

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION

GLOBAL MARKETS ADVISORY COMMITTEE MEETING

Washington, D.C.
Wednesday, December 9, 2009

1 PARTICIPANTS:
2 CHAIRMAN GARY GENSLER
3 COMMISSIONER MICHAEL DUNN
4 COMMISSIONER BART CHILTON
5 TERRY ARBIT
6 THOMAS CALLAHAN
7 GEORGE CRAPPLE
8 BERNARD DAN
9 MICHAEL DAWLEY (Participate by phone)
10 DAVID A. DOHNALEK
11 PROFESSOR RON FILLER
12 SEBASTIJAN HROVATIN (EU)
13 PETER KARSTENS (EU)
14 ROGER LIDDELL (Video Conference)
15 BONNIE LITT
16 JOANNE MEDERO
17 JACKIE MESA
18 JAMES NEWSOME (Participate by phone)
19 JIRO OKOCHI
20 PATRICK PEARSON (EU)
21 ANADAN RADHAKRISHNAN
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1 PARTICIPANTS (CONT'D)

2 ERIC VINCENT

3 BOB WASSERMAN

4 DONALD WILSON

5 DAVID WRIGHT (EU)

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

2 (1:14 p.m.)

3 COMMISSIONER SOMMERS: Good afternoon.

4 I think we'll go ahead and get started. I want to
5 start off by thanking everyone for being here this
6 afternoon. I know travel in from either New York
7 or Chicago was not easy this morning, so I really
8 appreciate you all being here.

9 Today is our 13th meeting of the Global
10 Markets Advisory Committee. This advisory
11 committee was created in 1998 to report and make
12 recommendations to the Commission to be utilized
13 by the Commission to obtain input on international
14 market issues that affect the integrity and
15 competitiveness of U.S. markets and U.S. firms
16 engaged in global business.

17 It is interesting to look back at the
18 agendas of the past 11 years to note that in June
19 of 2004 the discussion revolved around global
20 clearing and regulatory coordination between
21 nations. While the issues we are struggling with
22 today have been brought into focus by the

1 financial crisis that unfolded over the past year,
2 it's somewhat daunting to remember these issues
3 have been at the forefront of importance with
4 respect to the futures markets for many years.

5 We are meeting today to obtain the views
6 of the committee members on bankruptcy issues with
7 an emphasis on how the insolvency regime in the
8 U.S. compared to the insolvency regime in the
9 U.K., particularly in the case of the bankruptcy
10 of Lehman Brothers Holdings and Lehman Brothers
11 International Europe. We will also discuss global
12 financial regulatory reform.

13 This dialogue could not come at a more
14 crucial time for market regulators as we consider
15 the proposals for harmonizing regulation and
16 closing regulatory gaps.

17 Policymakers face the challenge of
18 reshaping financial market oversight, to better
19 serve the public by strengthening regulation where
20 needed and eliminating inefficiencies where
21 possible. The questions surrounding most issues
22 are enormously complex and require thoughtful

1 resolutions. Comprehensive financial reform will
2 not be easy but it is moving forward, and I
3 believe reform is important to restore confidence
4 in the system.

5 International coordination is also
6 essential to ensure comprehensive regulation of
7 the over-the-counter derivatives markets. We must
8 not leave gaps in our regulatory structure that
9 allow traders to evade one country's regulations
10 by taking their business elsewhere. The
11 Commission has been working not only with our
12 fellow regulators here in the U.S. but with our
13 international counterparts to prevent
14 opportunities for regulatory arbitrage.

15 Through discussions with regulators in
16 Europe we have found that proposals in the U.S.
17 and in Europe are complimentary, and we're pleased
18 to tell you that today with us is David Wright,
19 the Deputy Director-General for Internal Market
20 and Services of the European Commission, to
21 discuss issues of mutual importance to U.S. and
22 European policymakers.

1 And joining Mr. Wright is Patrick
2 Pearson, Head of Financial Markets Infrastructure
3 at the European Commission, and Sebastijan
4 Hrovatin, Administrator of Financial Markets
5 Infrastructure of the European Commission, and
6 Peter Kerstens, the First Counselor of Economics
7 and Finance with the Delegation of the European
8 Union to the United States. The Commission is
9 honored to be hosting our colleagues from the
10 European Commission and we hope for a productive
11 discussion comparing and contrasting the European
12 derivatives proposals with U.S. proposals.

13 I'm now going to turn to my fellow
14 commissioners but first want to welcome three new
15 members of GMAC that are joining us today: David
16 Dohnalek from the Boeing Company is here with us.
17 Don Wilson from DRW Trading Group is with us, and
18 Jiro Okochi is here from Reval. So thank you to
19 all three of you for your participation in the
20 GMAC, and we welcome you here today.

21 I'm now going to turn to our Chairman
22 for his opening statement.

1 CHAIRMAN GENSLER: Thank you, good
2 morning. Thank you, Commissioner Sommers, for
3 chairing today's meeting of the Global Markets
4 Advisory Committee. This is my first GMAC
5 meeting.

6 As Chairman of the Commission I look
7 forward to today's discussion. I think I've met
8 many of the committee members before, but look
9 forward to getting to know each of you, and I,
10 too, welcome Don, and David, and Jiro to the
11 committee.

12 I also want to give a particular warm
13 welcome and thanks to David Wright who not only,
14 for all the reasons Jill said about the need for
15 coordination with the European Commission and
16 being here today, but I also want to thank you
17 because the last time I saw David was in Brussels
18 where I was honored. As he invited me over to
19 speak to a group, or as the European Commission's
20 Conference of Over-the-Counter Derivatives Reform,
21 he did put me in a room with about 400 people and
22 put me on the dais, and then they didn't let me

1 leave for three or four hours. And I took a lot
2 of very interesting and probing questions from
3 end-users.

4 But I really -- it's a great honor,
5 David, you're here with your colleagues Sebastijan
6 and Patrick, and -- is it Pierre or Pieter?
7 Pieter -- and I look forward to ongoing
8 cooperating with the European Commission on
9 bringing comprehensive reform to the
10 over-the-counter derivatives marketplace.

11 I mean, last year's financial crisis
12 really just reminded us what we knew, that our
13 financial markets are global in nature. Capital
14 and risk knows no geographic boundaries, and that
15 what we have to do to respond to the worst crisis
16 in 80 years, it is a response which needs to be
17 global. In the United States, our legislative
18 process is in full swing, as you know. This week
19 the House of Representatives is debating the
20 regulatory reform package that introduces
21 comprehensive reform for over-the-counter
22 derivatives for the first time. It is truly

1 historic what the House is taking up this week.

2 The Senate, of course, will have their
3 process and their own procedures. And, hopefully,
4 with the support of the House later this week, the
5 CFTC will continue to work with both chambers
6 providing both advice and technical assistance to
7 bring the most comprehensive and effective reform
8 forward.

9 Fortunately, I think it's that the U.S.
10 is not alone in this, and in October the European
11 Commission, with a lot of help from the four
12 gentlemen that are in the room here, announced a
13 broad agenda of regulatory reform in derivatives.

14 The Commission's plan included similar
15 provisions to what we have been recommending here,
16 so though we have different cultures and different
17 political systems, we're dealing and grappling
18 with the same problem, and it appears -- I'm very
19 optimistic -- it appears we're coming up to the
20 same suggested solutions.

21 The Commission proposals include central
22 clearing -- I should say mandated central clearing

1 -- of derivative transactions that are
2 standardized. It requires higher capital for
3 customized over-the-counter derivatives
4 transactions and mandates trading of all
5 standardized transactions in regulated trading
6 venues. So I'm very encouraged that we're moving
7 in the same direction.

8 Now again, though we have different
9 cultures and political systems, we've been coming
10 together with a consensus, and we're going to
11 continue to have dialogues, and today is an
12 important part of that as well. I think reform
13 starts with bringing transparency to these opaque
14 markets. Economists for decades have recognized
15 that market transparency benefits the public, and
16 if derivative users knew what others were paying
17 to enter into similar contracts, would they not
18 receive better pricing on their transactions?
19 Isn't that really at the heart of what we're
20 trying to do?

