something like this
11 were to happen in the swap sector where 1.6
12 billion might be small change compared to what
13 could happen, the system is just going to
14 collapse because people -- you know, the swaps
15 people are saying I'll engage in swaps. I'll do
16 it for more of a cost but I want to make an
17 analysis of whether it's worth it.

18 If we have a similar collapse in segregation
19 policy for, you know, a trillion dollars, the
20 system is going to collapse.

21 MR. BARNETT: All the more reason to get
22 this right.

23 MS. BURKE: Excuse me, Mr. Barnett? If you
24 don't mind, sir. Just to hit on a couple of the
25 points that --

1 MR. BARNETT: Please remember to state your
2 name.

3 MS. BURKE: Oh, Maureen Burke, Bank of
4 America/Merrill Lynch representing FIA.

5 So just to hit on a couple of the points.
6 So the committee, as I mentioned earlier, did
7 focus on some of these items making several
8 recommendations. And one of the recommendations
9 is that the FCM would have to have -- and if you
10 don't mind if I read it: Committee recommends
11 that the commission propose a rule requiring each
12 FCM to certify that there are, and have been
13 since the last report, no material weaknesses in
14 its internal controls regarding the computation
15 of adjusted net capital in compliance with
16 revisions of the act and rule -- commission's
17 rules regarding the protection of customer funds.

18 The SEC is coming out with a rule and we
19 feel very strongly that there should be rules
20 around the internal control processes and
21 certification annually that there -- there are no
22 material weaknesses. This will be done through
23 our external auditors. There's also further
24 recommendation that the FCMs would document their
25 internal control policies and procedures.

1 So back to your point, what we're looking at
2 all size FCMs. Even if you have a smaller FCM,
3 there should be proper internal controls. There
4 should be separation of duties between the area
5 that has to perform the segregation computation,
6 the area that has the authority to withdraw, and
7 the excess segregated funds with -- and having
8 documented policies and procedures that the SROs
9 can come in and audit through the course of their
10 audit process, at any point in time they can come
11 in and review the policies and procedures and
12 ensure that the FCMs are in compliance.

13 We're also looking at additional record
14 keeping requirements that we think would give the
15 SROs more information to work with on a daily
16 basis. A requirement to have the FCMs --

17 MR. BARNETT: Okay.

18 MS. BURKE: -- file their segregation
19 computation daily and the SROs can --

20 MR. BARNETT: Yeah. Let's stay on track.

21 I know I saw some of this last night. I
22 have some thoughts on it, too, that we should
23 talk about.

24 But, David, you had your hand up.

25 MR. YERES: Just a very small point. Again,

1 to commend the FIA for the work they've done what
2 they produced last night is a very good start.
3 Although I'm sure no one's had a chance to fully
4 digest its ramifications.

5 But in very short order, audits are
6 critical. Policies and procedures are critical.
7 But I'll go back to Refco. They were audited
8 quarterly for year after year. \$500 million
9 missing was never found. The audits have to be
10 surprise audits. And to the extent the audits
11 reveal any material deficiency, they need to be
12 public.

13 At this point, for the most part, the public
14 is unaware, other than in an independent auditing
15 firms annual report, of whether or not there are
16 material deficiencies. So I would suggest that
17 the audit not be predictable. Not allow a firm
18 to clean up its books at quarter end, and that to
19 the extent there are deficiencies, they're made
20 public. And I believe that would be the CIEBA
21 position.

22 MR. BARNETT: Great. Okay. You had your
23 hand up.

24 MR. LOTHIAN: Thank you. I'd like to
25 applaud David for his remarks about Refco having

1 had -- first off, John Lothian, at John Lothian
2 and Company. I'm also registered representative
3 with the Price Futures Group where we had a
4 customer that had \$364 million stolen from their
5 segregated account the day before all the news
6 about the great loss happened, okay. And it took
7 two and a half years out of my boss's life in
8 order to get that money back because it went from
9 a segregated account to an offshore Refco
10 unregulated broker dealer, okay.

11 There's no written procedures that could
12 have stopped that, okay. There's nothing that
13 has -- that I've heard that will help get that
14 back, although it was gotten back through the,
15 you know, bankruptcy procedures and all of that.
16 But we talk about Refco as being the seamless
17 move of an FCM from, you know, from Refco to man,
18 and except for \$364 million from a segregated
19 customer account, that was true. Because at
20 least, you know, there may be some other
21 examples, but that was a major problem.

22 I also want to talk about what Ms- --
23 Professor Greenberg talked about the difference
24 between reality and theory when you get into some
25 of these things, okay. As a registered

1 representative I'm tested. I have to go through
2 ethics testing. I have to go through money
3 laundering testing, all of that.

4 The people in the back office where we've
5 seen some of these problems occur are not
6 licensed, they are not tested, they have every
7 opportunity to come back and to be at another
8 firm where the problems could reoccur and all
9 kinds of things.

10 There needs to be a licensing for the people
11 that touch customer money. We have learned that
12 customer money is vulnerable, not just to a
13 broker who's going to jerk around a customer, but
14 to somebody in the back office that's going to
15 push the wrong button and send the money to a
16 wrong place.

17 MR. BARNETT: Okay. Thank you. Anne?

18 MS. BAGAN: Thank you. Anne Bagan from CME
19 Group. I just wanted to touch base on some of
20 the comments that have been made here.

21 First off is our regulatory audits are done
22 on a surprise basis and we agree that that is a
23 good control to have in place. Second, to
24 Maureen's point about the certification, we do
25 get a management rep letter from -- which you

1 probably are all familiar with -- on our
2 regulatory audits. And one of the additions that
3 we're putting in for this year and forward is
4 that the CEO or CFO has to say that there have
5 been no violations of capital, Seg, secured, or
6 sequestered throughout the year from the
7 certified audit that's through to the regulatory
8 audit date. So we will be getting that going
9 forward.

10 Although I agree I think the outside
11 auditors could do more on internal controls and
12 perhaps that should be done on a different date
13 than the certified date only because they're
14 rushed to get that done. And we'd like to see
15 them spend a little bit more time on that.

16 The other thing is internal controls.
17 Totally agree, everybody needs to have the --
18 have good internal controls. And to Carl's and
19 Maureen's point, it's not so much of whether at
20 every moment of every day you, you know, exact
21 Seg position, but that you have those things to
22 look at throughout the day to make sure that you
23 are over segregated and that you do maintain a
24 cushion.

25 But this is not a one size fits all type of

1 industry by any means. We have very large firms
2 with 50 people in the back office moving hundreds
3 of millions of dollars every day and we've got
4 small firms with three people in the back office
5 moving thousands of dollars to local traders. So
6 I think we do need to accept that flexibility has
7 got to be a part of our risk management and our
8 control environment. The joint audit committee
9 does look at firms' procedures, particularly for
10 cash, moving cash.

11 Another thing that we're looking at is to
12 ask firms what are your procedures to make sure
13 that you're in Seg compliance during the day.
14 But to Michael's point, if they have the best
15 procedures in place and they don't follow them,
16 that doesn't really help us. Or if worse, if
17 they are following their procedures and they're
18 not good. So that's one thing that we look at on
19 our regulatory audits. And if we find areas
20 where we do have questions or concerns, we'll
21 focus more of our audit time in those particular
22 areas.

23 MR. BARNETT: Do you track the follow up for
24 violations, internal violations, whether they're
25 monitored? And if you see a repeat, you know,

1 what the repercussions are for people who have
2 violated an internal policy or procedure?

3 MS. BAGAN: Do we -- if we have a problem
4 with something?

5 MR. BARNETT: No. No. No. When you go out
6 and examine somebody and you look at their
7 controls, do you look at training point or a
8 problem with somebody who has violated a limit or
9 a rule or a procedure and what, you know, and
10 what the repercussions are for such a person?

11 MS. BAGAN: You know, what I think is the
12 better control there is because do spend so much
13 our audits looking at financial, you know, and
14 results if you will.

15 MR. BARNETT: Yeah.

16 MS. BAGAN: Again, if they follow their
17 procedures and they follow their limits but
18 they're not good, are we going to have a problem
19 on the financial side when we do that audit?
20 Most likely yes, right. So that's what we're
21 going to be following up on to make sure those
22 type of issues aren't repeated.

23 MR. BARNETT: Can I -- can I go back -- I've
24 got to go back for a second, too. We got -- we
25 sidetracked for a little bit. We talked about

1 the risks, the unintended consequences if we were
2 to track Seg once a day and say you can only take
3 it out once at a time. Just three short
4 questions together and get a response from
5 people.

6 So, you know, what if there was a
7 prohibition or notice requirement for withdrawing
8 more than a certain percentage of your target
9 residual interest? And I guess related question
10 is should there -- should there be a requirement
11 to maintain a certain percentage of excess
12 segregated funds?

13 I'm not sure how you'd respond to that. And
14 I guess, an even farther one out is not should
15 the commission have authority to require -- or an
16 SRO have the authority to require an FCM to
17 increase Seg funds, or, you know, increase some
18 buffer that's in their system? What's your
19 reaction to that?

20 MS. STREIT: Julie from Country Hedging. I
21 think there might be more unintended consequences
22 with the percentage. If you set a percentage
23 maximum on withdrawals, you're penalizing firms
24 who carry more excess, you know, and not allowing
25 them to draw as much.

1 MR. WASSERMAN: Can you speak --

2 MS. STREIT: Sure. Your -- if you set a
3 maximum percentage, you're penalizing firms who
4 are keeping more excess in their accounts
5 potentially in as far as residual funds. More
6 effective would probably be to establish a
7 buffer, you know, establish a minimum percentage
8 above the required that would have to be
9 maintained.

10 MR. BARNETT: Uh-huh. Other reactions?

11 MS. MCCARTHY: This is Sandy McCarthy is
12 FCStone. We were of the opinion that you were
13 actually going back to the old capital rules to
14 some degree when capital was based on Seg funds.
15 So the more Seg funds you had the more capital
16 you had to have and you were basically penalized
17 again.

18 So we were of the same opinion here also
19 that potentially we would think if you went to
20 some 10 percent level, which is what was in this
21 document I received, you would potentially be
22 concentrating your risk into fewer entities
23 because I think there would be less FCMs.

24 MR. BARNETT: Okay.

25 MS. BURKE: So just --

1 MR. BARNETT: Go ahead.

2 MS. BURKE: Through the committee again, not
3 to have a prescribed amount. And the withdrawal,
4 if it's -- it would have to be signed off.

5 MR. BARNETT: I'm sorry. Say that again. I
6 can't hear you.

7 MS. BURKE: Sorry. Just go through your
8 questions one more time just to make sure we've
9 got them.

10 MR. BARNETT: I guess the question was,
11 should there be a notice requirement? Actually,
12 I think I saw this in your write up whether there
13 should be a notice given if you withdraw more
14 than a certain amount of your residual interest
15 at one time.

16 MS. BURKE: What we're recommending is that
17 the CFO would have to sign off on it. That they
18 would have to actually, you know, authorize that
19 it doesn't put into a Seg deficiency. That it
20 would -- it would be authorized by a
21 representative, a senior level representative
22 that it would not -- if it goes -- if it changes
23 a policy -- so it starts with a policy and that
24 the policies would be made public to the SROs who
25 come in and perform the audit that what is the

1 policy for your Seg excess. What is your
2 targeted Seg policy? And some firms have that as
3 an end of day, mid day. There's different types
4 of policies.

5 And we were making it prescriptive because
6 every FCM is different. But they'd have a policy
7 that could be audited, back to Anne's point. And
8 then if an FCM was going to actually change that
9 policy and actually reduce their Seg excess, they
10 would have to have their CFO or a very senior
11 level officer who has the responsibility for the
12 Seg oversight that they're signing off that it
13 would not put it -- the account into any
14 deficiency.

15 MR. KARSH: This is Andrew Karsh. You know,
16 it's interesting just listening to everybody's
17 view in terms of the policies you can put in
18 place and their self regulatory nature. And
19 obviously the CFO signing off is something that
20 obviously is a favorable move.

21 But, I mean, to John's point earlier, I
22 mean, I think there is a fundamental concern with
23 the self regulatory approach in the internal
24 policy approach that, in general, it's -- even
25 with random audit processes and regulatory

1 controls that the markets now in an inherent
2 increase in volatility that we've seen in the
3 markets. Look at the flash crash, you know, look
4 at what we've seen over the last 12 to 18 months
5 in terms of volumes changing based on program
6 trading and the like.

7 You know, I think we're just -- the
8 environment has changed so much this concept that
9 you keep asking about in terms of inter-day
10 monitoring is critical for us to think about.
11 Because as somebody who participates in the
12 market and large volumes in looking at the way
13 the market has evolved based on electronic
14 trading, I mean, it's something that, you know,
15 our view is it really does need to be monitored
16 on an ongoing basis because, you know, inter
17 audit or by the time the CFTC or the regulators
18 find out that there may be an issue, you know, by
19 the time you get people to their office two days
20 later it may be too late. I mean, I think we've
21 all learned the lesson that things are moving a
22 lot faster than they have historically and we all
23 need to be cognizant of that and think about how
24 to be proactive.

25 And to your point, you know, the real time

1 approach is something that, you know, we would
2 find highly favorable.

3 MR. BARNETT: How would you -- just to flush
4 this out -- ask you to flush out what you're
5 proposing. How would you provide for that kind
6 of ongoing monitoring? What would it consist of?

7 MR. KARSH: Well, I mean, if I think about
8 it any organization, you know, all the FCMS in
9 the room included, you know, when you have a
10 trading desk you've got real-time P&L. You've got
11 calculations that are going on a real time basis.
12 I don't see why that kind of implementation
13 couldn't be done through the back office into the
14 system as well.

15 I mean, it's something that, you know, the
16 traders have something where they've got minute
17 by minute P&L, but that doesn't move through the
18 back office until the end of the day, right. So,
19 you know, you have this time lag to where by the
20 time it's actually seize the checks and balances,
21 you've got an issue, right.

22 So might point would be if there's some way
23 we could use the modern technology that people
24 are using to do, you know, millisecond-level
25 trading, it's actually helping the security of

1 the system and the operational infrastructure of
2 the FCMs. I think that's something that, as an
3 entire market, would actually make the whole
4 system more commensurate to the speed with which
5 we're trading as opposed to having, you know,
6 people that can trade, you know, 500 million
7 shares inter day, but nothing happens on the back
8 office side until the market closes at 4 o'clock,
9 for instance.

10 MR. BARNETT: What do others think? Is that
11 -- is it feasible?

12 MR. GILMORE: Carl Gilmore from Penson
13 again. And maybe I wasn't clear before when I
14 said in response to your back office not knowing
15 until the end of the day comment, I don't think
16 there is an FCM in this room that waits until the
17 end of the day for some of the examples that you
18 just put out. You can't do it. If we learned
19 one thing out of the credit crisis is that you
20 can't wait till the end of the day.

21 And perhaps I wasn't clear in expressing why
22 I think you can reasonably estimate your
23 segregation position on an inter-day basis. If
24 you know the things that will impact segregation
25 particularly from a risk-management standpoint,

1 you can reasonably estimate what your segregation
2 excess is if you knew what it was at the
3 beginning of the day.

4 So I don't want it -- I don't want the
5 gentleman down there to think that we're standing
6 for the premises FCMS of waiting until the end of
7 the day for somebody that's trading. We're not.
8 We know virtually right after that trade has
9 occurred and we can calculate it and we can
10 stress test it and we can do all the different
11 things that FCMS here in this room will do. But
12 we are not waiting until the end of the day.

13 And so I guess we're saying the same thing.
14 But I don't want -- I don't want the impression
15 by certainly by any of the buy side people to
16 think that FCMS aren't doing that. Because every
17 FCM I know is stress testing and monitoring its
18 trading of its customers on an inter day basis.
19 Not waiting till the end of the day.

20 MR. BARNETT: Yes, ma'am.

21 MS. DOWNS: Maureen Downs, Rosenthal Collins
22 Group. I'd like to follow up with what you said,
23 Carl, in talking about inter-day monitoring of
24 customer positions. We're now in a position
25 where we can, through technology, really take a

1 look at where our exposures are. Not just
2 customer by customer, but market segment by
3 market segment. For those of us who have
4 concentrations in certain particular product
5 markets -- in my firm, for example, the grain
6 business is a big feature of our firm -- we can
7 be looking at exposures across customers and
8 knowing that we are going to have a bigger buffer
9 for excess Seg that day.

10 So we're coming in as soon as -- as soon as
11 the day starts and if we have the grain markets
12 open limit up, we're already anticipating that
13 problem. And as we're watching the trading
14 during the day we can refine that. But
15 technology is helping us know by concentration of
16 customer, by product market all the way down to
17 even, you know, even to particular option strikes
18 where our exposures are. So technology has
19 helped us build those buffers.

20 And so, Carl, you're exactly right. We can
21 never be -- I don't think we're ever getting it
22 down to the penny. We just simply can't. But
23 technology has helped us get so much smarter and
24 so much better and I think better at building
25 excesses.

1 MR. KARSH: Now --

2 MR. BARNETT: On counterpoint.

3 MR. KARSH: I certainly take your point in
4 terms of the internal calculations and how that's
5 looked at on an ongoing basis to monitor your end
6 of day cash requirements and things like that.

7 I think my point was more so at what point
8 does that leave your organization? And then,
9 therefore, is it monitored by regulators and the
10 exchanges and people as such. And, you know, I
11 think about some of the proposals that have been
12 put out there in terms of, for example, position
13 limits and some of the banks are, you know,
14 potentially in a position where they've got to
15 report inter-day position limits to the
16 regulators, right. So I totally take your point
17 and I appreciate that the advancements are being
18 used internally to manage (indiscernible)
19 requirements and cash requirements.

20 But I think the question is at what point do
21 you take it to the next level that those
22 inter-day positions and inter-day risk profiles
23 are being externally reported to regulators? So,
24 therefore, it's not -- you know, to some of the
25 points earlier, a scenario where we all know it

1 happens where you get towards the end of the day,
2 you know, management realizes there's going to be
3 a problem and they take some sort of evasive
4 action so you don't at the end of the day have an
5 issue with the exchange then is reportable.

6 So, you know, my point was really more so
7 how do we get real-time monitoring externally of
8 these positions and, therefore, you know, we
9 don't have to rely on CFO sign off of movements
10 and things like that that, you know, tend to
11 happen in extreme cases.

12 MR. BARNETT: Okay. Let me --

13 MS. DOWNS: May I?

14 MR. BARNETT: I also want -- okay. Go
15 ahead.

16 MS. DOWNS: And my I just respond in that
17 our DSRO is the CME Group and they are aware of
18 the positions carried by Rosenthal Collins Group
19 during the day.

20 MR. BARNETT: You need to speak up.

21 MS. DOWNS: They are aware of the positions
22 carried by Rosenthal Collins Group during the
23 day. So they do have a broad oversight of what's
24 happening at our firm in terms of product
25 markets. So there is --

1 MS. BAGAN: All of your exchanges where your
2 members are going to know --

3 MS. DOWNS: Absolutely.

4 MS. BAGAN: -- on a real-time basis what
5 those positions are if they're stress testing
6 through the day. So if we see a firm running
7 into trouble, we know about it.

8 MR. GREENBERGER: Well, isn't that alive
9 though by the unmentionable thing we have here
10 that it wasn't know about for several days?

11 MS. BAGAN: No. I'm just talking about
12 positions here.

13 MR. GREENBERGER: Pardon?

14 MS. BAGAN: I'm talking about positions.

15 MR. GREENBERGER: To follow up on Calpers'
16 point, I think it's absolutely right. It's one
17 thing to say that the FCM can make some kind of
18 -- and take Carl's point that it's not a perfect
19 judgment because of the variables of collecting
20 money. But it seems to me that the SRO and the
21 CFTC -- and if the CFTC doesn't have enough staff
22 to do this, and I fear it does not for no fault
23 of its own -- that that information -- if Carl's
24 talking about all these calculations information
25 it has to go to an external source so the red

1 flag is flashed to somebody who's not -- has an
2 unbiased independent judgment about a problem.

3 I would also add I don't think if I were
4 advising somebody who was to become a CEO of an
5 FCM I would tell that person you better have on a
6 daily basis red flag information about segregated
7 accounts.

8 Conversely, I don't think it may be have
9 been perfectly permissible in the old pre-October
10 2011 world for a CEO to say I don't know what
11 goes on in my back office. But segregated
12 accounts are the third rail of the Futures'
13 market. Without proper segregation the market
14 will collapse. A -- to my mind, poor judgments
15 made in propriety trading pale compare to poor
16 judgments in keeping track of segregated
17 accounts.

18 On October 25th signals should have gone
19 out. And they had to go out. If the technology
20 is available to make some kind of calculation,
21 it's in the interest of the FCM, it's in the
22 interest of the clearing facility to have the
23 signals go out on a real-time basis to somebody
24 who can do something about it.

25 And the final thing I would say, it's -- I

1 really applaud the technology that is being used
2 here. I worry that it's not being used
3 throughout the FCM community. But it's one thing
4 my history in working with technology is the
5 industry that's trying to create the technology
6 is often the worst position to know what good
7 technology there is.

8 And I would suggest to the CFTC that besides
9 talking to stakeholders in the Futures' market,
10 we should be talking to there's a lot of people
11 out there working on software algorithms and
12 everything else to increase transparency in
13 reporting. And to find out what can be done you
14 have to go to that community and see -- and make
15 reasonable judgments because a lot of people
16 oversell what they can do -- what can be done out
17 there to make the transparency better for the
18 community.

19 MR. BARNETT: Thank you. Kevin, you've got
20 a point?

21 MR. PICCOLI: Yeah. If I could just follow
22 up on a couple of the points that were made
23 because I think it all gets down to control of
24 the cash. And so I would like to just reiterate
25 one of Gary's questions because I think we're

1 anxious to get any feedback on.

2 Is there a minimum excess, minimum residual
3 interest that should be maintained by a firm or
4 alternatively should the CFTC or one of the DSROs
5 have the ability to come in when we're noticing a
6 red flag going off and say we're now increasing
7 your minimum requirement and you now have to have
8 105 percent, not just 100 percent of your Seg
9 requirement?

10 MS. MCCARTHY: Isn't to some degree that
11 done by the exchange through the guarantee
12 requirements? They can come in and assess a
13 higher guarantee if they think the firm is at a
14 financial risk. Now, while those funds aren't
15 held in Seg they are still held at the clearing
16 house potentially because that -- that's what I
17 see.

18 MR. PICCOLI: Yeah. But I think we're
19 looking for whether or not it should be held in
20 Seg for customers, an exclusive benefit for
21 customers.

22 MS. MCCARTHY: This is Sandy McCarthy with
23 FCStone. I'd be very happy if you held our
24 guaranteed funds in Seg.

25 MR. BARNETT: Very quickly, I want to get to

1 insurance -- shortly, okay.

2 MR. WINTER: I just I think there's an
3 important point here. And obviously we're
4 focusing on the issue point of residual Seg.
5 But, to me, if that's our worry then we really
6 have a bigger issue. And the bigger issue is
7 recognizing what Anne said, that every FCM runs a
8 different business model. And, therefore, the
9 bigger question is does every FCM have sufficient
10 capital and liquidity for its business model?
11 That's the key issue. Not focusing on the excess
12 Seg.

13 MR. BARNETT: Thank you. Okay. And we'll
14 come back to some of those issues later. One
15 question we wanted to get out in this context
16 before we move onto some other topics is could
17 insurance or some other type of fund be
18 established to cover potential shortfalls in Seg
19 funds? And how might such be administered?

20 MR. ACKERMAN: I'm Ken Ackerman and I'm here
21 today with the American Feed Industry
22 Association. And, Gary, thank you for
23 recognizing me on this.

24 This -- this is one idea that we did want to
25 put on the table as one of the options for this

1 group and for the CFTC to look at in this
2 situation. The lesson that the members of the
3 AFIA, that many people in the agriculture
4 community have learned the hard way recently, is
5 that at the end of the day while all of the
6 protections and rules for segregation of funds
7 have worked very well over the years and many
8 important steps have been made and very effective
9 steps to make them very effective, at the end of
10 the day if there is a gap and if something goes
11 wrong on a very rare occasion, we see that it's
12 the customers who end up holding the bag.

13 What's very striking about the situation
14 we're going through now is that many months after
15 the bankruptcy occurred they're still an open
16 question whether customers will be fully made
17 whole or not despite the fact that their money
18 was in a segregated account.

19 We wanted to put on the table the idea of
20 account insurance. I come at this from two
21 aspects. First, I worked here at the CFTC back
22 in the 1980s and was involved in the development
23 of this report, the report on the bankruptcy of a
24 firm called Volume Investors Corporation.

25 This was a firm that was mentioned this

1 morning. That was an FCM that had essentially
2 three customers who became overexposed and drove
3 the firm underground. In that case, because of
4 the margining rules in effect at that time, many
5 non-defaulting customers were placed in jeopardy.

6 This report and the response of the Futures
7 community at the time was a very good one and a
8 very effective one. Rules were tightened,
9 protections were tightened. But the report made
10 the conclusion towards the end that no system
11 essentially is perfect. You can come close to
12 perfect. But because particularly of what's been
13 described as operational risk, things like
14 negligence, bad faith, operational breakdown,
15 things that can come up on a firm very rarely,
16 come up in the real world very rarely.

17 But once every year, every five years, every
18 ten years you have a unique unusual situation
19 where a new exposure is discovered and a
20 bankruptcy occurs. And those cases you can have
21 a situation where customers are exposed.

22 The other background I bring to the table is
23 after leaving the CFTC I worked for many years in
24 the insurance world for the -- I was for about
25 eight years the manager of the Federal Crop

1 Insurance Corporation and was involved in many
2 forms of insurance, both backed by government in
3 various ways and those from the private sector.

4 And looking at this problem today, it seems
5 like the very type that fits into the traditional
6 mold of liability insurance. Liability insurance
7 of many different forms is designed to cover
8 exposures like this.

9 Now I understand that insurance or deposit
10 protection was looked at both in the wake of
11 Volume Investors in 1985 and I understand NFA
12 recently has been brushing off its files and
13 looking at it again freshly this year. There've
14 been two concerns that have traditionally been
15 raised, two hurdles that have been raised to make
16 this difficult to do. One is cost. The second
17 is moral hazard.

18 My view, and the proposal I would like to
19 make, is simply this be studied and that some
20 feasibility review occur. But there should be
21 ways to control both of these aspects.

22 As far as cost goes, when an insurance
23 coverage is develop on an actuarial basis the
24 insurance company tries to measure the exposure
25 in as accurate a way as it can. It looks at the

1 history of the risk. It studies the severity of
2 loss and the frequency of loss. It uses
3 underwriting guidelines to contain the risk in
4 the future. And based on that it develops
5 actuarially appropriate rates.

6 I'll be very brief. I apologize. Okay.
7 I'll be very brief. In this case because the
8 exposure is, in fact, very infrequent and is, in
9 fact, very contained and because the underwriting
10 rules can be shaped by the industry, it should be
11 possible to contain cost to a significant degree.

12 Second is moral hazard. The typical concern
13 of moral hazard is that, for instance, in crop
14 insurance a farmer will plant a wheat crop, buy
15 heavy insurance on it and then not take care of
16 the crop expecting to get the insurance in the
17 end.

18 In this case we're talking about something
19 very different. Customer account insurance,
20 liability insurance in this context would not
21 trigger until there's already a bankruptcy. You
22 don't have that exposure. Similarly to the
23 extent that customers have a right to collect
24 against the FCM and that that's -- that is what's
25 imposing the discipline on the system, that right

1 to collect would not disappear with a payment to
2 the claim by the insurance company. Rather the
3 insurance company would now have the right to
4 collect. So that discipline would remain.

5 And so I throw this on the table as a point
6 of discussion as something to be considered as a
7 way to get to the bottom of the page and deal
8 with the risk that's left at the end of the day.

9 MR. BARNETT: Thank you. Thoughts?

10 MR. LOTHIAN: Just to add a thought to that.

11 MR. WASSERMAN: Please state your name.

12 MR. LOTHIAN: John Lothian. I -- some
13 customers from some anecdotal experiences of
14 mine, and I'm pretty keyed in as you can imagine,
15 have already adopted an insurance scheme. And
16 that insurance scheme is that they open a
17 securities account. And then at the securities
18 broker they open a Futures account. And from
19 there their margins are held at the clearing
20 house for their Futures positions and then all of
21 their excess margins are swept over into their
22 securities account where they're covered by SIPC,
23 okay. So they're self medicating already from,
24 again, this is anecdotal. I don't have hard data
25 on it. But I've lost customers to this -- to

1 this scenario and I've talked to brokers on the
2 other side of it who are seeing thousands of
3 customers come in.

4 And I'm not passing judgment on this because
5 it's customers making a choice. But unless the
6 Futures industry has a level playing field from
7 an insurance standpoint, they risk the
8 possibility of losing lots of customers to the
9 securities side which would harm the market
10 quality, you know. It's traders going in to
11 trade ETF, oil ETF for free as opposed to trading
12 crude oil on NYMEX or trading a gold ETF for some
13 of the index products.

14 And, you know, these firms, because they're
15 securities firms are marketing securities
16 products. They're not marketing Futures. And so
17 it could really erode the support and the
18 education and some of the things that we've
19 worked so hard for on the Futures side to build
20 up the liquidity of these markets. So I support
21 the idea of exploring this option again.

22 MR. BARNETT: Has CME or NFA or any of the
23 industries, FIA, anybody done any kind of white
24 paper or cost benefit or feasibility sort of
25 analysis on insurance?

1 MR. DRISCOLL: Dan Driscoll from NFA.
2 Although we've talked about this internally with
3 staff a little bit, we haven't really done a
4 white paper and our board hasn't either. We did
5 do a study back in 1986 at the behest of the
6 commission after Volume. But we have not really
7 updated that study.

8 MR. BARNETT: Others? Okay.

9 MS. BURKE: Study -- sorry. Maureen Burke
10 again from the FIA.

11 MR. BARNETT: Yes.

12 MS. BURKE: We haven't, you know, looked at
13 this. All of our recommendations were initial
14 recommendations. It's a living, you know, review
15 and we're open to looking at anything that will
16 enhance customer protection. So we'll take it
17 back to the board.

18 MR. BARNETT: David?

19 MR. YERES: And, Ken, had you had a
20 particular market segment in mind? Because as we
21 look towards the clearing of swaps which we
22 understand now to be a multi trillion dollar
23 industry, is there insurance capital to insure
24 that?

25 MR. ACKERMAN: I have -- I have to be very

1 up front. I've been researching this for just a
2 couple of days, not a couple of weeks. But my
3 thought is that there's a very large private
4 reins- -- private insurance industry in this --
5 in this country. The way insurance manages risks
6 is different than the way the Futures industry
7 manages risk.

8 The insurance -- the insurance companies who
9 sell policies take their risk and they resell it
10 into the -- into the reinsurance pools that exist
11 on a global basis and are extremely large.

12 They manage risks by creating the largest
13 possible pools of risk by spreading risk to the
14 largest possible market. By expanding the amount
15 of risk that is covered, you allow an insurance
16 company to get the greatest efficiency. You
17 allow it to spread it to the greatest extent.
18 That allows it to establish the most efficient
19 rates and allows it to place it most efficiently
20 in the reinsurance pools.

21 Also it's very common in the insurance world
22 to take a risk such as bankruptcy risk or
23 customer segregation risk and spread it not only
24 across the size of a population, the population
25 of FCMs or the population of segregated accounts,

1 but also to spread it over time. If there's a
2 payment of a billion dollars once every 10 or 15
3 years, then the annualized risk is viewed more as
4 one-tenth or one-fifteenth of that. And that is
5 a very common practice in establishing rates and
6 it keeps rates manageable. That way of -- that
7 form of actuarial analysis, I think, would work
8 to the benefit of this industry.

9 MR. BARNETT: I would think that a typical
10 insurer would look at -- you know, they'd
11 underwrite the risk as you mentioned. Do we have
12 any idea -- have you looked at all into what sort
13 of policies and procedures that the insurer would
14 want on an FCM's operations for, you know, if
15 that's errors and omissions or liability or fraud
16 risk, so on and so forth? What kinds of controls
17 would an insurer want?

18 MR. ACKERMAN: I have not. And again, as
19 I've said, I've gotten involved in this just in
20 the past few days. But I think it would be a
21 helpful step to bring insurers to the table to
22 talk through the practicalities of it. I imagine
23 that there is a community of insurance companies
24 that service the brokerage community, the FCM
25 community for other needs. And that those

1 insurance companies have a great depth of
2 expertise that they could bring to shaping this
3 kind of policy.

4 My sense is that the actual premium cost,
5 the marginal extra premium cost of liability
6 coverage for this particular exposure when it's
7 packaged together with other costs that a --
8 other insurance costs that an FCM would normally
9 bear would not be that large.

10 MR. BARNETT: Okay. Thank you. Why don't
11 we take a -minute break and then come back --
12 let's say, it's 2:55. Let's come back at ten
13 after 3 and continue. Thank you.

14 (A brief recess was taken.)