21 I mean whether it's a small
22 municipality, or a retailer, or an oil company,

1 they would all be able to make better decisions on
2 their hedging; they would get better pricing on
3 their contracts if it was based upon reported
4 pricing and a broader market. I mean could you
5 imagine an investor buying 100 shares of a
6 security and not knowing where that security just
7 traded? Would you even go into a store and buy an
8 apple if you didn't know where the pricing of the
9 apple was?

10 But that's exactly what we ask end-users
11 to do in the derivatives marketplace right now. I
12 don't know. I mean the bill before the House does
13 a great deal: It subjects Wall Street banks to
14 broad regulatory requirements and also subjects
15 Wall Street banks to a transparency requirement
16 trading with each other where Wall Street banks
17 trading between Wall Street banks would have to be
18 brought into regulated trading platforms and
19 clearing.

20 But as Congress continues to debate
21 regulatory reform in the over-the-counter
22 derivatives marketplace, I believe it's critical

1 that we also bring this to the transactions with
2 the end-users; that we not have exemptions from
3 mandatory trading requirements for standardized
4 transactions. I think that the only group that
5 really benefits from these exemptions is Wall
6 Street, and that end-users, whether they be small
7 municipalities or the largest corporation,
8 benefits from transparency in these marketplace.

9 So during today's meeting, I look
10 forward to hearing participants' views on the
11 global financial system. I specifically would
12 like to hear thoughts on how we're progressing and
13 how that works in an international context. And I
14 know that I've heard from some of the
15 organizations represented around the table that
16 the U.S. should not reform our regimes until
17 foreign regulators reform theirs. I actually
18 think it's in reverse. I think that if we don't
19 reform our regulatory system, others around the
20 globe will fail to reform theirs.

21 And we've got a great consensus right
22 now. I thank our friends from Europe for being

1 here and all the committee members, and I turn it
2 back to Jill and my other commissioners.

3 COMMISSIONER SOMMERS: Thank you, Mr.
4 Chairman. Commissioner Dunn?

5 COMMISSIONER DUNN: Thank you, Madam
6 Chairman, for convening this Global Market
7 Advisory Committee. I look forward to hearing
8 from the experts gathered here today and hope that
9 their thoughts and insight can help to inform the
10 Commission of recently confronted bankruptcy
11 issues and on the various over-the-counter
12 derivatives proposals.

13 It is important that we take the time to
14 look at the global impact that the financial
15 meltdown has had on the sector of the financial
16 market that the CFTC regulates. We need to review
17 the lessons learned and understand the
18 shortcomings of our current domestic and global
19 regulatory regimes. And, most importantly, we
20 need to work with regulators around the world to
21 address those issues that are identified.

22 While Thomas Freedman's notion that the

1 world is flat has gained mainstream acceptance in
2 recent years, it is also clear to me that not only
3 does equal opportunity exist in our global
4 marketplace but also a degree of interdependency.
5 What we do here in the U.S. affects markets around
6 the world and actions taken around the world
7 affects markets here. Accepting the existence of
8 global interdependency, we as regulators must work
9 harder to understand developments around the world
10 and be more cognizant of the global effects that
11 our own actions may have. The world's regulatory
12 bodies must work in harmony to address needed
13 changes to prevent future financial crisis, and if
14 one does arrive, be prepared to face it on a
15 global playing field.

16 Today we'll examine some of the concerns
17 that became evidence over the last couple of years
18 and discuss what actions are necessary to address
19 these actions. We're really taking our cue from
20 the heads of states. At recent G-8 and G-20
21 meetings have resulted in heads of states calling
22 for the need for regulators to address excessive

1 price volatility [sic] and energy and agricultural
2 markets. The September G-20 called for work by
3 regulators in four areas: collect data on large
4 concentrations of trader positions on oil
5 commodity markets; implement a data collection
6 system covering OTC oil markets; publish more
7 detail and disaggregated data and analyze the
8 issue of excessive volatility; and review of
9 possible measure to prevent market manipulation.

10 International organization of security
11 commissions has reconvened its commodity futures
12 market task force to address the G-20 directives.
13 If we are to make headway in providing true global
14 reform, it is important that we embrace this
15 notion of global interdependency and work together
16 to diligently and quickly provide the world
17 meaningful financial regulatory oversight.
18 Today's meeting is a milestone in the journey to
19 achieve that end.

20 I thank all of you for your
21 participation and work.

22 COMMISSIONER SOMMERS: Thank you,

1 Commissioner Dunn. Commissioner Chilton?

2 COMMISSIONER CHILTON: Thanks, Madam
3 Chair, and welcome to everybody, particularly our
4 new members. And thinking about sort of half of
5 the continental United States as encumbered with
6 some sort of severe weather today, I'm pleased
7 that everybody was able to get here or will be
8 here. It made me think of a talk I gave last year
9 which was entitled Driving On Ice.

10 And what I said about regulatory reform,
11 the analogy I tried to make was that when you're
12 driving in bad weather, when you're driving in ice
13 that maybe, if you veer too far one way -- and I
14 made the analogy that we may be veered too far to
15 the right since 1999 with banking and mortgage and
16 deregulating credit and false swaps -- that we
17 need to be careful not to oversteer and to go back
18 too far; that the middle of the road sometimes is
19 a good place to be. And I think there's a
20 recognition that there are appropriate guard rails
21 on this road to regulatory reforms, metaphorical
22 road to regulatory reform, that we can all agree

1 on whether or not we're first or the E.U. is
2 first. It doesn't bother me. I associate my
3 remarks with the Chairman, I don't have a lot of
4 trepidation about going first just as long as we
5 do it in a fashion that isn't overzealous.

6 The first speed limit in the world was
7 in Britain. It was two miles an hour in 1865.
8 That's in the city for horseless carriages; four
9 miles an hour in the country, and you had to have
10 three people: two drivers and another fellow
11 walking out in front of the horseless carriage
12 with a red flag waving it. Now that's
13 overzealous.

14 So as long as we are thoughtful -- and
15 keep in mind what our end game is and that's
16 protecting consumers -- and to my mind protecting
17 consumers means ensuring that the commercial
18 interest, the reason these markets sort of began
19 are able to legitimately use the markets to hedge
20 the risk and price discovery, I mean it doesn't
21 ultimately become what people are concerned about
22 it, justifiably or not, a private jungle gym for

1 speculators, to play on, that I think we'll get it
2 right.

3 And in particular, if we look, if that
4 wasn't enough reason to move forward with
5 thoughtful regulation, if you look at what's been
6 going on just this week in the U.S. with EPA and
7 their designation of carbon and what they're
8 talking about in Copenhagen -- and Commissioner
9 O'Malia may have a better clue than I since he's
10 been up on the Hill more recently -- but I
11 wouldn't be surprised if we don't have some sort
12 of cap and trade bill at some point that could
13 equal a \$2 trillion transactional market, the
14 largest physical commodity market in the world,
15 more than better -- larger not better -- larger
16 than crude oil.

17 So without additional authority like the
18 Chairman was talking about from Congress,
19 additional rulemaking changes from the CFTC
20 without the additional staff that Commissioner
21 Dunn's talked about so many times, the additional
22 resources, there's a whole host of problems that

1 we can open the door for.

2 But in summation, I'm not worried about
3 going forward as long as we get it right. As long
4 as we keep our eye on the ball and think about,
5 you know, we're going to protect consumers, and I
6 think we'll be fine.

7 Thanks, Madam Chair.

8 COMMISSIONER SOMMERS: Thank you,
9 Commissioner Chilton. Commissioner O'Malia?

10 COMMISSIONER O'MALIA: It's no fun
11 following Bart. Really, 1865? I don't think it
12 was four, I think it was in kilometers at the
13 time.

14 SPEAKER: We have the question. Read
15 the footnote.

16 COMMISSIONER O'MALIA: Okay. Thank you,
17 Commissioner Sommers, for organizing this meeting,
18 and I appreciate the willingness of all the
19 participants, including our friends from Europe,
20 to join us today to share their views and
21 knowledge with the Commission regarding the state
22 of our global over-the-counter markets and the

1 opportunities for regulatory reform.