15 MR. WASSERMAN: We're going to start in one
16 minute. Please be seated.

17 Ladies and gentlemen on the panel, I hate to
18 be a scold, but two things. First, please,
19 please remember to just briefly state your name
20 at the beginning of your remarks. And second
21 please speak up. Make sure folks can hear you.
22 We're having some complaints from folks even in
23 the audience who can't hear you. And if they
24 can't hear you, the -- when we view the
25 transcript it'll be even worse. So please speak

1 up. Thank you.

2 MR. BARNETT: Okay. Thank you. Welcome
3 back. Okay. Let's get back into the flow. One
4 thing I forgot to ask people for their views. We
5 keep hearing from different sources, different
6 folks amongst you about another alternative
7 structure. One that was -- has been suggested by
8 Phil McBride Johnson. And I just wanted to see
9 if I could get people's reactions to that.

10 It's some -- it's sort of a mutually owned
11 central customer funds depository that basically
12 gets into the middle of the cash flows and
13 receives client funds and gets in the middle of
14 -- and I've heard that from a number of the
15 group. Anyone have a reaction they want to
16 offer? No? Okay.

17 Dan, go ahead.

18 MR. DRISCOLL: Dan Driscoll, NFA. And this
19 is just a cautionary note on that that -- and
20 unintended consequences is an overused term.
21 But, you know, back about 30 years ago a company
22 came into the commission when I was chief
23 accountant and they had a business plan. And the
24 business plan was that they were going to take
25 Seg funds from any FCM that would give it to

1 them. That basically they would invest that on
2 behalf of the FCMs and 1.25 securities. And this
3 was back when 1.25 was really just essentially
4 treasury securities.

5 They weren't going to take out any market
6 position so they didn't have Futures market risk.
7 They didn't have a lot of investment risk because
8 it was treasuries. But they'd have to be an FCM
9 or else they couldn't be a depository. And, you
10 know, they didn't think they needed much capital
11 because there wasn't a lot of risk.

12 And back in 1981 the commission said, well,
13 that makes sense to us. Maybe this will work and
14 they got registered as an FCM and, of, course,
15 the name of that company is Sentinel. And we all
16 know how that ended.

17 So the fact is is that you can -- you need
18 to be careful not to craft a solution that's
19 highly focused on one particular situation
20 because don't kid yourself, the solution has
21 risks, too, that it might not be readily
22 ascertainable at the time that it's first
23 presented.

24 MR. BARNETT: Okay. Thank you. David?

25 MR. YERES: I'd hark back -- I'm David Yeres

1 here for CIEBA -- to the CME CIEBA model
2 discussed this morning. The settlement bank for
3 the DCO would essentially play the role that you
4 just described without creating a mutually owned
5 company.

6 We have in place, of course, a long history
7 of DCOs operating with their settlement banks and
8 with their FCM clearing members on a daily basis
9 to make margin payments, to conduct, you know,
10 intra-bank transfers with a great deal of
11 success. And the system already provides for
12 that. So I would think that the settlement bank
13 is existing opportune facility to accomplish that
14 goal.

15 MR. BARNETT: Okay. Are you -- and I'll ask
16 the question but basically if that's a structure
17 that already exists, being used in one context,
18 are you -- is there discussions with FIA or one
19 of the other?

20 MR. YERES: Well, perhaps I should
21 elaborate. I might not have been clear. As of
22 now I think it would be agreed that as a rule the
23 cash flows that exist to support derivatives
24 occur through the carrying FCM or come through
25 the carrying FCM, move through the DCO settlement

1 bank into the DCO. That's the daily arrangement.

2 What I'm merely suggesting is that the CIEBA
3 model merely -- it merely utilizes that same
4 approach. But rather than have the
5 intermediation of the FCM with respect to those
6 funds, the funds go directly to the DCO
7 settlement bank. Hence, the DCO settlement bank
8 seems to play the role that you described might
9 be played by the mutually owned company that Phil
10 Johnson suggested.

11 MR. BARNETT: Okay. Thank you.

12 MR. LOTHIAN: I think one of the differences
13 is that if you look at the risk committee, for
14 example, at the -- at the exchanges, the clearing
15 houses that they are represented by the member
16 firms. And that those member firms have a great
17 deal of interest in, you know, securing --
18 securing of the funds and being exposed to each
19 other and the like. And so a mutually owned
20 organization would have that same make up of
21 people protecting and looking after those funds.

22 This is the type of idea that would reassure
23 the public confidence in the markets. Taking a
24 broader look at this, including in the Sentinel
25 issue, the problem is is that the FCM model, as

1 perceived by the public, is broken. And a number
2 of firms that invested funds with Sentinel were
3 seeking higher returns because they couldn't make
4 enough money through traditional means. And, of
5 course, they were looking for And, of course,
6 they were looking for higher returns without
7 realizing they were taking higher risk of known
8 and unknown, you know, quantities. And there are
9 a number of firms that are no longer in being
10 because they were Sentinel clients. They've
11 either been bought or gone out of business or
12 whatever.

13 And now you've had two firms -- Refco wasn't
14 necessarily about -- about lower interest rates,
15 but in some ways it was because their strategy
16 was to aggregate as much money as possible. They
17 were low commissions and get as much money in
18 house as you could and earn the float on that.

19 And the firm that shall not be named kind
20 of had a similar -- similar MO and I know brokers
21 that are no longer in the business because their
22 model didn't fit anymore because they were there.

23 So all of these firms were chasing yield
24 and, quite frankly, were in environment where we
25 may not have higher interest rates for some time

1 to come. And so it's all of that being in the
2 FCM business kind of on the come of higher
3 interest rates somewhere down the line. Maybe
4 what needs to be done is maybe we need to compete
5 again on price and prices need to go higher.

6 MR. BARNETT: Okay. Let me shift focus
7 right now. Let's shift topic. Let's look at
8 transparency in investor disclosure.

9 And I guess the question is, and I think the
10 answer is no, is there anyone here who disagrees
11 with the proposition that FCMs should provide
12 greater detail regarding the amount of customer
13 funds held and where such funds are held --
14 banks, depositories, DCOs, other FCMs -- and
15 greater detail regarding the investment of
16 customer funds?

17 You agree that's something that should be --
18 Maureen, do you want to --

19 MS. BURKE: Sure. Yes. Maureen Burke, Bank
20 of America/Merrill Lynch representing FIA. And,
21 you know, the committee, which is a broad
22 spectrum of FCMs, clearing houses, and banks
23 strongly supports for the transparency on the
24 investment of customer segregated funds.

25 We're recommending that on a monthly basis

1 that the FCMs would go out and input their
2 customer segregated funds into Windjammer. Also
3 input that on a mid-month basis as well in case
4 there's any changes to that. Because there can
5 be some changes go through at month end for
6 balance sheet. But we strongly recommend, you
7 know, further transparency.

8 Also included in that is the breakout by
9 investment sector as well as the waited average
10 maturity of the securities so that it can be
11 reviewed to see what type of risk is embedded in
12 investment of customer segregated funds.

13 MR. BARNETT: Is this -- is this and then
14 disclosed to the SRO and regulators or made
15 available but post it on a website to customers?

16 MS. BURKE: Our initial recommendation --
17 and, you know, everything that we've been
18 speaking about today is truly initial
19 recommendations.

20 Initially, we thought that it would be, you
21 know, good information for the SROs to have if
22 they would like to get it more frequently. We
23 understand the NFA has a similar rule in place
24 today, and I don't want to take over Dan's
25 airtime on that, which is monthly and, you know,

1 requires a notification if there's a 20 percent
2 change or more in any investment sector. So
3 that's the initial recommendations would be that
4 it goes out to the SROs. The SROs receive that.
5 But, you know, we're open to potential public
6 disclosure.

7 MS. DOWNS: Maureen Downs from Rosenthal
8 Collins Group. Starting in November 30th of last
9 year, we posted on our website the details of our
10 investments and we have done so every month
11 thereafter. We find that our customers
12 appreciate it. It shows exactly what the
13 investments are and where the depositories are.

14 And we feel that that open disclosure is
15 something that in this particular time in the
16 industry is welcomed by customers and certainly
17 we would be open to doing it more frequently.

18 MS. MCCARTHY: This is Sandy McCarthy with
19 FCStone. May of '08, we actually generated a
20 letter to all customers explaining our investment
21 policy of Seg funds. And then we've continuously
22 updated it as needed.

23 MR. BARNETT: Carl?

24 MR. GILMORE: Carl Gilmore from Penson.
25 There is little downside in more transparency.

1 So we can't see any reason why more transparency
2 would not be a good thing. So we agree as well.

3 MR. BARNETT: Anne?

4 MS. BAGAN: The report that Maureen is
5 referring to is called the CIDER report that NFA
6 has put together. As you probably know, the NFA
7 and CME and some of the other exchanges have
8 formed an SRO group. And getting that CIDER
9 report to all exchanges now is actually one of
10 the things on our to-do list or wish list. So
11 that's already being worked on now.

12 Timing of it is a little bit different than
13 what FIAs proposing. We're actually looking at
14 how easy it would be to get these on a daily
15 basis along with the Seg reports.

16 And then the final comment I have is one of
17 our FCMs did tell me that he would be nervous
18 about publicly disclosing the dollar amounts in
19 each sector. He'd be okay if they had to do
20 percentages. But dollar amounts, depending on
21 how granular you get, he thought would make it
22 very difficult to have negotiations with
23 customers on interest sharing. So I just throw
24 that out there as one concern.

25 MR. BARNETT: Dan?

1 MR. DRISCOLL: Dan Driscoll, NFA. And NFA
2 has an internal special committee that's made up
3 of all of the public directors of our board
4 that's studying things that NFA could do with
5 regard to beefing up customer protection.

6 And among those are disclosures to the
7 public of some of this same information that
8 we're talking about here. So we still need to
9 work through some of these and they're not final
10 yet. But among the things that would be
11 considered would be daily segregation
12 information, monthly, weekly, daily CIDER
13 information, and perhaps some other information
14 as well.

15 Because I believe our board thinks it's very
16 important that the public, particularly ones that
17 aren't, you know, sophisticated institutional
18 customers, have some information that will help
19 them make decisions when they decide which firm
20 they want to put their money with.

21 MR. PARKE: Ross Parke at Barclays Capital.
22 We, as well, are very supportive of increased
23 transparency on the customer investments on an ad
24 hoc basis with customers today we'll review the
25 types of investments we have. So we're

1 completely supportive of bringing increased
2 transparency to the SROs on that.

3 MR. O'SHIELDS: Reggie O'Shields from
4 Federal Home Loan Banks. We're very supportive
5 as well of having public disclosure of
6 information. We're new to the cleared swaps
7 area, although we've been in swaps for a long
8 time. And I know sometimes when we've tried to
9 put clearing relationships in place with our FCMs
10 there has been a reluctance to provide
11 (indiscernible) information to us. There have
12 been questions about confidentiality of
13 information that goes to the regulator, the
14 fairness to other customers.

15 We think it's important that end users are
16 able to actually monitor the financial condition
17 and the performance and the safety of their FCMs.
18 And we think that it's proper in this context for
19 the customer to receive that kind of information
20 from their FCMs because there's not a run on the
21 bank type of scenario in this market.
22 Portability is fundamental to this market. So
23 it's helpful if the customers are able to monitor
24 their FCM's performance.

25 And it kind of goes to the moral hazard

1 question we're talking about in terms of an
2 insurance fund. I think if the customer is able
3 to monitor that performance, there's less need
4 for that kind of insurance fund. We're
5 effectively performing the function of an
6 insurance company in that context.

7 MR. BARNETT: Let me ask you, I mean, so
8 what some of the considerations you just
9 mentioned would take you beyond, you know, where
10 the investments are and who your counterpart --
11 who the counterparts and custodians are, whether,
12 you know, the custodian or a bank is affiliated.

13 What are some of the other things -- other
14 -- what's other information that would be
15 helpful to customers?

16 MR. KASTENHOLZ: I think the -- this is
17 Steve Kastenzholz from Newedge. I think, as has
18 been pointed out earlier, the weighted average
19 maturity of each sector is important. Because
20 while we've, you know, eliminated a lot of credit
21 risks with the new 125 there are still a lot of
22 price risks available under 125 given the 24
23 month WAM that's allowed in Seg and secured
24 funds. So having that additional information of
25 WAM by sector I think is critical for clients to

1 know because then they can truly judge the type
2 of risk their clearing firm is taking with their
3 Seg funds portfolio.

4 MR. BARNETT: Okay.

5 MS. MCCARTHY: This is Sandy McCarthy with
6 FCStone. We also thought it might be something
7 to put into the account opening risk disclosure
8 documents as to address 1.25 in the risk
9 disclosure document that's signed by the
10 customer. That was actually brought to our CEOs
11 attention at a Texas Grain and Feed meeting two
12 weeks ago that it was never in the risk
13 disclosure document about how FCMs were investing
14 customer's funds.

15 MR. BARNETT: Okay. David?

16 MR. YERES: I note that the FIA published, I
17 think, yesterday a Q and A on the protection and
18 custody of customer funds which seems very
19 helpful, a good step forward. And whether it's
20 this FIA document or another document developed
21 by the commission or the FIA or the NFA or the
22 SRO of any kind, it seems reasonable to me that
23 customers should receive this disclosure as a
24 rule when accounts are opened. There are
25 probably 30 people around this table collectively

1 having hundreds of years of experience dealing
2 with customer funds. But I would imagine that if
3 we got into the intricacies of how those funds
4 are handled and how bankruptcies are actually
5 administered, we'd find a lot of different
6 understandings.

7 It would be very good if the commission
8 would facilitate a simple document. As simple as
9 one is capable of the intricacies of this
10 business that customers could have would be
11 useful to not only to small customers, but large
12 customers to understand the risks, be able to
13 make choices because it looks like there will
14 turn out to be more than one model available for
15 customer protection. This would be, I think, of
16 great value. But beyond that, of course, CIEBA
17 echos the views of others here. Public
18 disclosure of FCM investments, which are
19 essentially the customers money, make perfect
20 sense.

21 MR. BARNETT: Okay. Ron? No. You're okay.
22 Tracey?

23 MS. JORDAL: Tracy Jordal, Pimco on behalf
24 of AMG/SIFMA. So we echo everything that's been
25 said here. Obviously transparencies a good

1 thing.

2 You know, I think knowing where customers
3 funds investments are at account opening on the
4 ongoing basis is frequently as daily if they want
5 it, it should be made available. I like the idea
6 of having it on the website to the extent it can
7 also be, you know, attached to customers' monthly
8 statements. And I think Maureen mentioned a
9 requirement if there's a significant change above
10 perhaps a certain threshold in their investment
11 structure that customers should be notified about
12 it.

13 But I think it's also important that it
14 should be something easily that customers can
15 obtain. You know, we shouldn't have to jump
16 through hoops to get the information. It should
17 be easily accessible meaning, you know, it
18 shouldn't be hidden -- not hidden, but you
19 shouldn't have to navigate through ten different
20 web links in order to find it. Because, you
21 know, the more sophisticated customers might be
22 more attuned to it, but an average customer, you
23 know, it should be very transparent and easily
24 transparent to them.

25 And they -- it's all part of the due

1 diligence in terms of who you're going to select
2 as your FCM.

3 MR. BARNETT: Okay. Yes?

4 MS. DOWNS: Maureen Downs, Rosenthal Collins
5 Group. I think the other -- the important point
6 is to remember these disclosures have to be made
7 in plain language that a potential customer can
8 understand. I mean, all of us in this room
9 understand a lot about investments but a
10 surprising number of customers do not. So the
11 challenge is not only to put the information out
12 there, but to put it in a way that an ordinary
13 investor looking at the website, looking at the
14 pie chart can understand what it means.

15 And we've worked very hard and we continue
16 to work hard. When we get questions back from
17 our customers saying I was looking at your pie
18 chart and can you tell me what this means. So
19 we've refined the language in the last few months
20 that we've had the information out there. But I
21 think that's really key.

22 MR. BARNETT: Do you think that one -- one
23 FCM deposits funds at one bank that's got lesser
24 credit but provides a higher yield and another
25 FCM is putting it at a bank that's got a higher

1 credit worthiness and a lower yield, different
2 risk appetites, do the customers understand that
3 risk? If the bank goes down or the bank's not
4 supported and then FCM can't back stop it?

5 MS. DOWNS: Certain customers would. But I
6 think you have to realize that a lot of this
7 information hasn't been out there for the public
8 so we haven't gotten a lot of the questions.
9 Some sophisticated customers have asked us about
10 where our monies are kept. But for the vast
11 majority they've never had access to the
12 information so we haven't gotten the questions,
13 the types of questions that you've asked. And
14 probably in the future as we reveal it as we
15 reveal more and more information about where our
16 funds are held, where the depositories, we will
17 get those questions.

18 I don't know how to answer your question
19 about how you indicate credit risk for one
20 facility over another. Maybe some of the folks
21 from the banking sector can talk about that a
22 little bit better.