2 In response to the financial crisis,
3 both the United States and European Union
4 regulators have recommended significant reforms to
5 these markets. Both proposals seek to better
6 manage risk, increase transparency through
7 improved trade reporting, and expand the use of
8 clearing to minimize counterparty trading exposure
9 and reduce systemic risk.

10 This meeting is timely and will provide
11 the Commission with the opportunity to compare
12 U.S. and E.U. proposals to regulate these
13 increasingly global markets. According to the
14 Bank of International Settlements, the global OTC
15 market size is estimated at \$600 trillion. Over
16 90 percent of the Fortune 500 companies use these
17 products in the course of business to hedge risk,
18 manage global activities ranging from interest
19 rates, foreign exchange commodities, and the CDS
20 market. As regulators, we must be cognizant that
21 the U.S. is not the center of all trading and
22 markets. In fact, 80 percent of all OTC trades by

1 value are executed in markets outside the U.S.
2 Interest rates make up \$420 trillion of the \$600
3 trillion OTC markets with over 74 percent of
4 trades done overseas.

5 Foreign exchange trades are worth \$50
6 trillion and with roughly 85 percent of trades
7 executed outside the U.S. We must ensure our
8 cross-border rules and regulations do not offer
9 opportunities for regulatory arbitrage or
10 undermine U.S. Competitiveness.

11 I hope to see a regulatory framework put
12 in place that will establish clear market rules
13 for years to come and to enable these markets to
14 serve as a cost-effective mechanism in managing
15 commercial risk. The rules we put in place today
16 also must expand our capability to identify and
17 management systemic risk for the future.

18 I'm pleased to have several experts here
19 to provide the views on U.S. and regulatory
20 reforms, and I look forward to their
21 presentations. Thank you.

22 COMMISSIONER SOMMERS: Thank you,

1 Commissioner O'Malia.

2 I want to take care of a couple of
3 housekeeping items. The microphones, I think,
4 will not work if there are more than two on at one
5 time, so when you're finished speaking if you'll
6 just turn your mike off. If you have a question,
7 if you'll raise your name placard, we can call on
8 you for questions.

9 And for the court reporter, if you could
10 introduce yourself before asking a question. I'm
11 going to have everybody introduce themselves
12 around the table, but I first wanted to check, we
13 have a couple of members that I believe are
14 participating via telephone: Jim Newsome, former
15 CFTC Chairman and CME board member. Jim, are you
16 on the phone?

17 MR. NEWSOME: I am on the phone,
18 Commissioner.

19 COMMISSIONER SOMMERS: Great. Thank
20 you, Jim. And Mike Dawley who's Chairman of the
21 FIA, I believe was also going to participate via
22 telephone. Mike, are you there? Maybe not, okay.

1 And we are supposed to have Roger Liddell via
2 video conference for this part of the meeting as
3 well, so hopefully that will be hooked up shortly.

4 So I'll start with Eric, if you'd like
5 to go around the table and introduce yourself.

6 MR. LIDDELL: I can hear you and see
7 you, but I don't know if you can hear or see me.
8 Roger.

9 COMMISSIONER SOMMERS: Great, Roger,
10 thank you. Thanks for being with us.

11 MR. VINCENT: Thanks, Commissioner.
12 Eric Vincent. I'm president of Osprai Management
13 and Board Member of the Managed Funds Association.

14 MR. CALLAHAN: My name is Thomas
15 Callahan. I'm Executive Vice President of NYSE
16 Euronext and CEO of NYSE Liffe U.S., the U.S.
17 derivative exchange of NYSE Euronext.

18 MR. OKOCHI: Good afternoon. My name is
19 Jiro Okochi. I'm the CEO and Cofounder of Reval.

20 MR. KLEIN: Good afternoon. My name is
21 Bob Klein. I'm a Managing Director and Counsel at
22 Citi Group.

1 MS. MODERO: I'm Joanne Meedero, a
2 Managing Director of Black Hawk.

3 MR. CRAPPLE: George Crapple, CoChairman
4 and Co-CEO of Millburn Ridgefield. We're a CTA
5 and CPO. I'm also on the Board of the FIA and the
6 NFA.

7 PROFESSOR FILLER: My name is Ronald
8 Filler. I'm a professor of law now and Director
9 of the Center on Financial Services Law at New
10 York Law School.

11 MS. MESA: I'm Jackie Mesa, the Director
12 of International Affairs at the CFTC.

13 MR. WASSERMAN: Bob Wasserman, Associate
14 Director in DCIO here at CFTC.

15 MR. WRIGHT: My name's David Wright.
16 I'm the Deputy Director-General in the European
17 Commission dealing with financial markets.

18 MR. DOHNALEK: I'm Dave Dohnalek,
19 Treasurer of the Boeing Company.

20 MS. LITT: I'm Bonnie Litt. I'm a
21 Managing Director and Associate General Counsel at
22 Goldman Sachs, and I'm also president of the

1 Executive Committee of the Law and Compliance
2 Division of FIA.

3 MR. ROTH: I'm Dan Roth from the
4 National Futures Association.

5 MR. WILSON: I'm Donald Wilson. I'm the
6 Founder and CEO of DRW Trading, which is a
7 proprietary trading group. We focus on providing
8 liquidity in exchange traded markets.

9 COMMISSIONER SOMMERS: Thank you,
10 everyone. I'm going to go ahead and get started
11 with the first part of our meeting, which is
12 having Jackie give us an update on IOSCO issues.
13 Thank you, Jackie.

14 MS. MESA: Thank you, Chairman Sommers.
15 I was hoping that maybe you just ate right through
16 my time, and I would just sit here and pleasantly
17 smile at everyone. But seeing that you're still
18 going to want me to go forward, I wanted to
19 provide an update on IOSCO issues, and IOSCO has
20 been very busy in the last year as you can
21 imagine. So I won't go through everything they're
22 working on but sort of what they've been doing

1 post-crisis.

2 In response to a G-20 call for action,
3 IOSCO formed three task forces: one on unregulated
4 markets and products, one on unregulated entities,
5 and one on short selling. The CFTC participated
6 in two of those, unregulated markets and products
7 and the task forces on unregulated entities. Both
8 task force have released final reports adopted by
9 IOSCO.

10 In the unregulated markets and products
11 report, it focused on two instruments that were
12 viewed to be at the core of the crisis:
13 collateralized debt obligations and credit default
14 swaps. On CDOs, IOSCO felt that because CDOs
15 contained such complex leverage that even an
16 accredited investor sometimes had difficulty
17 understanding the risk. IOSCO recommended several
18 actions: 1) to improve disclosure; 2) encourage
19 members to reconsider the standard of a
20 sophisticated or a credited investor; and finally,
21 ask regulators to examine incentives, and that's
22 typically known as the skin in the game

1 requirement.

2 Regarding CDS, IOSCO encouraged
3 standardization of products. For those that were
4 standardized, IOSCO encouraged clearing and
5 exchange trading of those CDSs and recommended
6 that counterparties have appropriate capital and
7 margining for nonstandardized products. As you
8 can see, I think the U.S. and E.U. and other
9 countries have moved generally in that direction
10 which was the agreement of regulators very early
11 on right after the crisis.

12 Currently, both of these task forces are
13 considering monitoring the implementation of the
14 recommendations and are considering particularly
15 with the unregulated markets and products if this
16 can be extended to all OTC products.

17 On unregulated entities in June 2009,
18 the TC endorsed and published a report and
19 recommended six principals for hedge fund
20 regulation: 1) Hedge fund managers should be
21 subject to mandatory registration; 2) that hedge
22 fund managers which are required to be registered

1 should be subject to appropriate ongoing
2 regulatory requirements -- and there are a number
3 of details which I won't go through here; but
4 they, prime brokers and banks providing funding to
5 hedge funds, should be subject to mandatory
6 registration and regulation and a public oversight
7 system and have them place appropriate risk
8 management systems and controls; that hedge fund
9 advisors and fund brokers should provide to the
10 relevant regulator information for systemic risk
11 purposes. This is the area that IOSCO is working
12 on now and trying to go forward on a united front
13 on what information they're going to collect from
14 hedge funds; 5) that regulators should encourage
15 and take account of the development,
16 implementation, and convergence of the industry
17 good practices where appropriate; and 6) that
18 regulators should have the authority to cooperate
19 and share information.

20 IOSCO is also up getting its 30
21 principles for regulation for securities and
22 futures regulators and is going to adopt at least

1 three new principles: 1st) on systemic risk; 2nd)
2 on the perimeter of regulation; and 3rd) for
3 credit rating agencies, auditors, and other
4 "information providers."

5 There are also separate standards for
6 clearing and settlement systems, i.e., the IOSCO
7 CPSS standards. These are also going to be under
8 significant review. Right now IOSCO is reviewing
9 these standards to update for OTC clearing but
10 during this update, discovered that there are a
11 number of areas that needed significant review and
12 update and have agreed to go forward and revise
13 those principles.

14 I'm going to address a couple more areas
15 that IOSCO is looking at. One is direct
16 electronic access, and the reason I'm pointing
17 this out is because this was the subject of the
18 last GMAC meeting where we had significant
19 discussion.

20 IOSCO did put out a report in this area
21 for consultation, and one of the primary
22 recommendations was that markets should not offer

1 direct electronic access unless they can ensure
2 automatic pretrade controls that allow the
3 responsible firms the ability to limit the market
4 members' exposure.

5 Although a majority of commentators
6 supported the proposed principles, some objected
7 to mandating the use of automated risk limits
8 controls as an infringement on their activities.
9 Their standing committees are still looking at
10 comments and deciding what is appropriate given
11 the high speed algorithmic trading that occurs
12 today and making sure that regulators are up to
13 date and in their rules and regulations.

14 And, finally, the last point I'm going
15 to talk about is the commodity futures markets
16 task force, and it's the subject that Commissioner
17 Dunn highlighted in his opening remarks. This is
18 a call by the G-20 to specifically look at oil
19 markets and how regulators can handle the
20 volatility over the last couple of years in the
21 oil markets. Specifically, they asked for us to
22 look at large concentrations and to look at on

1 exchange and over-the-counter.

2 We met just Monday in London, so sorry
3 if I look a little tired. I just flew back, and
4 some of you flew here today as well. And it was a
5 very good meeting, and there was substantial
6 progress made during the meeting on Monday.
7 Regulators are going to take steps to look at oil
8 trading and over-the-counter markets to actually
9 aggregate that data and put it forward for the
10 public and to make sure that they are properly
11 looking for manipulation and other abuses in the
12 oil markets.

13 So that's it for me. Thank you.

14 COMMISSIONER SOMMERS: Thank you,
15 Jackie. Does anyone have any particular questions
16 on the IOSCO projects that are ongoing? If not,
17 we're going to move on to the first part of our
18 meeting, and we are honored to have Ron Filler,
19 who is a long-time member of GMAC, back with us
20 today. Thank you for being here, Ron, and
21 participating as he's going to give us an overview
22 of the bankruptcy issues associated with Lehman

1 Brothers bankruptcy that happened last year.

2 PROFESSOR FILLER: Thank you,
3 Commissioner Sommers. As I mentioned, I am now a
4 professor of law, but I think the reason I was
5 asked to come here is, before joining the faculty
6 at the law school, I was a managing director in
7 the Capital Markets Prime Service Division at
8 Lehman Brothers for over 15 years where my
9 responsibilities included a variety of business
10 and legal issues affecting Lehman's global futures
11 business.

12 So I hope to use those perspectives and
13 during my 30-plus years in this industry, I've had
14 the opportunity and privilege of serving on a
15 number of governmental exchange industry and
16 clearing house boards and advisory committees.

17 And I want to thank Commissioner Sommers
18 for using this forum to bring this issue to this
19 discussion. This issue goes to the very heart and
20 purpose of our industry, and that's the providing
21 soundness and safety to customers who trade not
22 only futures but this issue has also got to be

1 addressed by this agency; and, as Commissioner
2 Sommers mentioned, by global regulators as you
3 tackle concepts like portfolio margin.

4 I deal with the OTC clearing issues.
5 When you deal with the concept of segregation and
6 the role that segregation should or may play in
7 connection with these and other concepts, so it's
8 a very important issue and it's a global issue.
9 And the task before this Committee is a very
10 challenging one because of the global issues and
11 the differences in the bankruptcy laws that exist
12 around the world.

13 So let's go back to September the 15th,
14 2008, a little over 15 months ago -- it seems like
15 a lifetime -- but on Monday morning, September the
16 15th, 2008, as you may remember and I have a paper
17 for you that has a lot of the facts in it --
18 Lehman Brother Holding, the parent holding company
19 of Lehman and of all of its affiliates, filed for
20 bankruptcy. And many of the Lehman subsidiaries
21 around the world also filed for bankruptcy that
22 same morning.

1 Lehman Brothers, Inc., that regulated
2 broker dealer in FCM, does not file for
3 bankruptcy; it still has the necessary capital to
4 play the game, although by the end of that week on
5 September the 19th that entity, the LBI, also
6 files for bankruptcy. And while Lehman has, I
7 think when we filed our org. chart listing all the
8 different maps, material-affiliated persons,
9 probably a chart of some 200 different companies,
10 I want to focus just on those Lehman entities that
11 held or dealt with futures clients.

12 So you have LBI here, Lehman Brothers,
13 Inc., in the U.S. You have Lehman Brothers
14 International, Europe, or LBIE, or Lehman London.
15 You have Lehman Brothers, Japan, which was the
16 clearing member of the three exchanges in Tokyo.
17 You have Lehman Brothers Futures, Asia Limited, or
18 which was a clearing arm in Hong Kong, and you had
19 Lehman Brothers PTE, which was the clearing firm
20 on the SGX Exchange in Singapore. And the way the
21 Lehman system was structured from a futures
22 perspective, LBI -- only LBI and LBIE held client

1 accounts. LBI probably had about 65 percent of
2 the business, and LBIE had about 35 percent of the
3 business.

4 And also what's important in this,
5 thinking about the structure and the issues that
6 we're about to talk about, LBI would then have a
7 customer omnibus account with each of the other
8 Lehman affiliates around the world that acted as
9 the respective clearing member on those clearing
10 houses. And to the extent Lehman did not have a
11 clearing membership on some of the exchanges,
12 where we use a third-party clearing firm, LBI
13 would have the customer omnibus account with those
14 third-party firms.

15 So LBIE was the clearing arm for Europe,
16 LBI was the clearing arm for the U.S. and had the
17 relationships with all of the other Lehman
18 affiliates primarily in Asia. So when Lehman
19 Brother Holdings filed for bankruptcy, and if you
20 also remember Monday, September the 15th, the
21 markets were extremely volatile that day. So I
22 think it's best in looking at the picture and to

1 try to figure out what issues, what reforms, what
2 concepts need to be addressed, I like to separate
3 what happened here in the U.S. and then look what
4 happened outside the U.S. for discussion purposes.

5 In the U.S., I think with the exception
6 of one small glitch which we're going to talk
7 about, the system worked pretty well. Monday
8 morning -- and Lehman's client business was
9 strictly institutional, probably some of the
10 premier mutual funds, pension plans, state
11 retirement plans, money managers, hedge funds,
12 corporations, and governments -- we really had, I
13 considered, a premier list of institutional
14 clients.

15 Many of them had multiple clearing
16 relationships. They would be not only using
17 Lehman as their clearing firm but they would have
18 clearing relationships with other clearing firms
19 on the street. And those firms that had clearing
20 relationships with those clients, had accounts
21 with us, that also had an account at another firm,
22 obviously, with the news breaking that morning,

1 they started sending us what we call a, in the
2 industry, an ex-bid transfer letter requesting
3 that their open positions be transferred off the
4 books of Lehman, LBI, to the other clearing firms.
5 And in the course of that week that's what
6 happened.

7 Monday night the positions that we got
8 letters for removed to other firms. Tuesday --
9 that happens after the close of business on Monday
10 -- Tuesday morning we all come in and the
11 positions were closed out and therefore no open
12 positions remained on the books of Lehman for that
13 account. We then transferred the assets that we
14 use for margin patch and collateral to the
15 clearing member that received those positions on
16 close of business that night.