23 MR. BARNETT: Yeah. I guess my point is
24 just the FCMs have taken -- are taking on
25 different -- they have different risk appetites.

1 One chooses yield over and accepts more risk, and
2 the other one doesn't, does the customer have any
3 way of knowing or analyzing that maybe with
4 respect to the bank deposit -- the bank's risk,
5 showing who your bank is and where the funds are
6 sitting, the customer presumably could make that
7 determination. But should that risk be taken
8 into account in the capital model? Dan?

9 MR. DRISCOLL: Dan Driscoll from NFA. NFA's
10 special committee among the things that they're
11 going to talk about are whether firms should
12 regularly report the extent they use leverage, to
13 the extent they trade speculatively for their own
14 account, things like that. I don't think we've
15 got down to looking at the depositories and
16 trying to differentiate between the credit
17 worthiness of those institutions. But we are
18 thinking about things that a normal customer
19 could have some understanding of what that means
20 and make distinctions based upon that.

21 MR. BARNETT: That's excellent. Yeah.

22 MR. YERES: Yeah. Davis Yeres on behalf of
23 CIEBA. CIEBA is greatly concerned that its
24 members be able to see into the FCMS leverage and
25 risk ratio to the extent possible without, of

1 course, compromising propriety issues for the FCM
2 that might be able to be achieved purely by
3 leverage matters. But some study should be made
4 because of the obvious risk that if an FCM is
5 undertaking particularly risky positions in its
6 propriety account, a cataclysmic episode may
7 occur which wouldn't be dealt with by audit or by
8 policies and procedures, which could take place
9 in an afternoon, in a morning, or even a weekend.
10 And trying to avoid the likelihood of that kind
11 of risk would be of great value.

12 MR. BARNETT: Reggie?

13 MR. O'SHIELDS: Yeah. Yeah. I think --

14 MR. BARNETT: And I'm sorry, whoever's going
15 to transcribe this -- name and --

16 MR. O'SHIELDS: Sure. Reggie O'Shields with
17 the Federal Home Loan Bank. I think to your
18 question do customers really understand these
19 various risks, the suggestion that maybe there's
20 a disclosure document you see those risks and you
21 understand them. I think sometimes as we've had
22 our discussions with the FCMs there's not always
23 clarity on the amount of risk a customer is
24 taking to their FCM. We all understand that risk
25 I think better over the last few months. But

1 sometimes there's an indication you're not really
2 taking credit risk to an FCM and sometimes more
3 clarity on exactly the role of the FCM and that
4 relationship could be helpful to customers to
5 better understand that.

6 MR. BARNETT: Let me ask, Anne, I'm going to
7 ask you a question. And, Kevin, I may need your
8 help here too.

9 So because what I'm hearing is to the extent
10 we can't be absolutely 100 percent sure on Seg
11 funds, then the more pressure there is on these
12 sorts of issues, right, because the insolvency
13 risk is a concern when the music stops. So how
14 does that effect the way we should be -- and if
15 we're saying that investors should have these
16 sorts of indicia so that they could be analyzing
17 or looking at where they want to invest or where
18 they want to put their funds, how should that
19 effect the way we examine FCMs? What do you
20 think? And Kevin as well.

21 MS. BAGAN: Well, we do a risk disclosure --
22 that's not the right term. A risk questionnaire
23 at the beginning of every regulatory audit. And,
24 you know, understanding more about their
25 investments is certainly, you know, one thing to

1 be added. We spend a lot of time with our firms
2 going over the 1.25 requirements. That's
3 probably been one of our biggest findings. Not
4 that these aren't properly Seg'd funds but
5 perhaps they're not meeting all the liquidity and
6 marketability, all those types of issues. And
7 that's probably been one of the biggest findings
8 we've had in the past couple years of working
9 with firms to make sure that they understand what
10 those requirements are and how they should be
11 ensuring that these assets actually are very
12 liquid. So, I mean, that's been a big focus for
13 us.

14 MR. BARNETT: Kevin?

15 MR. PICCOLI: Yeah. The only thing I'd like
16 to add to what Anne is saying is you certainly
17 need a risk focus. But I also think you need to
18 understand the firm's processes on how they
19 monitor and evaluate their investments on a
20 real-time basis. And, you know, it's great to
21 have good controls, but you need to know where
22 your positions are at all times, what the risk is
23 of those positions.

24 Make sure your risk committee, the board or
25 the audit committee, whatever may be going to is

1 informed of these as well. So it's got to -- you
2 know, you've got to have all the proper reporting
3 all the way up the line and the tone at the top
4 from the, you know, the top of the house right on
5 down on exactly how these invest- -- these funds
6 should be invested.

7 MS. BURKE: And just I --

8 MR. BARNETT: Maureen?

9 MS. BURKE: To just hit on a couple points
10 so, you know, back to the recommendations. A few
11 of them are that there would be policies and
12 procedures of the FCMs would document regarding
13 the -- for the depositories -- both bank
14 depositories, custodial providers, brokers
15 affiliated, and third-party brokers -- that there
16 would be documented policies on how the FCMs
17 chose their depositories, an ongoing thorough
18 review on an annual basis and an ongoing review.
19 So the auditors could come in, review the
20 policies, and also determine if the, you know,
21 FCMs in compliance with their own policy.

22 So in addition to the enhanced disclosure
23 through 1.25 investments and the counterparties
24 that we're depositing funds with, but also to
25 have requirements that the FCM document their

1 policies for monitoring anywhere where segregated
2 funds are held.

3 And that as far as the valuing of the
4 securities, that's required. It's in the regs
5 today. In order to compute your Seg on a daily
6 basis the FCM has to mark the positions to market
7 every day. And they need to -- and this has
8 already been beefed up through the audit process,
9 the JAC, CFTC pushed this down post 2008 when
10 some of the securities became illiquid you could
11 not rely upon vendor pricing or model pricing.
12 You had to prove that the securities that you
13 held in you segregated account, either investment
14 of customer segregated funds or securities that
15 you receive from your clients, that they're
16 regularly marketable and liquid.

17 So we're also recommending that those
18 policies and procedures get documented. All the
19 FCMs -- and this is back to what we spoke about
20 earlier that, you know, these are working through
21 our committee. These are already procedures,
22 internal controls, best practices that are
23 already in place, but now we're saying they
24 really should be documented so to aid in the
25 audit process to hit on just both of those

1 points.

2 MR. BARNETT: Thank you. Dan, when you said
3 the leverage, is it leverage at the entity level?

4 Is it to a consolidated level? What level
5 are we -- are you thinking of?

6 MR. DRISCOLL: Well, and it's not final --
7 Dan Driscoll, NFA. It's not finalized yet. But
8 I -- it was talking about at the entity level,
9 not the consolidated with all of the entities
10 that are affiliates. It would be the entity
11 level.

12 MR. BARNETT: Uh-huh. So the idea is to
13 look at risks in the business, I guess, so that
14 investors could not only look at where their cash
15 -- where their investments are but also other
16 things affecting the credit worthiness --

17 MR. DRISCOLL: That's right.

18 MR. BARNETT: -- or health of that entity?

19 MR. DRISCOLL: Right. And I should clarify
20 when I say at the entity level. If the entity
21 files consolidated financial statements, it would
22 include everybody within that consolidation.

23 MR. BARNETT: Okay. Thank you.

24 MR. KASTENHOLZ: This is Steve Kastenholz,
25 Newedge. So just a quick question, Dan. When

1 you talk about leverage, how are you actually
2 going to define it? Because obviously there are
3 many ways of looking at leverage in a firm.

4 MR. DRISCOLL: Right.

5 MR. KASTENHOLZ: And then second, I guess
6 the point you're really trying to get to, a point
7 that we think a lot about is what are the other
8 calls on capital or what are the other calls on
9 residual or excess you have in that pool because
10 that's the real risk we're trying to talk about
11 today.

12 MR. DRISCOLL: And at this point we haven't
13 final- -- and I agree that there are any number
14 of definitions you could come up with including
15 off balance sheet, on balance sheet, comparing
16 your assets to your total capital to your
17 regulatory capital. So that hasn't been
18 finalized yet. But it's things that the special
19 committee will consider.

20 MR. BARNETT: Sandy?

21 MS. MCCARTHY: This is Sandy McCarthy with
22 FCStone. And I just want to make a comment.
23 Before we start passing rules about what size of
24 banks Seg funds can be utilized in I want to
25 explain that we have small guaranteed IBs out in

1 rural Kansas where they get a check and we open a
2 small Seg bank account at a local bank so they
3 can process those checks that day.

4 MR. BARNETT: Understood.

5 MR. GILMORE: Carl Gilmore from Penson.

6 Going back to that question. And, Sandy, I
7 would think that the focus here isn't on those
8 banks because basically that's going to be cash
9 sitting there, right?

10 MR. MCCARTHY: It should be.

11 MR. GILMORE: So if you're taking customer
12 cash from somewhere else and investing it with
13 that bank, that's a different analysis. But to
14 go back to your question, I think you're right,
15 Gary. When it comes down to a bank that may be
16 less creditworthy that pays a higher yield, that
17 ought to be addressed in the capital model. I
18 think it's in the rule now and maybe a little bit
19 more definition on that's probably a good thing.

20 MR. BARNETT: All right. Maureen, I
21 remember briefly -- again, I had to read it, FIA.

22 MS. BURKE: Yes.

23 MR. BARNETT: About you had some stuff in
24 there about comparability and affiliated --

25 MS. BURKE: Oh, yes. And, if you don't

1 mind, just addressing the point that we're not
2 being prescriptive on the banks that can be used.
3 So just to address the point at the end, FCStone,
4 we're stating there should be policies and
5 procedures that should be followed and that you
6 have some competencies that are reviewed. And
7 there's annual review and ongoing review so you
8 know that the bank where you're depositing the
9 funds or any other depository hasn't gone below
10 the standards that you set internally. And that
11 can be reviewed by the auditors.

12 I'm just addressing the first point. So now
13 I'm back to your affiliate. On your affiliate
14 question.

15 MR. BARNETT: Yes.

16 MS. BURKE: Yes. That there should be
17 comparable standards in utilizing affiliates.
18 That you should be reviewing your affiliates for
19 insuring their counterparty creditworthiness very
20 similar to an external depository. And there's,
21 you know, many times with an affiliate that you
22 have much more information at your disposal so.

23 MR. BARNETT: Okay. But your proposal, your
24 initial proposal is that the affiliation of, say,
25 the bank that an FCM uses or custodian or so on

1 is okay as long as you can show comparability to
2 the policies that you've adopted.

3 MS. BURKE: The policies that you have for
4 an external, for a third-party bank, an
5 affiliated or a third-party broker that you're
6 monitoring your affiliates in a similar manner
7 that you're going to monitor your third parties
8 for depository custodial provider. That there's
9 some level of due diligence and monitoring.

10 MR. BARNETT: Okay. Concerns by any others
11 about affiliations? Yes, sure.

12 MR. WASSERMAN: Just getting back to one of
13 the points that was raised. I just wanted to
14 clarify that --

15 MR. BARNETT: It's blinking somehow. Let's
16 try it, wait.

17 MR. WASSERMAN: Just wanted to clarify if
18 there is a failure at any depository, that would
19 be the responsibility of the FCM. And second,
20 and Sandy raised some very relevant point as to
21 why one would use particular depositories, but
22 there should be no question that is going to
23 effect all of the, you know, in the event heaven
24 forbid the FCM fails, that would effect be spread
25 among all of the customers. Not those whose

1 checks were deposited at a particular depository.

2 MR. PICCOLI: Gary, can I just add onto
3 that? Just one question, Maureen. When the FIA
4 looked at the disclosures, did you consider
5 whether or not disclosure of the investment was
6 with an affiliate whether that would be something
7 to consider?

8 MS. BURKE: Yes, we did. On the pie chart
9 that you would -- if you have deposits with a
10 bank or a third-party broker you would break it
11 out between third party and affiliate.

12 MR. FOLEY: Kevin Foley, at Katten. Bob,
13 can I just ask for clarification on that com- --
14 your last comment that if an FCM deposits funds
15 with a bank and the bank fails it's the FCM's
16 responsibility? Has the commission ever said
17 that?

18 MR. WASSERMAN: I -- there's no cut through.
19 I -- I do not know and as I sit here whether that
20 has been officially stated. I will tell you
21 that's certainly our view. I really was getting
22 more towards the latter point which is whatever
23 the failure might be, that would end up getting
24 spread among all the customers. And indeed it's
25 not clear to me how you would end up in a

1 different place and saying, well, this is going
2 to affect -- that essentially the customers are
3 going to have responsibility.

4 And so and indeed I recall, and I could have
5 gotten this wrong, that some of FIAs comments on
6 the earlier rule making dictated that if there
7 were investments -- and I take it you may be
8 drawing a distinction between investments and
9 deposits -- that that would be -- and even in the
10 report that that would be at the risk of the FCM.

11 So I'm --

12 MR. FOLEY: Right. If you invest under Rule
13 1.25, I think it is -- it is clear and it's in
14 the recom- -- the FIA recommendation is that that
15 be made explicit in the rule that any losses
16 incurred on those investments would be at the
17 risk of the FCM.

18 To my knowledge, and I think it's the only
19 statement there is an AD issued by the CEA, this
20 obviously predates CFTC which --

21 MR. WASSERMAN: You're speaking of
22 administration determination by the commodity
23 exchange authority?

24 MR. FOLEY: Yes. I'm sorry. That if, you
25 know, in those circumstances as long as the FCM

1 exercised its due diligence in choosing the bank,
2 that it would not be responsible if that bank
3 should fail. That's the only statement I know
4 of, but there could be something else out there.

5 MR. WASSERMAN: To be -- I don't want to
6 belabor this one and I should -- I will reiterate
7 what I said earlier which, of course, is anything
8 that I might say is not necessarily the views of
9 the staff or the commission or even myself.

10 MR. BARNETT: Ron?

11 MR. FILLER: I agree with Kevin, Bob. The
12 CFTC has never made any such pronouncement in the
13 last 35 years, to my knowledge. And if this is
14 -- if your beliefs are correct, you just killed
15 the GCP program. Because if a client's monies
16 are going to the collateral program that's being
17 envisioned and the FCM could be held liable if
18 the GCP custodial bank takes money out improperly
19 -- what if the GCP has 100,000 accounts and they
20 send funds from Account A to Account B in a
21 different place? Is the FCM liable for that?

22 It is when the FCM -- so I think you ought
23 to be real careful in saying that the -- in the
24 absence of what Kevin just said, you know, as
25 long as I acted in a commercial reasonable

1 manner, due diligence and so forth, I'm not aware
2 of any pronouncement by the CFTC that the FCM is
3 liable for a failure at the custodial bank level.

4 MR. WASSERMAN: I'll simply say the -- my
5 understanding, as we were discussing earlier, the
6 GCP model that was not a customer model. And
7 whenever I was saying -- and which as we say is
8 not necessarily the views of the commission or
9 anyone else, that was speaking of customers as
10 opposed to a relationship -- a very different
11 relationship.

12 MR. BARNETT: David?

13 MR. YERES: First, David Yeres on behalf of
14 the CIEBA. I'll agree with Kevin. I'll agree
15 with Ron. In my reading in the last 35 years, I
16 haven't seen the commission take the view that
17 the FCM is responsible for the failure of a bank.
18 And the administrative determination that Kevin
19 relates -- related is one I recall as well.

20 But since you mentioned the GCP model, the
21 GCP model probably avoids this issue because the
22 funds of the customer GCP are not going to the
23 FCM. The FCM is not depositing in a bank
24 selected by the FCM. The funds of the customer
25 are going from its custodian to the DSO

1 settlement bank. And I think it'd be very hard
2 to hold the FCM liable for the customer's choice
3 of which settlement bank to use.

4 MR. BARNETT: You want to hold the DCO
5 liable instead?

6 MR. YERES: No. I think -- I think this is a
7 question of choice. And coming back to the
8 earlier point, maybe the broader point I'd like
9 to make on behalf of CIEBA public disclosure is
10 critical. And up until now, as it's been said by
11 Maureen and others, there hasn't been as much
12 disclosure as is now being proposed. That
13 disclosure will prompt customers, thousands of
14 customer eyes. You know, as trained as are the
15 people at the CFTC and the NFA and the CME having
16 thousands of self-interested customers reviewing
17 publicly disclosed documents will probably help
18 dramatically not only the confidence in the
19 market, but upgrade the quality of the services
20 available. So, in general, what whether it's a
21 question of disclosing whether funds are
22 deposited with an affiliate or otherwise, we
23 think it should be public.

24 MR. BARNETT: Okay. I wanted to -- we've
25 talked about the depositories and custodians. We

1 wanted -- and again go back to more operational
2 kind of questions. We had a series of questions.
3 We wanted to know whether controls should be --
4 whether there should be some controls put in the
5 hands of a bank or depository to provide greater
6 protection of customer funds.

7 So, for instance, should the standard
8 acknowledgement letter list the instances when
9 withdrawals are permitted or should the FCM be
10 required to provide an explanation to the bank or
11 depository at the time it submits a withdrawal
12 request or should the bank or depository have
13 heightened duties to reject a withdrawal request
14 that's not consistent with an acknowledgement
15 letter for instance?

16 Is there any -- you don't love it?

17 MR. FERRIS: I think as the sole settlement
18 banker in the room, why don't I start with this
19 one. I think importantly -- and I think people
20 in this room understand this. But you'd be
21 surprised how many of your clients don't -- the
22 customer accounts that reside on the books of the
23 settlement bank or any other banking institution
24 are effectively omnibus accounts.

25 The assets that are residing within that

1 account at any given time may or may not
2 represent the totality of those assets and most
3 likely don't because at least there's money at
4 the DCO.

5 There's no clarity or transparency as to the
6 degree which is truly customer versus the
7 residual excess. And there is not in the course
8 of daily transactions, which are by thousands
9 both from a money transfer prospective as well as
10 a securities transfer perspective, a mechanism to
11 capture transfers that would occur out of the
12 customer account and flag those if there were --
13 if they were going to another account with a firm
14 or to another bank for the firm's account.

15 And so, you know, relying on -- relying on
16 the bank to form protection the bank just doesn't
17 have the knowledge and would not be able to
18 validate a statement that an FCM would provide to
19 us. And, quite frankly, given that I think it
20 would be very, very difficult for the bank to
21 even accept any sort of statement that the FCM is
22 making because it then draws that institution
23 into sort of the duty of care. And I think
24 that's a liability the that the banks just would
25 not be willing to accept.

1 MR. BARNETT: Ron?

2 MR. FILLER: I'm not speaking on behalf of
3 the custodial banks, but on the just concept of
4 acknowledgement letters. Having chaired the FIA
5 committee and Maureen and I were on that, and the
6 CFTC proposed a new draft acknowledgement letter
7 about a year and a half ago I think it is. I'm
8 not sure the exact date. And I know CFTC staff
9 is looking on it. I would highly recommend that
10 the commission adopt a new acknowledgment letter
11 soon.

12 I mean, FCMS have probably 50 to 100
13 custodial relationships around the world. And
14 the letter is not only for Futures but it's going
15 to be necessary for clear swap accounts as well.

16 And I think the sooner that you have a new
17 recommended -- or I thought the proposal
18 acknowledgement letter was great. But, I mean,
19 if you can make any amendments or whatever I just
20 think you need to provide that to the community
21 so they can start the process in getting new
22 acknowledgment letters. So I'm not sure what the
23 status is, but I would highly encourage the
24 commission staff to try to publish a final rule
25 soon.

1 MR. BARNETT: Okay. Thank you. Scott, is
2 it again, not pushing back on the breadth of what
3 I was saying before. But in thinking about
4 examination is it reaction to acknowledgement
5 letters allowing CFTC or an SRO to have online
6 access to Seg account? What would your reaction
7 be to something like that?

8 MR. FERRIS: You know, I think -- I'll speak
9 from my own opinion. Not of my institution.
10 But, you know, from a reporting standpoint I
11 don't think we have an issue with providing
12 reporting. We provide -- you know, in connection
13 with audits that are done by SROs today we will
14 provide information of that. Ultimately the FCM
15 has to authorize the release of any information
16 regarding their accounts. But should they do
17 that then, you know, we would be willing to
18 provide that.

19 MR. PICCOLI: Scott, could that
20 authorization letter be in the acknowledgment
21 letter that comes out so it's not when the crisis
22 comes up we already have the approval from the
23 FCM. All's we have to do is say we're exercising
24 that option. Would that be something -- would
25 that be reasonable?

1 MR. FERRIS: I think as long as presumably
2 the -- presumably the account holder has
3 authorized that then I think that it's something
4 we'd be willing to take a service standing order
5 on.

6 MR. BARNETT: Sandy? Oh, got it wrong,
7 sorry. It's Julie.

8 MS. STREIT: Julie Streit from Country
9 Hedging. The one thing I would maybe add is that
10 if the bank has any reason to question or any --
11 you know, for whatever reason if they were to
12 request a confirmation from the FCM and we're not
13 able to get it, I would expect that the bank
14 would not process whatever request that they're
15 questioning.

16 MR. FERRIS: Yeah. I think the -- I think
17 the standard as it relates to any sort of
18 transaction, if we have knowledge to believe that
19 any transaction is fraudulent or is in conflict
20 with any law or regulation and we are aware of
21 it, we obviously have a duty to, you know, to not
22 be complicit in that.

23 I think the point that I would stress is in
24 the normal course of processing transactions
25 through the institution most of which are done

1 through online systems that the customer employs,
2 and so in the world of sort of straight-through
3 processing in all of our businesses there's not a
4 mechanism for red flags to go up. It would be --
5 it would be actually the unusual outside of, you
6 know, certain things relate to AML and so forth
7 for us to catch certainly something that would be
8 -- could appear to be normal course in this
9 industry.

10 MR. BARNETT: Okay. What I want to do is I
11 want to take a five-minute break and collect
12 thoughts here to make sure that we can --

13 MR. WASSERMAN: 4:25.

14 MR. BARNETT: We're going to stop at 4:25.
15 But I want to take a five-minute break right now
16 to not start again. But I want to make sure that
17 we've gotten our questions out so at the benefit
18 of y'all here and make sure we're able to hit you
19 with all our questions. So five minutes we'll
20 come right back.

21 (A brief recess was taken.)

22 MR. BARNETT: Okay. Just maybe two more
23 questions for the group and then we'll end our
24 session.

25 I want to thank you all, too. It's been

1 really helpful to us so thank you for your
2 participation. It's really been great. Very
3 helpful.

4 So the two questions that we have, very
5 different topics. One is whether we covered off
6 enough on the notices and events. That -- so Dan
7 mentioned, you know, looking at leverage, looking
8 at prop trading. Are there other events that we
9 should be taking into account and reporting on, I
10 guess, making that information available? I
11 think the two that Dan mentioned are excellent.
12 What other sorts of things come to mind that we
13 should be thinking about?

14 MR. LOTHIAN: There's all types of
15 operational risks that are different from firm to
16 firm. The firm that shall not be named, for
17 example, had bought lots of different firms over
18 the years and had done a very poor job of
19 integrating them all together. And that was one
20 of the big challenges that they had been working
21 on with the last couple of CEOs or some of those
22 things.

23 Some of the stories that you hear coming out
24 of this whole thing, you know, the cash flows.
25 The record keeping for that was basically an

1 Excel spreadsheet, you know, kind of thing, you
2 know. So the level of technology in the systems
3 that are present in some of these things, the
4 ability to track some of the data in some of
5 these things is perhaps different from firm to
6 firm. So assessing it from an operational risk
7 is a difficult thing and a different thing.

8 A lot of firms have not invested in
9 technology as much as they have -- as others
10 have. There are some very good examples of firms
11 that have invested in technology and can blow a
12 customer out the minute they're on margin call
13 or, you know, know exactly where they are. There
14 are other firms where, you know, it's the broker
15 calling the margin department telling them, hey,
16 I have a customer on margin call kind of thing
17 that they're unaware of it because they don't
18 have the systems, the market knowledge, the
19 experience, whatever. But a lot of it could be
20 made up with technology. A lot of it is having
21 properly trained people and a level of
22 professionalism that is with this.

23 You know, I think the industry as a whole,
24 for example, has underinvested in regulation from
25 the standpoint of having a truly higher class of

1 regulator. I know you guys are going to like
2 this, better paid, you know, more, you know, more
3 criteria, you know, for that, okay. So there's
4 lots of different things that you can look at in
5 terms of the experience of the people, the
6 quality of the technology and other aspects that
7 are operational risk oriented.

8 MR. BARNETT: Okay. Thank you. Other
9 thoughts on that topic? Yes, Christine.

10 MS. COCHRAN: I just -- this is Christine
11 Cochran with the Commodity Markets Council. I'd
12 like to chime in here a little bit and just say
13 that I think you guys are asking really good
14 questions. And I think the dialog today has been
15 a very positive one.

16 My organization is still very much in the
17 process of internal deliberation so I can't say
18 definitively where CMC is on some of these
19 issues. But one thing that is very, very clear
20 and we've discussed throughout this panel is the
21 idea that customers have lost faith in the
22 system, those who are actively engaged and those
23 who are sitting outside of it and observing it.

24 So when I look at FIAs recommendations,
25 again, I can't make any kind of official

1 pronouncement here, but I think that it's part of
2 that matrix I was talking about earlier. They
3 may not solve all the problems, right. And they
4 may only be as good as the people who submit
5 those reports or document those procedures.

6 But I think it's very, very important that
7 we communicate that back to the customer base
8 that they should -- you know, we are trying to
9 create a system of responsible FCMs. And that
10 you give the information to the customer so if
11 they want to do their due diligence, they can and
12 they can move around accordingly. But the only
13 way we're really going to get to the trust divide
14 and bridge that trust divide is by, I think,
15 looking at some of these business conduct
16 standards.

17 MR. BARNETT: Thank you. Yes, Maureen?

18 MS. DOWNS: Maureen Downs from Rosenthal
19 Collins Group. Besides looking at propriety
20 trading, I think we'd want to look at any
21 principal trading that is unhedged. So any time
22 an FCM is taking a principle position be it in
23 foreign exchange, be it in an OTC agricultural
24 contract, and so on and so forth, that FCM is
25 taking a risk. So any unhedged principal trading

1 I would say would be something we'd want to look
2 at as well.

3 MR. BARNETT: Okay. Thank you. Okay. So
4 then let me move onto the last question. Going
5 back to -- and I've got two Maureens today, so
6 Maureen Burke. So going back to the question --
7 again, we haven't had time to digest your write
8 up.

9 But the thing about policies and procedures,
10 and it came up in various context. I guess is
11 the how did -- how to develop them? We have an
12 industry that hasn't really been subject to them.

13 What would help in that regard? Is that
14 roundtables lead by, you know, the bigger
15 institutions? I mean, what -- what would help
16 bring about an educated but oriented to
17 particular situations creating systems that work
18 in particular settings.

19 MS. BURKE: Sure. So Maureen Burke again.
20 You know, when we thought about this because
21 every -- and to the point you have smaller FCMs,
22 you have larger FCMs. And through the group that
23 we had it really was many of the firms -- all of
24 them had their own best practices internal
25 control in place and we didn't detail out every

1 single internal control. But the intent was that
2 you would -- each firm would have their internal
3 controls and best practices. We could put
4 through this committee, you know, and I've
5 already invited some smaller FCMs to be a party
6 to it, to develop a best practice type guide. I
7 mean, that's been done in other markets, and make
8 it public. And we would invite, you know the
9 CFTC, the clearing houses, and NFA and regulators
10 to be a party to that. So, you know, we can lay
11 out what the best practice guides are because
12 they truly are (indiscernible) back to the conf-
13 -- reinstating the confidence in the market.

14 You know, the Futures has -- maybe people
15 relied upon the (indiscernible) 100 percent safe
16 but it does -- truly things start with internal
17 controls, best practices. You can't regulate for
18 everything, you know. And that's what we're all
19 trying to solve here. So, you know, we're
20 willing to do anything to help restore the
21 confidence in the market. And we'll expand the
22 group, the financial management committee group.
23 The long compliance group put tremendous work
24 into the FAQs and they'll continue to work on
25 that especially moving into the OTC cleared --

1 the cleared swap space which is changing, moving
2 to LSOC. The CFTC or some deviation of that ever
3 occurs, you know, if we ever had something that
4 comes to market I think having it in layman's
5 language so that everyone can understand it is
6 very beneficial. So we're open to developing,
7 you know, our best practice guide. It's been
8 done in other industries and it makes sense to do
9 it here as well.

10 MR. BARNETT: Great. Okay. All right.

11 MR. WINTER: I would just add a couple of
12 points, I think when you look at the FCMs, I
13 think you really need to look at the risk profile
14 of the FCM and the risk profile of the entity,
15 itself. Because while you're having potential
16 procedures and controls, they have to be prudent
17 in line of your business model. Every FCM here
18 has a different model, has a different client
19 base, has a different approach to the market.
20 And so it's not a one size fits all. But what's
21 important is there's got to be some way to make
22 an apples to apples comparison.

23 And that means to take into account the
24 procedures. The business model, the risks they
25 take, how much proprietary trading they do. What

1 about their affiliate business that they're
2 clearing on their behalf or activities within
3 that legal entity that are not necessarily the
4 FCMS, but a part of the broker dealer if the
5 broker dealer and the FCM are the same entity?
6 All those things have to be taken into account.

7 MR. BARNETT: Thank you.

8 MR. KANNAMBADI: Hi. Sanjay Kannambadi
9 (indiscernible). I think we talked earlier about
10 the same thing about, you know, the systems they
11 utilize, the FCMS utilize, the process
12 procedures. Best practice on process and
13 procedures certainly have precedence in other
14 industries, other segments of the industry, and
15 things like that.

16 But drilling it down to systems you utilize
17 for whether it's management of risk or management
18 for banking entities and things like that could
19 complicate the matter in the sense that, you
20 know, you don't want necessarily a comparison
21 between systems per se or platforms. And I think
22 it's -- at that point it could get to a point
23 where it's easy to -- I think Mike Dawley said it
24 the last time we were talking, to game the system
25 if you may by identifying certain systems or

1 specific, you know, third-party software that one
2 utilizes versus the other. So that's the balance
3 we need to find here.

4 MR. BARNETT: Thank you. Tracey?

5 MS. JORDAL: Tracey Jordal, Pimco and behalf
6 of AMG/SIGMA. I think also in connection with
7 the risk profile of the firm to the extent
8 there's any significant change, you know, again
9 when you do an account opening customers do due
10 diligence but it should be ongoing. And if
11 there's any significant change in the risk
12 profile of the firm, then customers should be
13 aware -- made aware of it.

14 And I don't -- I think that, you know,
15 that's fine if a firm wants to change their risk
16 profile. But customers need to be able to make a
17 decision if they still want to stay with that
18 firm when they change their risk profile because
19 it's going to be a different firm perhaps then
20 what they signed up for in the beginning. So I
21 think that's important. And perhaps there should
22 be a, I don't know, a time period there before
23 they can actually change it so customers have
24 enough time to think about it.

25 MR. BARNETT: All right. Well, thank you

1 all very much. And we'll turn you over to the
2 next which is going to start --

3 MR. WASSERMAN: In about five minutes.

4 MR. BARNETT: Thank you all.

5 (A brief recess was taken.)

6 C FOR DISCUSSION: Commodity Broker
7 ruptcies/Part 190

8 MR. WASSERMAN: This is a one minute
9 warning. We're going to get started in about one
10 minute.

11 If I could, will the panelists take their
12 seats, find their seats. Take them. David,
13 you've been -- I think you were moved. He was
14 next to Phil.

15 Okay. Thank you all. So this is our last
16 panel and we'll be going until 5:30. I should
17 mention just as a -- not quite a housekeeping
18 detail, but folks who are interested in this
19 panel will probably be interested to note that
20 the United Kingdom Supreme Court has issued its
21 decision in the Lehman client money case. That's
22 not for discussion here but just thought
23 something that would be of interest.

24 And I will once more note that CFTC staff
25 cannot engage in a discussion concerning matters

1 involved MF Global in light of our division of
2 enforcement's ongoing investigation. We ask the
3 participants to respect our request that
4 specifics not be injected into the discussion
5 here today.

6 And so let's just take a very brief moment
7 among those who are here and let's just have
8 every -- we'll go around very quickly introducing
9 ourselves by name and affiliation. Bob
10 Wasserman, CFTC.

11 MR. SMITH: Tom Smith, CFTC.

12 MR. FILLER: Ron Filler, New York Law
13 School.

14 MR. YERES: David Yeres, Clifford Chance on
15 behalf of CIEBA.

16 MR. WINTER: Steven Winter, State Street.

17 MS. TRKLA: Katie Trkla, Foley and Lardner,
18 not representing anybody except my own views
19 based on more years in the industry that I'm
20 going to admit to in public.

21 MS. KLIMPEL: Laura Klimpel New York
22 Portfolio Clearing.

23 MR. SALZMAN: Jerry Salzman Skadden Arps on
24 behalf of CME.

25 MR. GROSSHANDLER: Seth Grosshandler Cleary

1 Gottlieb on behalf of FIA.

2 MR. EDMONDS: Chris Edmonds ICE Clear
3 Credit.

4 MS. ASTRADA: Laura Astrada, CFTC.

5 MR. WASSERMAN: Okay. So the first
6 question, which I will throw open is what changes
7 to Part 190 should be made, if any, based on our
8 experience with commodity -- recent commodity
9 broker bankruptcy proceedings? Ron?