17 Tuesday night -- Tuesday during the day
18 the same thing happened. We got another lot of
19 requests, and Wednesday morning we transferred the
20 funds. Wednesday night we had -- Wednesday during
21 the day, we got more requests. Everything was
22 working smoothly until Thursday. And that's the

1 one glitch that, to be honest, I don't have an
2 answer for you. I know it's an answer or an issue
3 that maybe the Commission is looking at, but our
4 custodial bank, J.P. Morgan Chase, for whatever
5 reason -- and I have never seen the reason behind
6 it -- froze the assets that were held in the
7 segregated account. And so while all the
8 positions got moved that week and the moneys had
9 been flowing out in a very smooth way Monday,
10 Tuesday, Wednesday and so forth, on Thursday those
11 assets were frozen. But through the great efforts
12 of the Commission staff and others in the
13 industry, about -- was it eight or ten days later?
14 -- J.P. Morgan eventually did move the cash and
15 collateral that we held with that bank over to the
16 respective clearing firms that receive it.

17 So addressing the U.S. approach, I would
18 say the systems worked. The laws dealing with
19 segregation, the regulations dealing with
20 segregation under 1.20, it worked for the most and
21 very successful. And by the close of business on
22 Friday, September the 19th, if you recalled after

1 the close of business that day, those clients who
2 did not have a clearing account at another firm,
3 all of their positions were moved to Barclay's
4 Capital which bought all of the client assets and
5 accounts at Lehman after the close of business on
6 that Friday.

7 So by the close of business of that week
8 the great news is all the positions and eventually
9 all of the moneys flowed over to the customers and
10 clearing firms, I should say, where the customers
11 now had accounts.

12 So the system works here, and it worked
13 pretty well. Now let's turn our attention --

14 CHAIRMAN GENSLER: Could I just ask one
15 quick question?

16 PROFESSOR FILLER: Sure.

17 CHAIRMAN GENSLER: What portion moved
18 during the week versus the Barclay's portability
19 at the end of the week?

20 PROFESSOR FILLER: You mean the last
21 part of the piece?

22 CHAIRMAN GENSLER: Yeah. I mean did,

1 you know --

2 PROFESSOR FILLER: The answer, Chairman
3 Gensler, is there was just those client accounts
4 that did not have a multiple clearing
5 relationship. I don't know the exact number, but
6 I'd probably say it's about 25, 30 percent. I
7 may be wrong in that number, it's a guess on my
8 part.

9 CHAIRMAN GENSLER: And so the vast, or
10 the majority, maybe 70-75 percent has moved
11 already.

12 PROFESSOR FILLER: Correct.

13 CHAIRMAN GENSLER: And 20 --

14 PROFESSOR FILLER: This was just -- and
15 it was impossible for those firms or clients to
16 open up an account that quickly that week with all
17 the things going on. And with Barclay's acquiring
18 all of the accounts that still remained on the
19 books of Lehman that day, the good news is all the
20 client positions got moved healthily.

21 CHAIRMAN GENSLER: Right. And just to
22 clarify, this is all just futures, it's not what

1 happened with prime or (inaudible) --

2 PROFESSOR FILLER: Prime or futures got

3 --

4 CHAIRMAN GENSLER: -- got force swaps.

5 PROFESSOR FILLER: IMF futures got --

6 CHAIRMAN GENSLER: Right. Right, so --

7 all right, thanks.

8 PROFESSOR FILLER: No, the swap world
9 we're still dealing with. And it's interesting
10 what you raise because the equity world is
11 slightly different than the futures, and, you
12 know, a lot of people will say, boy, it took five
13 days to move those futures positions. To me
14 that's a good thing. Some people say it should
15 have been done in one day or two days or three
16 days. But when you compare the futures regime to
17 even the equity regime, it's a much better regime
18 to facilitate transfers of both positions and
19 collateral to another firm.

20 Outside the U.S. we got a bigger issue,
21 and that issue I think if you talk to any lawyer
22 in this room, prior to September the 15th you

1 would have got a different answer to the question
2 about the raise or the issue than what we now
3 know. And what we learned post-Lehman is that the
4 bankruptcy laws trump all the regulations that we
5 have in place to protect customers. And the
6 bankruptcy laws in London and Japan and Hong Kong
7 preempted all of the rules and regulations and
8 customer protections that we thought were in place
9 within the connection with both not only LBI but
10 LBIE clients as well.

11 London, as you know, the U.K. has a
12 client money rule regime which is very similar to
13 the segregation rule here. There are some subtle
14 issues dealing with what happened in London, but
15 the concepts of customer protections are quite
16 similar between London and the U.S., but the
17 bankruptcy laws differ significantly outside the
18 U.S. versus what we have here. And if you think
19 about one of the more forward-thinking concepts
20 that we have here in the U.S. regarding bankruptcy
21 laws, we have specific provisions under the U.S.
22 bankruptcy code that deals with the bankruptcy of

1 a securities firm called SICP.

2 We have a different set of provisions
3 dealing with the bankruptcy of a commodity firm
4 and it's called "segregation," and the rules in
5 specific behind provisions, I should say, under
6 the bankruptcy code, all of which are designed to
7 protect the client assets against the claims of
8 creditors of the bankrupt firm.

9 So our regime is pretty good. But now
10 that you're considering portfolio margining,
11 you're considering OTC clearing, there is no
12 concepts of swap dealers in those codes.

13 There is no -- and the issue that we
14 deal with in the U.S., and it varies even between
15 securities and futures, is a concept called,
16 specifically, an identifiable property. How do
17 you treat assets of a bankrupt estate that
18 belonged to a particular individual versus cash.
19 And with futures margin and with OTC clearing with
20 cash being a principal player, you got to be very
21 careful and you got to address these issues just
22 to make sure customer assets are protected down

1 the road.

2 Now let's go across the ocean. Monday
3 morning, as I said, all four of these Lehman
4 affiliates as well as many others file for
5 bankruptcy in their respective countries. So I'm
6 going to focus mainly on LBIE, meaning Lehman
7 London, but the issues that happened in London
8 also exist as we speak in Japan and Hong Kong,
9 Singapore, and everywhere else. Morning the U.K.
10 government appoints, as you know, Price Waterhouse
11 Cooper as the administrator. And the
12 administrator is very similar to the concept of
13 bankruptcy, a trustee in bankruptcy that we have
14 here.

15 And PWC comes in Monday and really
16 doesn't allow any transactions, transfers, or even
17 positions liquidations to occur. Tuesday they do
18 not allow any transfers or position liquidations
19 to occur. By Wednesday afternoon, through a lot
20 of pressure, through put on by the PWC through a
21 lot of other entities, they finally allowed
22 positions to either be liquidated or transfers to

1 other firms.

2 Now I want to give some special credit
3 right now to LCH Clear Net. I know Roger is going
4 to be talking in a second.

5 I want to give special credit to Andreas
6 Preuss at Eurex Clearing. Those two clearing
7 houses stepped up to the plate and really helped
8 what's happened on Thursday and Friday of that
9 week. On Thursday and Friday, every customer
10 position held at LBIE got transferred to other
11 firms, and, to me, in a two-day period it was a
12 miraculous transfer. But by the close of business
13 on Friday, September the 19th, no Lehman entities
14 held any customer position. That's the great
15 news.

16 The bad news is not one dollar has been
17 transferred out of the bankruptcy estate in the
18 past 15 months. Margin, as we all know, are used
19 to provide risk protections to the clearing firms,
20 and when the positions are liquidated or
21 transferred and there's no longer a need for
22 margin, there's no longer a need for the clearing

1 ember to hold that cash or collateral for margin.

2 By September the 19th with all the
3 positions around the world transferred out,
4 there's no longer a need for the margins to be
5 held by any of the bankrupt estates, but because
6 outside the U.S. as same pot that the futures
7 margin was held, you have securities margin, you
8 have OTC swap margin or cash, or collateral, and
9 when you have the one-pot approach issue, they're
10 not going to allow the moneys that are held that
11 were strictly for futures to be released until
12 they resolve the entire pot.