10 MR. FILLER: All right. Thanks, Bob. And
11 thank you again for the commission staff for
12 inviting me here today.

13 I think one of the biggest issues that the
14 CFTC should start considering regarding Part 190
15 is the qualification of the trustee. With all
16 due respect to the current SIPC trustee and he
17 probably did a great job with Lehman Brothers, he
18 was not involved whatsoever with any of the
19 Futures related accounts that were at Lehman
20 Brothers. By the time he and his firm were
21 appointed SIPC trustee all the Futures assets, at
22 least here in the U.S., client property had been
23 transferred out or liquidated and returned back
24 to the clients.

25 And when you have a situation like this

1 where 90-plus percent of the account's at the
2 unnamed FCM that recently filed for bankruptcy on
3 October 31st, it's Futures. And I think you've
4 got to make sure whether as a co-trustee, whether
5 it's a trustee -- SIPC trustee that has extensive
6 knowledge or expertise in Futures, I really
7 believe that the CFTC should try to work closely
8 with, maybe even change the regulations to ensure
9 that that expertise exists at the trustee level.

10 MS. TRKLA: Yes. Katie Trkla, Foley and
11 Lardner. I would agree with Ron's comments. And
12 just to add some color to that, when you look at
13 the most recent information available on the
14 CFTCs website, which now includes the excess Seg
15 information as well, the top ten FCM firms in
16 terms of firms net capital and holding
17 segregative funds are all FCMBDs. And over, I
18 think, close to 60 percent of the clearing member
19 FCMs at the CME, for example, are also FCMBDs.
20 And so we have to just acknowledge that often
21 times when we're dealing with these issues we're
22 going to have a SIPC trustee in there. And so
23 the qualification and understanding is important.

24 And to that end, I think in terms of Part
25 190, itself, I think I have an understanding of

1 the logic behind it as someone who's been in the
2 industry for a while. But it's pretty dense to
3 get through and pretty intimidating even when
4 you've got a Futures industry background. And
5 while you can parse through it and the logic may
6 become apparent as you parse through it, it's not
7 readily apparent.

8 And I find myself thinking would there be
9 some benefit to just having a simple statement of
10 legal principles, a legal memorandum perhaps
11 similar to what the bankruptcy court in this
12 unnamed case asked the parties to submit on how
13 this should work on the reasons for it. Even
14 just helping to connect the dots of a very
15 complicated statutory framework where you've got
16 bankruptcy code provisions, SIPA provisions, some
17 provisions in the Commodity Exchange Act where
18 the CFTC derives its rule making authority for
19 Part 190 that have to have something sort of in
20 plain English explaining the logic and reasons
21 for things like the different account classes
22 might be very helpful so that you're not worrying
23 about doing the education at the time when you
24 can least afford to be spending that time.

25 MR. YERES: David Yeres on behalf of CIEBA.

1 On a historical note, when these rules were first
2 published in the early 80s it was then proposed
3 that the commission prepare a guide for trustees.
4 It didn't happen that way.

5 Certainly having such a guide for trustees
6 would be an important step. But going to
7 Kathryn's point and a point I made on the earlier
8 panel, I think even more important would be
9 having a disclosure to customers in plain English
10 that explained how an FCM bankruptcy was
11 administered. This would help customers
12 understand some of the intricacies that have been
13 discussed today before this commission panel.

14 MR. WASSERMAN: So I would note there's
15 actually really two ideas on the table. One of
16 them is essentially more work from the commission
17 to basically explain Part 190 both from a guide
18 to a trustee perspective, which I will note I
19 think is sort of the purpose of Part 190 in some
20 of its appendices, itself. But I will be the
21 first to admit that it can be done better.

22 And secondly, who appoints the trustee. I
23 would note -- and folks may have different views
24 and I'll solicit those. But when you look at
25 SIPA there is a provision in there on, I believe,

1 it's 5(b)3 it says: If The Court issues a
2 protective decree, such Court shall forthwith
3 appoint as trustee for the liquidation and as
4 attorney for such trustee such persons that SIPA
5 in its sole discretion specifies.

6 And so at least under the current statute
7 our ability to do that is somewhat constrained.

8 MR. FILLER: I mean, I agree with that and I
9 understand that. But there's also another
10 provision that's SIPA that the SIPA trustee
11 should to the extent because commodity Futures
12 accounts are excluded, but to the extent it
13 doesn't impact the SIPA estate they should
14 interpret or show guidance under the Commodity
15 Exchange Act and CFTC regulations. And I'm just
16 saying that if it's the SIPA trustee that has to
17 be appointed, that that person who is appointed
18 has a Futures background and expertise.

19 I don't believe the current trustee has that
20 expertise and I think it has hindered some of the
21 issues that is involved with the current
22 concerns. All I'm saying is I do think there
23 should be a role played by the CFTC in trying to
24 make sure that the trustee appointed has a
25 Futures background or knowledge or expertise.

1 MR. WASSERMAN: Chris?

2 MR. EDMONDS: So from a practical
3 perspective, the idea about either the guideline
4 or Ron's idea on the expertise, what we can't
5 have happen again that we did have happen early
6 in November late in the process of the most
7 recent instance is with you and others in the
8 commission on the phone with the trustee and
9 clearing houses asking a question can I move
10 collateral and positions or can I move positions
11 without collateral to an accepting FCM?

12 And the CFTC staff make a very matter of
13 fact statement, yes, you can. And the SIPC
14 trustee says no, you can't without my permission.
15 And nothing else is said.

16 And you're sitting here as a clearing house
17 operator and going what bed am I going to make?
18 How am I going to make this decision right now?
19 And you have everyone on that 4 o'clock call, I
20 think you probably remember it, that you know,
21 lots of debate but no final decision.

22 And I think that uncertainty at the end of
23 the day from a clearing house operation
24 perspective, you're doing the best you can. And
25 no one wants to wear that risk and that's what

1 Part 190 I think should get us to a point where
2 we don't have to wear that risk because we're
3 following very defined rules. And I think that's
4 maybe the point of what these -- the other
5 gentlemen have been saying so far. Let's say
6 what those rules are.

7 MR. WASSERMAN: Jerry?

8 MR. SALZMAN: Well, one problem is you're
9 actually not free to write whatever you want in
10 Part 190. There are limits both in bankruptcy
11 code and in your statute, itself. And I --
12 without going into details here, I'll have to
13 talk to you later, but Part 190, I believe, needs
14 to be completely rewritten at this point because
15 Dodd-Frank has made some things less -- less
16 flexible than they were. And there are things in
17 190 that could be problematic going forward which
18 we can talk about later.

19 So I just don't think you have those kinds
20 of degrees of freedom that will really say, okay,
21 yes, we wrote, the trustee must follow Part 190.
22 Part 190 says.

23 But not you have a SIPA trustee and he says,
24 yeah, they wrote that. Where does it say in the
25 bankruptcy code or in SIPA that I must absolutely

1 follow something unless I know that there was
2 legal authority to adopt it?

3 MR. WASSERMAN: Seth?

4 MR. GROSSHANDLER: And we may not even
5 really be talking about a SIPA trustee. We may
6 be talking about the FDIC as a receiver right
7 under orderly liquidation for authority for the
8 systemically significant FCMs or joint FCM broker
9 dealers and maybe a question for you to the
10 extent you can answer it, have there been
11 discussions with the FDIC about how they plan on
12 implementing all of that?

13 MR. WASSERMAN: All I think it would be
14 prudent to say is that we have been -- we are
15 aware of the issues raised by orderly liquidation
16 authority. We are working with the FDIC on a
17 bunch of those issues. There's a lot of work to
18 be done. It's very important. I mean, just
19 concepts of, you know, orderly liquidation is a
20 very developing area, you know, both here in the
21 U.S., around the world. And I think it's
22 something we are very aware of and working on.

23 While I certainly could not comment on any
24 particular bankruptcies or what may have happened
25 recently, I would note that in a number of

1 bankruptcies what we found is that the work that
2 has been done in terms of getting court approval
3 of various things to get things transferred has
4 while in the light of the Futures' world where
5 seconds, you know, milliseconds count, maybe a
6 very long time in the world of bankruptcy things
7 have happened in literally a day or two, when
8 that in -- in the normal bankruptcy world I think
9 it's rather unheard of. And so it's a matter of
10 the glass is -- it is half empty and half full.

11 MR. EDMONDS: I -- I would -- I don't
12 disagree with that statement. I would just say
13 factoring out the time, it doesn't seem like we
14 were encountering precedents. It seems like
15 every time we do this we're doing the same thing
16 for the first time. We bring up an issue of we
17 need to, you know, get The Court approval. It
18 needs to take this form, this substance, and
19 everyone's scrambling for that form of substance.
20 And we don't have much certainty around that of
21 whether or not we're starting over and this is
22 something new and different or if this is
23 something that is actually going to follow
24 previous behavior.

25 MR. SALZMAN: I think one thing that's

1 important is that when you combine LSOC with this
2 uncertainty you multiply the problem. Because if
3 the clearing house becomes responsible for all
4 the losses of the customers who've lost the money
5 and it can't be shared with the other customers
6 and you're locked into their positions for a
7 period of time, you wind up in a position where
8 you're unable to mitigate the risk. And where
9 it's solely been transferred up, Katie, as saying
10 it's creating greater systemic risk into the
11 system.

12 So I go along with Chris completely, you've
13 got to be able -- you've got to have the clearing
14 house able to act immediately and I don't know
15 how we get it if it's -- if the trustee is a SIPA
16 trustee because he's going to refuse to let us do
17 it. He's going to say go ahead -- I know what he
18 said. He said go ahead and do it. It's at your
19 risk.

20 MR. WASSERMAN: Let me press you on that
21 just a second. Is that an issue that is unique
22 to a SIPA trustee or if you have a trustee
23 appointed off of the Chapter 7 panel who may not
24 have the same -- who may not be educated, would
25 you run into the same issue?

1 MR. EDMONDS: My opinion is it's anyone
2 who's not following what's in Part 190. It
3 doesn't matter who it is. If Part 190 is all of
4 a sudden an option and not a mandate, it is just
5 subject to the interpretation of someone with no
6 background here, to Ron's point earlier, you're
7 going to be faced with this uncertainty.

8 MR. WASSERMAN: Laura?

9 MS. KLIMPEL: Right. And I think the other
10 point that needs to be made is we need to know as
11 DCOs in the moment exactly whose approvals we
12 need at that time for a given transfer. You
13 know, do we need the approval of both the
14 commission and the trustee or can we rely on Part
15 190? What about transfers with collateral versus
16 without collateral? And I think it would be
17 helpful to make sure that that guidance is
18 clearly in 190, but that also that the trustees
19 follow it whether through a code amendment or
20 otherwise.

21 MR. WASSERMAN: And I'm going to need to
22 remind people once again please state your name.

23 Ron?

24 MR. FILLER: Ron Filler, New York Law
25 School. I have a little bit slightly different

1 issue. And I'm not sure this is a 190 issue so
2 I'm just going to throw it out for -- see what
3 this -- if there's any need for a discussion.

4 But if what I read in the newspaper is true
5 recently where the trustee appointed for the
6 parent company has not been cooperating with the
7 trustee appointed for the broker dealer FCM, I
8 don't know whether that was true. It didn't
9 provide information or records or whatever,
10 something's got to be done to change that system
11 if that was, in fact, correct. I hope that's not
12 a correct report in the media. But I was just
13 appalled that there was not the cooperation
14 between the two.

15 I know they have separate estates, separate
16 bankruptcies, separate laws and so forth, but you
17 would assume that there's some common interest
18 among these different trustees that are
19 appointed. I'm not sure there's anything you can
20 do here, but if it requires legislative action or
21 whatever. But I hope that was not a true
22 statement.

23 MR. WASSERMAN: Let me press you on that for
24 just a second. And I'm obviously not commenting
25 on any newspaper articles. I'm not that foolish.

1 But to whom does each trustee owe duties?
2 And if the answer is to separate sets of
3 creditors, what is there that even Congress could
4 do practically to address that problem?

5 MR. FILLER: Well, we're not distributing
6 assets. We're sharing information type of thing.
7 Maybe those assets belong to the parent holding
8 company and the SIPA trustee has no access to it.

9 But how do they even make that decision?
10 How do you look at a call back provision? How do
11 you look at any of the other bankruptcy provision
12 -- the provisions in the bankruptcy code without
13 having all the complete record or information in
14 front of you to make a proper legal argument.

15 MR. WASSERMAN: David?

16 MR. YERES: Yeah. David Yeres from Clifford
17 Chance on behalf of CIEBA.

18 Going from Ron's point about something you
19 may not be able to do, towards -- moving from
20 Ron's point about something you may not be able
21 to do to something you can do, I hark back again
22 to the structural approach from the customers'
23 point of view. The GCP model takes that
24 question, we hope, out of the picture altogether.

25 The funds of the customer in that model have

1 been deposited in the DCO settlement bank are not
2 part of the FCMS bankruptcy. They're not part of
3 customer property if we structure it properly.
4 And if we -- you take all the right steps, we
5 hope would not be subject to a lien that would
6 impede them. And so this kind of conflict that
7 might arise between the trustee in respect of the
8 FCM, a SIPA trustee, an FDIC appointee would just
9 not be relevant to the customer. The customer
10 would have certainty that it had positions. It
11 has certainty where it's money was and it would
12 be instantaneous.

13 MR. WINTER: And I would just point out one
14 thing related to what David just said and that's
15 the certainty issue is the big issue. And when
16 there's a bankruptcy, the clients got concerns
17 about its cash and collateral which is the
18 assets. And that, we understand, gets locked up
19 into a bankruptcy until it's finally determined
20 what all is there, where it is, and how it gets
21 distributed.

22 But the bigger issue is the risk positions.
23 It's not an asset, but it's a liability at some
24 point to the client particularly if they don't
25 know where it is. It's in limbo, do they still

1 have it, is it being liquidated? How do they
2 hedge, how do they keep their risk position or
3 not create additional exposure? And that
4 uncertainty is the biggest concern.

5 MR. WASSERMAN: Katie?

6 MS. TRKLA: I wanted to follow up on Jerry's
7 point before about the uncertainty in the
8 process. And there are limits on the rule making
9 authority. There are limits to what we can do to
10 fix things just through Part 190. And I think we
11 do have to at some point look more broadly to
12 legislative changes. You know, going back to
13 have having a SIPA trustee, you know.

14 What's troubling to me is yes, they have the
15 duties of a commodity broker trustee, but that is
16 limited to the extent consistent with the
17 provisions of SIPA or as otherwise ordered by The
18 Court, whatever the heck that may mean or however
19 that may be interpreted by any particular
20 trustee.

21 And I think that's an issue that we need to
22 reconcile to have that kind of uncertainty
23 introduced by who is serving as the trustee.
24 And, you know, short of legislative changes, I do
25 think it's important to look at, then, the

1 qualifications of the trustee. Do they
2 understand the Part 190 framework and the basic
3 logic of it to know what they're supposed to be
4 doing and why those rules are in place and the
5 market protection reasons for that?

6 And I actually want to follow up on another
7 point that Jerry made and something that sort of
8 struck me throughout the day as we frame and talk
9 about these issues. To me, the whole customer
10 funds segregation framework and then once you
11 sort of followed Alice through the looking glass
12 and you're dealing with bankruptcy, there are
13 two, as I see it, fundamental policy issues.

14 One is to protect the funds of the customers
15 of the failed FCM. But the other, and the one
16 that historically has been given the greater
17 weight, has been to protect the integrity of the
18 markets from systemic risk to be able to allow
19 the default mechanisms of the clearing process to
20 be able to contain the risk to prevent it from
21 spreading to other FCMs and, in turn,
22 jeopardizing other customers of other FCMs.

23 And so that second policy consideration
24 seems implicit in the discussions today, but it
25 seems to be articulated as a cost. And I think

1 we need to recognize that that's a separate sort
2 of policy historically for segregation as we
3 evaluate different proposals.

4 MR. WASSERMAN: David?

5 MR. YERES: I follow up on what Kathryn said
6 and I know I'm may be Johnny one note here, but
7 the GCP model accomplishes that because the funds
8 are not in the FCM bankruptcy. They're available
9 to the DCO. They support the system from moment
10 one. And it creates a much simpler, more certain
11 approach not only for the trustee, but for
12 everyone in the market who has to be sure that
13 payments will be made and the positions are open.

14 MR. EDMONDS: On that point, and this is
15 Chris from ICE Clear Credit. That works fine
16 until it's the FCM that's -- the FCM that's
17 guaranteeing the GCP is the defaulting party.
18 I'm a little bit unsure that if your GCP and your
19 model could not find another guaranteeing FCM in
20 a time of stress in a five-day period that we, as
21 a clearing house, may not be faced with exactly
22 the same issue of a liquidation at that point in
23 time.