13 And that's one of the issues that I hope
14 that this committee and the Commission through
15 IOSCO or whatever, how do we address the
16 bankruptcy provisions globally? Bring them up to
17 some level where clients of a bankrupt estate do
18 receive the necessary protections, and not only to
19 protection of the assets but the rights to get the
20 assets distributed if the risks are no longer
21 associated. The products are no longer on the
22 books of the bankrupt estate and no longer in the

1 PROFESSOR FILLER: It's the margin --

2 CHAIRMAN GENSLER: -- the current assets

3 --

4 PROFESSOR FILLER: -- the margin that
5 was there in September of 2008 --

6 CHAIRMAN GENSLER: Still sits there
7 today.

8 PROFESSOR FILLER: -- still sits there.
9 The counterparty might have had the trade moved,
10 but the --

11 CHAIRMAN GENSLER: Right, and so --

12 PROFESSOR FILLER: Then they had to have
13 a lot of lawyers chase after the margin.

14 CHAIRMAN GENSLER: Well, if you think
15 about it, the client base were a lot of large U.S.
16 mutual funds and pension plans who had a global
17 trading strategy. Maybe they were trading
18 equities globally, and they used the stock index
19 futures outside the U.S. as a hedge. Those
20 positions --

21 SPEAKER: (inaudible)

22 CHAIRMAN GENSLER: I understand that.

1 So in the U.S. The position and the marge moved

2 --

3 PROFESSOR FILLER: Correct.

4 CHAIRMAN GENSLER: -- by Friday. There

5 was --

6 PROFESSOR FILLER: Well, the margin with
7 a little bit of a glitch.

8 CHAIRMAN GENSLER: Yeah. There was a
9 glitch by Friday it moved, right, that J.P.
10 Morgan glitch?

11 PROFESSOR FILLER: Well, it was about a
12 week later the margin got -- but it got moved.

13 CHAIRMAN GENSLER: But in Europe the
14 positions were moved but not the margin.

15 PROFESSOR FILLER: Correct.

16 CHAIRMAN GENSLER: I got that.

17 PROFESSOR FILLER: A couple of changes
18 around the world chose not to allow the transfers.
19 They were smaller amount.

20 They were not significant to our client
21 base, but a couple of smaller changes chose to
22 liquidate and not allow the transfers to occur.

1 So those are probably the exceptions on the
2 positions, or the open positions. But as you're
3 going to hear probably today from other speakers,
4 the issues outside the U.S. are not just
5 futurecentric; it's because of the one-pot
6 approach for all products you have that issue that
7 needs to be addressed and try to figure out what
8 reforms, either legislative or regulatory, are
9 needed to provide greater protections to
10 customers, because it is a global market.

11 MS. LITT: Ron, in the jurisdictions
12 where positions were liquidated, what happened to
13 the release of margin in connection with those
14 positions?

15 PROFESSOR FILLER: No difference.

16 MS. LITT: No difference. It was all
17 held up, yes.

18 PROFESSOR FILLER: It was. Those are
19 both European exchanges, Bonnie.

20 MS. LITT: Mm-hmm.

21 PROFESSOR FILLER: And LBIE had a
22 customer omnibus account --

1 MS. LITT: Right.

2 PROFESSOR FILLER: -- and they've still,
3 to my knowledge they're still holding them. And
4 they may have been returned to PWC. I don't know
5 the answer to your question.

6 The same thing happened with LCH and
7 UREK. We had a lot of client margins, obviously,
8 to place with the clearing houses to clear those
9 positions. I really haven't stayed with the issue
10 of what happened. Did PWC collect those assets
11 and still holding those assets?

12 The one thing I have heard, and again,
13 by the way, I was not a Lehman at the time. They
14 invited me back that week to come help, so I want
15 to make that straight. I was in academia land --
16 and, by the way, academic land is great. I
17 haven't followed what happened to the moneys, what
18 happened with the PWC. So at LCH they had a bunch
19 of client assets because Lehman was clearing.
20 When the positions got moved, did they give it to
21 PWC?

22 And the one thing I have heard, and I

1 can't verify this, is that the assets around the
2 world are still protected, still being held? It
3 just haven't been released, so that's the key part
4 of the issue.

5 COMMISSIONER SOMMERS: Actually, Roger
6 may --

7 MR. NEWSOME: Hey, Ron, this is Jim
8 Newsom.

9 COMMISSIONER SOMMERS: Okay.

10 MR. NEWSOME: One question. On the
11 exchanges that forced liquidation, how quick was
12 the liquidation period and how damaging was that
13 to the customers?

14 PROFESSOR FILLER: Thank you, Jim. I
15 think they happened on that Wednesday of that
16 week. I mean I was on -- I was brought back, as I
17 mentioned. I was on the phone call with those
18 officials at those exchanges pleading with them
19 from a public interest, public policy perspective
20 that it's not in your interest to liquidate. And
21 we had a home for those, so why not transfer them,
22 let's say, to a Goldman Sachs that night?

1 They're no longer on the books of LBIE,
2 they'll be on the books of Goldman Sachs at that
3 particular exchange, but they just chose to
4 liquidate.

5 Now, the good news is it was a very
6 small portion of the total pot.

7 COMMISSIONER SOMMERS: Eric, do you have
8 a question?

9 MR. CRAPPLE: Ron? Sorry -- when the
10 LBIE positions moved without the money, did the
11 new clearing firms require that margin to be
12 deposited before they would accept?

13 PROFESSOR FILLER: No, I think -- well,
14 as in any exit transfer, you take the positions
15 and expect the margins to come the next day, given
16 the fact that a lot of the clients were, you know,
17 very premier U.S. clients. What happened to
18 those, those clients had to put up extra margins
19 at the new clearing firms just to margin these
20 positions that came on that Thursday and Friday of
21 that week.

22 MR. VINCENT: Ron, I assume that had

1 been bankruptcies before Lehman of other broker
2 dealers in the U.K. whether it's Barings or -- I
3 don't know of any others. But why do you think
4 there was a lack of clarity in this case? Was it
5 something unique to this situation, or was it -- I
6 mean do you think there was a lack of diligence on
7 the part of various market participants about how
8 this regime worked?

9 PROFESSOR FILLER: Sorry -- thank you,
10 George. It's -- I don't have the exact answer to
11 your question, and I think you have to look at
12 Lehman, and you also have to look at the U.K.
13 bankruptcy laws. They have a unique approach to
14 -- much different than what we have here in the
15 U.S. Their approach is if you're the
16 administrator, PWC, and you release the funds, and
17 as it turns out that transfer or distribution of
18 those funds turns out to be an incorrect one,
19 you're personally liable. And they are fighting,
20 as you may know, or trying to wrestle with the
21 courts over there to allow a lot of the assets to
22 be distributed. And to date the courts have not

1 authorized those transfers, and there's a court
2 over there in their U.K. Bankruptcy laws that, to
3 me, needs to be addressed and fixed.

4 We don't have that issue here, but it
5 does exist there. I think that issue as much as
6 anything else has held up the transfer and
7 distribution of the asset. That's my personal
8 opinion, but I haven't been dealing with that on a
9 personal level in over a year.

10 MS. LITT: I also -- and this is
11 somewhat anecdotal -- but I think that to some
12 extent as the complexity of cross-margining and
13 cross-lien relationships and looking at single
14 pools of money to support multiple products and
15 multiple transactions, the possibility of moving
16 pots of money that are sort of clean and neat gets
17 harder.

18 And so if you're a trustee in bankruptcy
19 and you're very worried about the fact that you
20 could be liable for supporting one group of
21 creditors versus another, you're at much more risk
22 if those cross-collateralization arrangements

1 exist which, of course, is, you know, something
2 that we all need to think about as we talk about
3 portfolio margining and multiple SX classes
4 sitting in a single pool of customer funds.