24 MR. YERES: Let me try to answer that. And
25 you would be in a much better position than I

1 would be to know whether FCMs would take on the
2 GCP. But the GCP, as we're imagining it, is a
3 party that not only is fully funded with IM at
4 the DCO, but has very likely excess margin in the
5 DCO settlement bank which was additional -- which
6 was required additionally by the -- by its FCM.
7 Therefore, it would seem of all customers to be
8 the most likely to be able to find other
9 guarantor or FCM to port its positions since it
10 has the wherewithal to support them.

11 MR. EDMONDS: The issue with that assumption
12 I think at the end of the day, and it might very
13 well be true that that's where the world ends up,
14 that the problem is making that assumption where
15 you have a very limited timeframe to get that
16 done where it's not the amount of collateral held
17 on behalf of the GCP or the variation margin
18 being held there, that's wonderful. That gets us
19 one part of it. It's the amount of guarantee
20 fund potentially the clearing house is going to
21 require in order for that GCP's account to be
22 transferred over.

23 So if in a time of stress -- these are
24 catastrophic events we're trying to plan for. In
25 a time of stress you have a very large customer

1 who is a GCP whose got all his variation, all the
2 IM, he looks like a perfect bride to go to the
3 alter. Can't find someone who's willing to
4 commit hundreds of millions of -- you know, let's
5 think about a world where lots more things are
6 cleared, maybe even billions of dollars in a
7 short timeframe in a time of market stress, you
8 cannot be guaranteed you're going to find that
9 other guarantor in the timeframe that you need.
10 So there's going to have to be some rules around
11 that.

12 We won't solve this here today. I
13 appreciate the -- what you're trying to get to.
14 I just think there's another piece that we've got
15 to think through on that.

16 MR. WASSERMAN: Chris --

17 MR. YERES: I wouldn't presume --

18 MR. WASSERMAN: If I could -- the question I
19 would ask on that score is how is that unique --
20 I mean, what I think you're raising is a
21 portability issue as opposed to a GCP issue.
22 That is, how would it differ in terms of the
23 additional guarantee fund obligations if you're a
24 transferee of a GCP or you're a transferee of
25 ordinary customers?

1 MR. EDMONDS: I don't think it's any
2 different at the end of the day. I think that
3 the GCP has to realize that there is liquidation
4 risk sitting that for the timeframe if they're
5 unable to find another guarantor in that
6 timeframe.

7 MR. YERES: And actually, yes. I think that
8 is understandable. It makes sense. It's one of
9 those situations. And we could say the present
10 situation is not changed from the point of view
11 of systemic risk. The systemic risk remains the
12 same subject to the GCPs having adequate IM and
13 excess collateral just as I think was implied by
14 Bob Wasserman's question. If this position could
15 have been ported, it now can be ported or it can
16 be re guaranteed.

17 MR. EDMONDS: And, David, maybe I was taking
18 issue where you said this model's perfect because
19 it provides for the positions to remain open and
20 the collateral. I think to be technically
21 correct, it's only for a period of time that you
22 can put those other means in place. That's all I
23 was taking issue with.

24 MR. WASSERMAN: And so and I think you were
25 saying it makes it easier for them to be ported.

1 But regardless, I don't think there's any
2 guarantee. Moreover the one thing I think we're
3 very clear on is GCP is not going to be a
4 universal solution. And so there are going to
5 still be customers out there. And so we still
6 have to address what -- you know, even if David
7 is correct and the GCPs are more easily ported,
8 there's other folks out there. And then the
9 question is what do we need to do.

10 Seth?

11 MR. GROSSHANDLER: I don't want to go back
12 to the panel that we had on GCP. But you know,
13 this all begs the question of you ask why would,
14 you know, would there be another FCM to take over
15 the clearing -- the guaranteed participant begs
16 the question of why would an FCM do it in the
17 first place? What are the economics? When all
18 they're -- they're being entirely
19 disintermediated and just being an insurer.

20 But the other thing is, and most of this has
21 been covered, but, you know, the issues of -- I
22 mean, if you have a single entity that has
23 essentially two estates, right, the rules just
24 need to be really clear, right, as to how a
25 single trustee is going to administer those

1 estates. And it's not just Part 190. It's SIPA
2 and it's OLA.

3 Now, OLA is probably kind of refers to SIPA
4 and Part 190. But it seems to me, you know, the
5 sharing rules, all that kind of stuff needs to be
6 as much as possible worked out in advance so that
7 you don't have a single trustee who has two
8 masters with conflicting orders.

9 MR. WASSERMAN: You raise an -- and I think
10 I'm going to ask to put aside orderly liquidation
11 authority for the simple reason it is a big and
12 very complex issue. It is critical that it be
13 addressed. I fear it is a bit too big and too
14 complex to profitably address here and now.

15 So let's focus for the moment, putting that
16 aside. But let me ask you, in terms of SIPA I
17 think it is correct that you have two estates.
18 And there may yet -- there may in any
19 hypothetical case be a point at which there is a
20 differing interest between those estates. Until
21 that point -- and separately from that point and
22 acknowledging that point, to the extent you have
23 two estates and rule -- two sets of rules, one
24 for each of them, where is the necessary conflict
25 until the point when there's a conflict of

1 interest?

2 MR. GROSSHANDLER: There is no necessary
3 conflict. But it's also there should be if the
4 trustee is a SIPA trustee, that SIPA trustee just
5 needs to know what he or she needs to do with the
6 commodity estate. I mean, it just needs to be
7 very clear how it works and it's never been
8 really very clear. And it's not just Part 190.
9 It's also SIPA, I think. I think it's SIPA as
10 well as Part 190.

11 MR. WASSERMAN: Chris?

12 MR. EDMONDS: Changing topic slightly and
13 adding one. Could we also, at least, consider
14 the ability to allow DCOs to close out positions,
15 be it book out transfers, without a specific CFTC
16 order within some period of time?

17 MR. WASSERMAN: So I think you -- so you're
18 talking transfer out as opposed to liquidation?

19 MR. EDMONDS: Well, I think we can be
20 talking about both depending on where we are in
21 the timeframe.

22 MR. SALZMAN: Here -- here -- here's the
23 problem. Assume LSOC actually gets upheld by
24 some court and we're -- we're in that process and
25 you've got five accounts that are bad and you can

1 isolate them from all the rest. And you've
2 transferred out all the rest of the accounts.

3 Can you, with those five accounts, somehow
4 net out their positions? Can we still net out?
5 I think the answer's got to be yes. But what do
6 we need to be sure we can do that? And if we do
7 net them out, how are we going to price it
8 because some -- presumably they're mostly on the
9 same side of the market. But to the extent that
10 they are nettable, somebody's going to be a
11 winner, somebody's going to be a loser. How do
12 we pick the prices? What do we do to be sure
13 that we're handling the thing correctly when we
14 focused on five accounts and we have this fiction
15 that they're now actually segregated from each
16 other?

17 I think that's the question, Chris.

18 MR. EDMONDS: Yeah, no. I think it's right.
19 I think it is a bigger issue on the close out.
20 But I think right now if we're going to close out
21 those we have to have a specific order from the
22 CFTC in order to do that, to take that action.
23 Can we bake that into 190 where that --

24 MR. SALZMAN: I don't think we need an order
25 to close out an account that's in deficit.

1 Because we've now identified these particular
2 accounts as not having met an appropriate margin
3 call or (indiscernible).

4 MR. WASSERMAN: More than that, what is the
5 source of your -- your accounts right now, the
6 theory of clearing as I understand it, is you
7 have a -- every account is backed by a clearing
8 member in good standing. And so if you have an
9 account which is no longer backed by a clearing
10 member in good standing, what is there that
11 legally prevents you from liquidating that
12 account?

13 MR. SALZMAN: I actually think that it's
14 pretty clear that once we determine that the
15 clearing member's down and that these accounts
16 are in default we can liquidate them. And the
17 problem is that they're now -- we've now put them
18 each in a separate pot. We're not treating it as
19 a single account the way we would have before
20 when we would have auctioned off the entire -- if
21 we were to liquidate, auction off the entire
22 customer account set.

23 Now we've got five accounts, each is
24 separate. Can we net them down? I think the
25 answer's got to be yes. It's the only sensible

1 way to do it. And the question is do we need
2 anything in 190 or any place else to be sure it's
3 the right way to go and go quickly?

4 MR. WASSERMAN: Chris?

5 MR. EDMONDS: No. I think -- I think that is
6 the right guidance that we're looking for. But
7 I'll come back to you whether or not we have to
8 have an order. I have a note that says we do,
9 but I'll come back to you on that if that's not
10 the case. But at least our interpretation. But
11 I think making it certain is the issue at this
12 point.

13 Jerry, you think that's fully baked in at
14 the moment?

15 MR. SALZMAN: I --

16 MR. EDMONDS: Or that's just practical?

17 MR. SALZMAN: No. I think it follows from
18 the fact that there's no longer a clearing member
19 and they're in default and they are now
20 individual accounts under LSOC that a clearing
21 house does not have to keep open an account once
22 it reaches that stance. It's entitled to close
23 it. Same as a clearing member would be entitled
24 to do.

25 MR. WASSERMAN: And so it sounds like I'm

1 hearing two separate issues. One issue is may
2 the clearing house close out accounts that are
3 not backed by members in good standing? The
4 second issue is, if they do so, how does that
5 process proceed? How are prices set? And I
6 think those are separable issues.

7 MR. SALZMAN: Right. And, you know, right
8 now as, you know, we're not just from this
9 bankruptcy but from other similar situations in
10 the past, the clearing house, when it has a big
11 block of positions, generally the house
12 positions, it'll find some way to try and auction
13 them off and they'll try and put the positions
14 together in such a way as to make the most
15 favorable package.

16 But that's -- and this raises another
17 question that I have for you. That's because
18 we've always treated the house account as if it's
19 the account of a single entity and so we could
20 put all the positions together and auction them
21 off. Although I actually have a question about
22 that after Dodd-Frank and under 190 whether
23 that's permissible.

24 But when you have now these as five separate
25 individuals who are customers before, can we

1 still put them together for an auction? Do we
2 have to auction off each guy separately? Can we
3 net them out first? I mean, those are questions
4 that we should all solve together and just have
5 -- make sure you have authority to do it and that
6 we have authority to do it and get it down once
7 and for all so we're set when this happens, if it
8 happens again.

9 MR. WASSERMAN: Seth?

10 MR. GROSSHANDLER: Just in terms of the
11 topic of limitations on the DCO's rights against
12 a defaulting FCM, and I guess also in the context
13 of GCP against the defaulting customer -- sorry,
14 GCP, hard to get out of that customer terminology
15 -- I think there is a potential issue with the
16 stay under SIPA, right. And the order, right, I
17 think had an exclusion for a DCO's exercise of
18 rights.

19 MS. KLIMPEL: That's correct. It was
20 written in. So I think one comment is that we
21 should make sure that the template going forward
22 -- and I'm sure that people in this room were
23 involved in that. I'm sure that we should make
24 sure that the template going forward specifically
25 includes DCOs as well as securities clearing

1 agencies.

2 MR. GROSSHANDLER: Yes, exactly. And then
3 in the GCP model there may be some unintended
4 consequences, and this was alluded to a little in
5 an earlier panel, of the DCO facing more directly
6 the defaulting customer of right now fiducia, the
7 remedies it's all about the DCO against the
8 clearing member. It's almost as if the customer
9 doesn't exist, right.

10 And it's a great statute that allows the
11 exercise of all these remedies notwithstanding
12 most any other law you may lose that when you
13 have a relationship of the DCO directly against
14 the GCP. Because, yes, they are a member, okay.
15 But if they're non-U.S., you have that non-U.S.
16 issue as opposed to in the clearing world you
17 know they're all FCMs so you know U.S. law is
18 what's going to apply.

19 MR. WASSERMAN: So are you saying that
20 clearing houses with non-U.S. members may have
21 some legal question as to their use of the
22 collateral posted by those members?

23 MR. GROSSHANDLER: I mean, there are --
24 diligence needs to be done on the non-U.S. law.

25 MR. WASSERMAN: And I'm sure that consistent

1 with whatever principles for FM's that come out
2 and rules for that clearing houses will take all
3 steps necessary to do due diligence.

4 UNKNOWN SPEAKER: It's in the regs, yes.

5 MR. WASSERMAN: David? Okay. If we've
6 exhausted this one I guess the next question was
7 going to be, and we've touched on it a bit,
8 beyond our powers under 190 -- and I think it is
9 a very important point to remember, I certainly
10 do, that our powers are limited -- as a regulator
11 are limited. There are certain things that only
12 Congress can do.

13 What are the things that ought be
14 recommended to Congress either in terms of sub
15 Chapter 4 or there have been suggestions perhaps
16 of looking at other statutes.

17 MR. SALZMAN: I -- I mean, I don't mean to
18 beat a dead horse even more than David, but in
19 terms of LSOC, if you're going to do it, I think
20 you really want to be clear that it can be done
21 because otherwise we're all in a horrible mess.
22 Right now you have a statute that says -- your
23 statute, in particular, (indiscernible) says
24 okay, they have indiv- -- they're individual
25 segregated accounts but they can be commingled

1 for convenience.

2 LSOC says okay, they're commingled for
3 convenience but we have a springing explosion of
4 the accounts into their individual status at some
5 later point in time when somebody goes bankrupt.
6 And I have a real question if you can do that.
7 Because if it says they can be commingled and
8 you've made the decision to comingle them, then
9 when you take them apart essentially what you're
10 doing is you're making the clearing house and the
11 other members of the clearing house a guarantor
12 of the loss of certain fellow customers. I mean,
13 that was the idea.

14 And I think it would -- we'd all feel a lot
15 better if we're going forward with LSOC to have
16 the bankruptcy code or your statute make it clear
17 that that's going to be upheld. It's contrary to
18 766(h).

19 MR. WASSERMAN: Seth?

20 MR. GROSSHANDLER: I honestly don't see why
21 it's contrary to 766(h). It seems to me that
22 LSOC is simply addressing the relationship
23 between the DCO and the clearing member. Where
24 766(h) is talking about sharing of customers in
25 the FCM customer estate. It's operating -- 766

1 is operating at a separate level and LSOC, in
2 fact, doesn't operate at that level. It operates
3 at the level of DCO creditor, not customer, and
4 FCM.

5 MR. SALZMAN: No. I don't think so. Because
6 what it does is it says before LSOC if you agreed
7 that these accounts were going to be commingled,
8 that meant the clearing house could net among
9 those commingled accounts when there was a loss.
10 And it still means that up to the point of
11 bankruptcy because you're netting when you do
12 your pays and collects the day before which is
13 why LSOC doesn't work.

14 But the fact is all of a sudden you're
15 saying that the loss that was to be shared among
16 the customers is no longer shared among the
17 customers. The loss is isolated and passed to
18 the clearing house.

19 MR. WASSERMAN: Forgive me, Jerry, but does
20 766(h) say that the loss is to be shared among
21 the customers or that the customer property is to
22 be distributed ratably to the customers?

23 MR. SALZMAN: Which effectively is sharing
24 the loss, yes. Customer property is to be
25 distributed ratably among the customers. But

1 effectively what you've done is you've taken
2 things out of customer property.

3 MR. WASSERMAN: Are you taking things out of
4 customer property or rather defining what is
5 customer property based on what comes back to the
6 estate? LSOC seems to change what to the
7 clearing house has to send back to the estate
8 thereby arguably enhancing the customer property
9 pool. How is that contrary to 766(h) or indeed
10 affected by it?

11 MR. SALZMAN: Well, it effectively, in my
12 view anyway, is saying that the idea that this
13 was a commingled account in which everybody was
14 sharing in any loss that was occurred -- that
15 occurred is now springingly undone and the losses
16 transferred away from the customers who otherwise
17 would have suffered it to the clearing house.

18 And the question is is there authority for
19 that?

20 MR. GROSSHANDLER: I don't think that's a
21 766(h) issue, though. Because I agree with Bob,
22 it really is -- it's talking about what is
23 customer property that comes back into the
24 estate.

25 MR. SALZMAN: If not 766(h), then a CEA

1 issue under 4(d) and 4(d)(f).

2 MR. WASSERMAN: And, you know, on that score
3 I would ask what do the words "for convenience"
4 add and then we can even start getting into talk
5 about S's. But I think we should probably -- at
6 that point it's probably best to move onto
7 different things.

8 I mean, Jerry, you and I, of course, have
9 differences on this and that's probably going to
10 continue.

11 MR. SALZMAN: No. Not if we get it fixed. I
12 mean, you're asking about --

13 MR. WASSERMAN: No. But moving -- I guess
14 granting that point --

15 MR. GROSSHANDLER: And just one thing, it
16 cannot be -- it is always a good idea to clarify
17 things in statute if you can.