5 PROFESSOR FILLER: But, Bonnie, let me
6 just raise a little slightly different issue --

7 MS. LITT: Sure.

8 PROFESSOR FILLER: -- with futures.
9 Where you're talking about a -- let's take an LBI,
10 LBI had a customer omnibus account with LBIE, and
11 the only positions in that one account, which is
12 the name of LBI on the books of LBIE, were futures
13 positions.

14 Let's say, hypothetically, the margin
15 requirements were \$100 million. I don't know the
16 number. When the positions were moved out by
17 Friday, September the 19th, you can identify that
18 that \$100 million belongs to LBI and the customer
19 of LBI, and I am still uncertain and surprised
20 why, because they've been able to identify that;
21 they haven't released it.

22 Now, I think the answer is, is because

1 this is the one-pot approach and if the swaps or
2 other products had a shortfall, everyone has to be
3 treated in a prorata basis. So I can't distribute
4 a hundred because there may be a 10 percent
5 shortfall, or a 20 percent shortfall, or some
6 other amount. So why haven't they even
7 distributed 50 or 60 percent, or some other number
8 back to the Lehman clients issue? That's the one
9 part I have not heard a proper answer for.

10 COMMISSIONER SOMMERS: I think at this
11 point we'll turn to Bob Wasserman to give -- oh,
12 sure. Commissioner Dunn has a question.

13 COMMISSIONER DUNN: Just a quick
14 question, Ron, because I thought your paper was
15 excellent and your recommendation, 13
16 recommendations that you had in there, of what we
17 ought to be doing is very important.

18 But No. 12 on your recommendations that
19 we -- that comes to the tip of your tongue, I'm
20 sure is to put together a task force to come up
21 with some best practices. And, frankly, I was
22 dismayed that we here at the CFTC did not have a

1 contingency plan available. Fortunately, we have
2 some very dedicated employees like Bob Wasserman,
3 who was on vacation at the time, was working from
4 truck stops calling us, telling us: Here's what
5 you've got to do and here's how we establish it.

6 But that appears to me as something that
7 could be done immediately in concert with our
8 regulator brotherhood to think about these base
9 practices, at least in the futures side establish
10 some of those now, and have these contingency
11 plans so that you're not called back from academia
12 the next time there's such a --

13 PROFESSOR FILLER: Well, a couple
14 comments, Mike. First of all, then acting Walt
15 Lukken, his staff, Ananda and his staff were
16 fantastic that week in September. I was on the
17 phone with them two, three, four times a day
18 bringing information to them, alerting them about
19 current status as well as seeking their assistance
20 on a number of issues. So I want to commend not
21 only Chairman Luken's staff but the staff of DCIO.
22 They were fantastic that week.

1 But the reason I think the task force
2 and why I recommended it, I was on the Barings
3 task force -- what was it, in '95 or '96? -- and,
4 you know, Barings alerted us to a very important
5 and large problem that existed, and I thought that
6 task force really brought together not many people
7 of different types within the global industry, and
8 it came out with a lot of reforms that followed
9 that task force. I thought, if you ever read the
10 task force report, I think it was one of the
11 better reports this industry ever did. And I
12 think the same type of study review, analysis
13 should also be considered in connection with this
14 issue.

15 COMMISSIONER SOMMERS: Bob, if you
16 would, please walk us through from DCIO and from
17 the CFTC's perspective.

18 MR. WASSERMAN: So I'm going to do,
19 ultimately, three things: One of them is to
20 discuss our perspective on what happened to
21 Lehman.

22 The second is to talk about actually an

1 IOSCO project that we're currently leading in
2 terms of understanding and bringing, frankly, out
3 to the world an understanding of what both
4 customer protections regimes and insolvency
5 regimes for investment firms look like.

6 And, finally, talking about some of the
7 things that we're doing now. I want to do the
8 first two of those now, and then the third after
9 Roger Liddell has had a chance to speak.

10 If we could the put Power Point up, or
11 -- thanks. So very briefly, in terms of our
12 perspective as to what happened during the Lehman
13 insolvency, basically, protection of LBI's futures
14 customers worked. They were transferred to
15 Barclay's, not quite on Friday -- actually we had
16 to wait until the bankruptcy court approval which
17 happened at about 1:15 a.m. Saturday morning --
18 and then the process happened, happily, over the
19 weekend so that by the time the markets were open
20 on Sunday, customers who had been at Lehman were
21 transferred to Barclay's.

22 And with minor exceptions, and Ron

1 alluded to that with some of the issues with,
2 well, customer funds, customers did not lose
3 control of their positions or their property. And
4 so, in other words, again, subject to those minor
5 exceptions, at all times futures customers for LBI
6 had control.

7 Protection in other jurisdictions worked
8 somewhat less promptly and effectively, and in
9 most jurisdictions that process is ongoing and in
10 many of them it is unclear that all futures and
11 securities customers will recover the value of all
12 customer property.

13 I'd like to talk a little bit about,
14 from my perspective, what the requirements that we
15 have that contributed to the success of our model.
16 First is that the Act, Section 4d in our
17 regulations require that all customer property be
18 segregated at all times; that no liens on customer
19 property are permitted; and that while we do,
20 under 1.25, have certain arrangements like
21 hypothecation of investments, the full balance --
22 and that's the proceeds from that hypothecation

1 are required to be in segregation.

2 Our bankruptcy code and the Commission's
3 regulations in Part 190 encourage transfers, and
4 those transfers are protected against avoidance
5 under the bankruptcy code 764(b).

6 There are also some circumstances, some
7 factual issues that contributed to our success.
8 Lehman chose to compute their Part 30 secured
9 amount in a manner consistent with 4d; that is to
10 say they chose to require that all foreign futures
11 customers, all of their customers who they were
12 clearing positions for on non-U.S. exchanges, they
13 had their funds and property segregated as part of
14 that secured amount, and they did all customer
15 property rather than the minimum requirements
16 which would be required margin plus accruals.

17 We're also lucky that there was no
18 shortfall on customer property. A number of you
19 will remember Griffin Trading where there was, and
20 things did not work quite as efficiently.

21 And the fact of the matter is that if
22 you have a book of business with no shortfall on

1 customer property, that's valuable. Somebody's
2 going to want to buy that. Indeed -- I mean in
3 this case there was a transfer that included real
4 estate in for some billion dollars, although I
5 think -- I think the value of the book was not
6 that quite so much.

7 And Refco a couple of years ago, the
8 transfer of the book brought into that estate \$200
9 million, just simply the privilege of having that
10 book.

11 I'd like to talk a little bit about an
12 insolvency project that CFTC has been leading at
13 IOSCO. And this is within Standing Committee 3 on
14 Intermediaries, and the purpose is to summarize
15 the regimes for protection of customer property
16 for futures and securities customers in major
17 jurisdictions. And that we have first designed a
18 survey to look at protection of customer property
19 both preinsolvency and as part of the insolvency
20 regime.

21 And I guess one of the important points
22 here is that I think prior to Lehman, a lot of

1 folks were thinking, okay, here are the rules for
2 protection of customer property, and we're going
3 to segregate it, and we're going to follow those
4 rules and make sure people are following that.
5 And every rule will live happily every after,
6 without thinking, well, that's nice, but how does
7 that work in practice when the insolvency comes?

8 And so it's not enough to look how
9 things work in the ordinary course, but then
10 practically, will it work? And this survey covers
11 both periods.

12 We've received preliminary answers to
13 the survey, and we're going to be working with
14 other jurisdictions to clarify those answers,
15 summarize and compare the results, and with the
16 approval of the technical committee to publish the
17 responses in a summary of that, of those
18 responses. And, if practicable, arrive at common
19 principles.

20 And because, of course, this is an
21 organization that works frankly, primarily by
22 consensus, it may or may not be practical to come

1 to consensus as to, at least within this
2 organization, as to what principles there should
3 be. However, I think we're fairly comfortable
4 that simply providing these answers is going to
5 advance the ball significantly.

6 MR. OKOCHI: Bob, what is the time frame
7 for the survey to be complete and potential
8 recommendations are practical solutions?

9 MR. WASSERMAN: Hopefully, within the
10 next six months. And as I say, we've gotten back
11 preliminary answers. I think staff here are going
12 to be working sort of bilaterally with the other
13 jurisdictions to clarify those answers, and we
14 basically are intending by our meeting in April to
15 essentially be able, hopefully, to finalize that.
16 That may or may not be practicable.