18 MR. WASSERMAN: Fair -- fair enough. David?

19 MR. YERES: Bob, have we left 190 altogether
20 now and are we at statutory level?

21 MR. WASSERMAN: Well, if you've got
22 something back on 190 we can step back there.

23 MR. YERES: Well, looking forward to what I
24 hope will be the implementation of the GCP
25 product, there are a couple of 190 modifications

1 that we would have -- we would suggest you have a
2 look at.

3 One would be 190.01(n). Just so it was
4 clear in the commission's rules that property
5 allocated to this GCP account or the individual
6 settlement account was not included within
7 customer property. Again, we have good reasons
8 to believe statutorily that's the case, but we
9 don't see any reason why the commission
10 regulation should not follow the statute.

11 And secondly, there's a technical point in
12 190.08(d), David, (2), which has to do with
13 determining whether or not a position is under
14 margined and how a trustee would treat it. We
15 would just want to make sure that any customer
16 property held in this ISA account -- or pardon
17 me, the GCP property in the ISA account, was
18 counted for purposes of determining margin.

19 These are, I think, technical points. But
20 I'm looking forward to the speedy implementation
21 of the GCP program and I thought I would tell you
22 about them now.

23 MR. WASSERMAN: Fair enough. Seth?

24 MR. GROSSHANDLER: Just some other things on
25 190. We're obviously focusing on FCM insolvency

1 here.

2 But there's also DCO insolvency, definition
3 of member property in 190.08, some issues about
4 how that works with SILO non-recourse structures
5 that could be --

6 MR. WASSERMAN: I'm sorry, that last point I
7 fear I didn't quite catch.

8 MR. GROSSHANDLER: Probably -- okay. So I
9 dug my own grave by mentioning it. Yes, it's
10 incredibly complicated and I have to study it
11 every time that I really talk about it so we
12 should take it off line. But the basic context
13 is you have structures where the Futures and the
14 cleared OTC swaps are in a single DCO, but
15 there's no recourse between them. And how does
16 that work in a DCO insolvency?

17 MR. WASSERMAN: So --

18 MR. SALZMAN: Let me try because you've been
19 yelling at me about this. So the problem is in
20 190.08 there's very bad sentence. And it's
21 difficult to say whether a member who's not a
22 bankrupt, whether its property in a guarantee
23 fund absolutely belongs to it if it's not used
24 for purposes of the guarantee fund. I think
25 that's a fair way of saying it.

1 And the problem becomes complicated when the
2 guarantee fund has some limits on its use. But I
3 think we can spell this out for you and --

4 MR. WASSERMAN: So two things. First, as
5 I'm understanding what you're saying if you have
6 a SILO guarantee fund presumably one portion of
7 the guarantee fund is going to be exhausted.
8 That's why you had a DCO insolvency. But what
9 you're saying is there may be another part of the
10 guarantee fund which is not exhausted and then
11 the question is what happens to that and is that
12 member property and how is that distributed?

13 MR. SALZMAN: And there's a very bad
14 sentence in 190.08. We can point it out to you
15 and you'll see. It just leads to two separate
16 interpretations that we've been fighting about.

17 MR. WASSERMAN: And so two things I will
18 mention. First, a very, very important
19 housekeeping detail that we probably should have
20 mentioned in earlier panels which is there is an
21 open comment file, one for today, one for
22 tomorrow. And to the extent folks have more
23 technical things or comments that they've not
24 been able to make but particularly things that
25 are more technical and would benefit from that

1 kind of analysis, folks are definitely invited to
2 -- and encouraged to file comments in that.

3 And secondly, yeah, there's an understanding
4 that some unlucky person is going to have to
5 spend a lot of time looking at 190 and updating
6 it. Somebody's been looking at it for about 10
7 years and trying to get around to doing that and
8 the time may well becoming mine.

9 MR. SALZMAN: One more thing about 190 and
10 the bankruptcy code is the treatment of customers
11 in the propriety account.

12 MR. WASSERMAN: You mean non-public
13 customers?

14 MR. SALZMAN: Non-public customers. And
15 there's a couple different references to them.
16 There's also a problem with what they call a
17 house account for an FCM clearing through a
18 clearing member which seems to be treated
19 differently than other customers, which seems a
20 little strange because it is a customer of the
21 clearing member.

22 But I -- when I read it, and maybe everybody
23 here already knew it, but it wasn't clear to me
24 just how crazy it is to be an affiliate in your
25 own -- of a clearing member and being the

1 proprietary account. Because when you talk about
2 fellow customer risk they have double fellow
3 customer risk. They're subordinated to all the
4 other customers of the firm, to the public
5 customers of the firm.

6 I think something else that at least I
7 didn't know and maybe others did know is they
8 aren't treated as a general creditor unless they
9 meet certain other requirements. They're
10 actually if there's any property leftover, they
11 get special treatment for that property. So I
12 think those things just generally aren't thought
13 about.

14 MR. WASSERMAN: And that is I'm pretty sure
15 in I think it's 190 -- strike that. 766(i), and
16 there is or may even be in (h) that basically
17 says that customer property must first go to pay
18 off all what are essentially public customers.

19 MR. SALZMAN: Right.

20 MR. WASSERMAN: And there is sort of a
21 sliver that the non-public customers, if there's
22 anything left, would have an interest in that.

23 MR. SALZMAN: Direct interest.

24 MR. WASSERMAN: And that anyone who is not
25 fully covered would then be a general creditor.

1 MR. SALZMAN: Right. And -- but some of the
2 customers in the account probably can't get that
3 benefit so there's going to be a conflict between
4 their affiliate status and their customer status,
5 or at least I'd be worried about that. I don't
6 know how that comes out. I'd have to look at
7 SEP.

8 MS. TRKLA: Some -- well, just a few other
9 thoughts on Part 190. I -- you know, putting
10 aside changes to accommodate say the GCP
11 approach, just would the account class concept
12 that's left intact. In addition to that being
13 important in terms of isolating different risks
14 for different account classes and the pro rata
15 distribution, do we need to perhaps rethink how
16 the rules play out in terms of the other aspects
17 of Part 190 in terms of trying to port positions
18 or liquidate positions where the differences in
19 response for cleared swaps may be different than
20 they would be for cleared Futures? And so are
21 there perhaps further distinctions that could be
22 -- or should be explored to be made in Part 190
23 along class -- account class lines?

24 I think also if there are any opportunities
25 to sort of simplify and update the rules, that

1 would be very helpful. It's mundane but the
2 whole area of specifically identifiable property
3 is very confusing. We consequently got a lot of
4 clients out of it because they couldn't make
5 sense out of what the form meant that they had to
6 fill out. And a lot of confusion when you've got
7 sort of one form for specifically identifiable
8 property for two separate purposes for delivery
9 purposes and for identifying what's held in
10 margin on a segregated basis.

11 And it seems there are parts of the rules
12 that are perhaps needlessly confusing and could
13 be simplified. And I think also with the whole
14 notion of sort of the delivery category, that's
15 an area that really needs to be updated because
16 it I think was drafted back in a day when
17 physical delivery contracts, delivery occurred by
18 delivery the paper delivery title document. When
19 most physical delivery contracts today now are
20 book entry. And so it's a different --

21 MR. SALZMAN: No.

22 MS. TRKLA: -- method.

23 MR. SALZMAN: This one is really --

24 MR. WASSERMAN: Jerry, state your name.

25 MR. SALZMAN: Jerry Salzman is my name. And

1 this one is really cause -- could cause serious
2 problems just because of the way people are
3 holding actual physical commodity and they're
4 holding it at FCMS at clearing members. Not
5 because they took delivery or because they're
6 going to make delivery, but just because they're
7 holding the stuff there. They're treating these
8 guys as banks.

9 If there were some way to make it easy for
10 these people to distinguish what's in the
11 customer Seg account and what's in some form of
12 trust account so that they could get these
13 documents back in due time -- and I know you made
14 -- you took a position with the trustee that
15 tried to deal with that and tried to distinguish
16 between the two types of accounts. But if
17 there's something we could do in the rules that
18 would either cause the firms to treat these
19 things differently when they really aren't being
20 held to support Futures contracts, it would have
21 saved or could save in the future a tremendous
22 problem.

23 MR. WASSERMAN: I'm going to turn that back
24 on you folks. What should we do?

25 MS. SALZMAN: Well, essentially --

1 essentially FCMs should be told that if property
2 is not being held for purposes of present or
3 immediate future, delivery or use in connection
4 with a contract where you need to have it
5 segregated and the client wants it held in trust,
6 put it in a damn trust account and document it.
7 Because without documentation it's pretty clear
8 that it's going to get treated just as customer
9 property, segregated customer property.

10 MS. TRKLA: Well, I'm not sure it even gets
11 treated as customer segregated property. In the
12 case not to be named that property receipts --
13 received under Futures contracts, and in
14 particular in the precious metals area for
15 investment, I mean, it started out as delivery
16 property but they were held in the delivery
17 account. Not in the segregated account.

18 And so we've got this definition of customer
19 property and we've got these categories for
20 customer property. I'm not sure that the
21 categories for customer property are all
22 inclusive. And I would take the position, and we
23 have, that you're outside entirely the customer
24 property class when you are in that situation
25 where you're holding by book entry title

1 documents and have to, through the FCM, because
2 it is a book entry system and you don't hold the
3 paper and that the FCM becomes the custodian and
4 you've got a separate basis under the bankruptcy
5 code to claim -- to get that property back.

6 But that's a point of confusion and debate
7 right now with the trustee. And I think it's
8 more just stepping back and acknowledging that
9 that issue exists and thinking through what's the
10 best way to address it and are the different
11 categories of customer property supposed to be
12 all inclusive or what happens if you have
13 something that a trustee may view is customer
14 property but it doesn't fit within one of these
15 neat categories?

16 MR. WASSERMAN: And so let me ask on that --
17 on the issue of specifically identifiable
18 property and specifically the issue Jerry
19 mentioned where you have some physical --
20 essentially physicals that are being held that
21 may not arguably not be for the purpose of making
22 or taking delivery, is the problem one of lack of
23 clarity of Part 190 or is the problem or the
24 solution saying that you have to keep in customer
25 property only that property which is intended to

1 make or take delivery? And if it's not intended
2 to make or take delivery, it, by regulation,
3 should be essentially kept out of Seg, outside of
4 customer property. And then you're left to
5 whatever trust issues that may or may not work.
6 And I certainly don't know enough to comment.

7 MS. TRKLA: Yeah. I think part of it is
8 lack of clarity and ambiguity so you get caught
9 up in these types of debates. I think part of it
10 is that in this area the rules are outdated
11 because we do now have book entry for most
12 delivery title documents. Not all, but for the
13 vast majority of them. And so the days of
14 saying, okay, I'm going to take my silver
15 certificate and put it in, you know, my bank
16 account and not even have to worry about getting
17 caught up in this situation that's not practical.
18 You're sort of forced as a customer to have your
19 positions held with an FCM. And I think we need
20 to recognize that this practice exists.

21 And, you know, we either define it as its
22 own category of customer property or we say it's
23 outside of customer property and protect yourself
24 under a trust concept or acknowledge that, you
25 know, the FCM is acting as your custodian. There

1 are other parts of the bankruptcy code that
2 support that.

3 MR. WINTER: Steven Winter. The only
4 comment I'll make to that is when clients hold
5 these certificates with the FCM, while they are
6 fully paid for instruments theoretically the
7 reality is they could be being used to get them
8 benefits in the margining process.

9 So, for example, if you've got a client
10 that's short the Futures contract and is longed
11 the gold receipts at the FCM, if you separate
12 them you're actually going to create additional
13 exposure. So you can't look at them individually
14 just because they're receipts that are
15 theoretically fully paid for.

16 MR. WASSERMAN: I guess the question is if
17 something is being -- is accepted and being held
18 as margin, then arguably it's in our jurisdiction
19 and it's customer property.

20 MR. WINTER: Not arguably, it is.

21 MR. WASSERMAN: Right. But here's my point.
22 But if it's not being held for that purpose, if
23 one -- if one says firmly, look, here is -- here
24 are some gold that is not being held to make or
25 take delivery, it's not being held as margin,

1 it's just an FCM is a really convenient
2 custodian. But if one says that, doesn't it
3 really take it outside of our jurisdiction in
4 which event if you're going to say that dens it
5 basically come outside of Part 190?

6 MS. TRKLA: Actually, that's the position
7 we're taking on behalf of clients that have
8 precious metal receipts that they're holding for
9 investment, that it's not in the delivery
10 category. I mean, as a fallback, you know,
11 because the trustee seems inclined to say it's
12 part of the broader customer property bucket, but
13 we think there's a stronger protection to say
14 outside 190 entirely and rely on other provisions
15 of the bankruptcy code that protect your
16 relationship when someone is acting as your
17 custodian and holds legal title but not
18 beneficial title to the property.

19 MR. SALZMAN: I mean, your jurisdiction --
20 your jurisdiction is to make sure that stuff
21 isn't just stuffed into the customer's segregated
22 account. I mean, it's just -- it's not for
23 general use. FCMs aren't supposed to be banks as
24 some of them have become. They're actually
25 supposed to be only putting stuff in customer

1 segregation that meets the qualifications of the
2 statute. So when they're -- when they're just
3 being sloppy, we should make sure -- and I'm not
4 sure whose obligation it is.

5 Maybe it's the -- maybe it's our auditors,
6 maybe it's your auditors, maybe it's the NFA,
7 maybe there should be some clarity. But I think
8 this should be cleared up because it was an
9 unholy mess especially in the Ag side. And it
10 just shouldn't happen again.

11 MR. WASSERMAN: So what I -- it strikes me
12 that what I'm hearing is a request that we
13 clearly state that the only thing that should be
14 -- that there needs to be a very clear
15 distinction in the books and records of an FCM
16 that what's being held either as margin or to
17 make it -- well, anything to make or take
18 delivery is margin as well. So it's either
19 collateral or it isn't. And it needs to be very
20 clearly identified as one or the other.

21 MR. SALZMAN: And then if they take delivery
22 through the FCM, there's got to be a period of
23 time where they can still keep it in customer
24 property. But at some point if they're just
25 taking, taking, taking delivery and holding

1 massive amounts of these certificates, they
2 shouldn't -- they shouldn't be in that pool. And
3 the only -- you know, in the old days they
4 weren't in the pool because the FCM was paying --
5 or had a capital charge based on that pool. But
6 now he only has a capital charge based on
7 essentially the required margin. So he doesn't
8 care what's in the pool and that's got to be
9 fixed.

10 MS. TRKLA: I think you really have to look
11 at it in terms of the way the practices work with
12 the trading. Because you may have very active
13 traders who routinely take delivery and it's part
14 of their trading strategies they hold them in the
15 delivery account, again, book entry, so they
16 really don't have the luxury of taking it out of
17 the system. But it's there for a period of time
18 because they do intend to deliver under the next
19 short Futures position as they continue to spread
20 and roll their positions forward.

21 So I think you need to look at how the
22 trading practices work and make sure that sort of
23 what you're defining as delivery property of is a
24 separate category in terms of what's going on in
25 the delivery account matches the way that market

1 users are trading those products.

2 MR. WASSERMAN: And we have one minute left
3 so I think we're going to leave -- well, okay.
4 Seth, you get the last word.

5 MR. GROSSHANDLER: Just because we only have
6 one minute left there's two things we haven't
7 talked about. One is there was talk in a prior
8 panel about bank insolvency custodial risk. It's
9 not really in the CFTCs jurisdiction, obviously.
10 But if you're going to Congress to ask for
11 clarifications, it would be great to have
12 clarifications about what happens to custodial
13 property in bank insolvency because it's not
14 statutory and it's kind of a mess.

15 The other thing is if there is support for a
16 GCP, you know, broadly and it moves forward,
17 there may be differing views as to how clear it
18 does get things out of customer property and that
19 would be a good thing to clarify in the statute
20 as well.

21 MR. YERES: For that purpose, coming back to
22 GCP for a moment, of course the structure that
23 will ultimately be used, and I certainly hope one
24 would be used for GCP, will have to be developed
25 before we go to try to seek a bankruptcy change.

1 We may not even have any bankruptcy issue or we
2 may need a particular fix in order to, for
3 example, assure the FCMs the comfort they need in
4 respect of the property. So I think I'd like to
5 keep that file open, the comment file open
6 awhile.

7 MR. WASSERMAN: Fair enough. I'd like to
8 thank you all for coming, particularly the
9 panelists, but also the audience. And we will be
10 having, of course, additional sessions tomorrow
11 starting at 9:30 a.m. very promptly. Take care
12 and have a good evening.

13 (Recording concluded.)

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