17 I'd like to talk over about the
18 preliminary results. Because they are
19 preliminary, I'm not going, in general, not going
20 to be too specific with regards to who said what
21 in the survey.

22 First let's talk about segregation.

1 Some jurisdictions require segregation on a
2 customer-by-customer basis; that is, each
3 individual customer has their own separate pot and
4 therefore is not exposed to their fellow
5 customers. That protects against fellow customer
6 risk, but there is, to be sure, some costs in
7 efficiency.

8 Some jurisdictions permit customer
9 property to be topped up promptly after a periodic
10 reconciliation. So, in other words, you can have
11 -- do over a reconciliation, say, weekly, and if
12 you find out that you don't have enough, you have
13 until the next day to put the money in.

14 Well, that's great. It certainly is
15 better than not doing that, but if an insolvency
16 occurs before the reconciliation or before you've
17 topped up, you've exposed yourself to a shortfall.

18 Debit balances. Some jurisdictions
19 permit a debit balance in one customer's account
20 to offset a credit in another customer accounts,
21 and, for instance, the Reg. 3-3 calculation for
22 security. However, that, of course, leaves

1 recovery dependent on collection from the
2 customers with the debit balances, and it may make
3 transfer less practical.

4 Firm property as a buffer. Our regime
5 permits and, de facto, I think strongly encourages
6 a buffer firm property in the customer account.
7 We require daily reconciliation. If at any time
8 when you do the daily reconciliation you realize
9 that you didn't -- don't have enough money, you do
10 the reconciliation by noon as of the close of
11 business the previous day. If you find that you
12 were undersegregated, you have to report what is a
13 violation.

14 There's a practical matter. More often
15 than not it will be some sort of innocent error,
16 and what'll happen is your self-regulatory
17 organization will be paying special attention to
18 you and make you, you know, write it on the
19 blackboard you won't do it again. But,
20 essentially, it is a violation and, therefore,
21 people want to avoid that. They put extra money
22 in which in the event of insolvency is therefore

1 available. Or, in the event of a large customer
2 loss, again the money's already there, and so
3 therefore there's that additional measure of
4 protection.

5 Some other jurisdictions permit such
6 buffers; some jurisdictions actually prohibit
7 leaving firm funds in the customer account. And,
8 specifically, there's a concern -- the U.K. is one
9 of these -- that there would be possible damage to
10 the trust status; that, essentially, if it's
11 supposed to be a trust for customer funds, then
12 you could only have customer funds in there.
13 Again, the downside of that is there's less money
14 available if and when something bad does happen.

15 Liens and rehypothecation. Some
16 jurisdictions allow liens on customer property
17 with permission of the customer, and some allow
18 the firms to rehypothecate customer property.

19 Well, when you think about it, property
20 that's been subject to a lien or has been
21 rehypothecated may not be available in case of the
22 firm insolvency, in fact, it likely won't be. And

1 I think, frankly, in the case of the U.K. a lot of
2 the difficulties that they have are tied up in
3 that permission, that you have customers who
4 granted permission to have their assets
5 rehypothecated, which essentially undercuts the
6 protection of those assets. And so if you granted
7 a right to use your property, it may not be there
8 for you when you need it.

9 That is the issue -- those are the
10 issues preinsolvency. Let's talk about what
11 happens in the context of the insolvency. Some
12 jurisdictions permit the futures of securities
13 regular control or influence over the selection of
14 a trustee, administrator, or similar officer. In
15 our context, what happens is we've been in contact
16 with the U.S. trustee who tends to select trustees
17 in the case of bankruptcies in Chapter 7, or we
18 were in contact with our colleagues at CIPIC in
19 the case of BCFCM bankruptcy in a CIPRO
20 proceeding, and so essentially there is a greater
21 likelihood of having a trustee and/or an attorney
22 for the trustee who's familiar with the industry,

1 who understands what's going on. Because if you
2 come in there without that understanding, there's
3 a steep learning curve and almost no time to get
4 up that learning curve.

5 Some jurisdictions provide specific
6 guidance for the trustee and, for instance, our
7 Part 190 is pretty much a cookbook as to what it
8 is they're supposed to be doing. Others do not,
9 and, as I say, a customer who's unfamiliar with
10 the industry taking charge in volatile markets,
11 acting without instructions from a regulator, can
12 cause some difficulties.

13 Transferring customers. Our, as I said,
14 our rules and statute encourage the trustee to
15 transfer customer property and positions to a
16 solvent firm, if practicable. Now, as I mentioned
17 before, the practicability in large part depends
18 upon, is the customer property there? If the
19 customer property isn't there, transfer is going
20 to be a lot less practicable.

21 But we've had in the past couple of
22 years a number of very large insolvencies, Refco

1 and Lehman, where the property was there, and that
2 instruction to transfer, that guidance to transfer
3 I think has helped. And, of course, transfer is
4 ideal for transferred customers and, arguably, for
5 the markets. But that efficiency may come at the
6 expense of fairness to other creditors.

7 And so I think folks in other
8 jurisdictions view that -- because, essentially,
9 for instance, we protect those transfers and the
10 transferred property against any call back.

11 That may happen at the expense of other
12 creditors. We've taken the decision, our
13 Congress, that essentially that's to the good
14 because it's important to protect the markets.
15 But other jurisdictions can weight that somewhat
16 differently. As I said, protection against "law
17 backs."

18 Compensation schemes. Many
19 jurisdictions have compensation schemes to protect
20 securities and futures customers against loss.
21 But that protection from a retail perspective is
22 very significant; from an institutional

1 perspective perhaps not so much.

2 For instance, CIPIC's \$500,000 limit is
3 among the largest among the jurisdictions that
4 report it. Most of them are closer to around
5 \$100,000.

6 Allocation of losses, and this actually
7 is important and, I think, goes to some of the
8 things Ron was talking about earlier in the U.S.
9 Some jurisdictions allocate the losses pro rata.
10 We do both on the futures end and on the
11 securities end, except the securities end has the
12 CIPIC protection. And so, essentially, we can
13 look at the customer property pot and say, okay,
14 everyone's going to get 50 cents on the dollar, or
15 maybe more, but we've got enough to pay people a
16 dividend, and so you can have dividends and get at
17 least some of the money out.

18 Some jurisdictions will allow allocate
19 losses based on customer permissions, so those
20 customers who said, well, you can use my
21 collateral are going to be treated differently
22 from those customers who said no, you can't.

1 Of course, once you have that permission
2 out there, there's an immediate practical effect
3 of you're going to need to pay some accountants a
4 whole lot of money to untangle all of that,
5 untangle the records and say, well, this customer
6 gets treated this way because the records say
7 this. And that one gets treated that way. There
8 is an efficiency to treating everyone the same and
9 mandating a treating everyone the same where,
10 because you can then say, okay, everyone's treated
11 the same, you don't have to worry each individual
12 customer.

13 Some jurisdictions allocate losses based
14 on which property is missing. The U.K. is among
15 these. And so heres for customer funds they would
16 operate pro rata. With respect to customer
17 property, they're going to allocate losses based
18 on which property is missing. If one customer, or
19 if one group of customers -- in other words, the
20 property they posted was IBM stock, another group
21 of customers posted Amazon stock -- and it turns
22 out that the IBM stock is almost all missing, the

1 Amazon stock is there, the first group of
2 customers is going to be allocated more of the
3 losses.

4 So until you can untangle who owns what,
5 then you can't do the distribution, and again,
6 hanging over the trustee, of course, is the fact
7 that, hey, if I distribute the wrong thing, I'm
8 personally liable. Not only that, but the courts
9 in the U.K., the trustee has been trying to urge
10 them to allow even some means of having a scheme
11 of distribution that would have some deadlines and
12 saying, okay, you've got to make your claim by
13 thus and such a time or we're just going to
14 distribute the money.

15 And my understanding is that first the
16 Queen's Bench, and then -- or the commercial
17 court, rather -- and most recently the Court of
18 Appeal have essentially held, no, sorry, you can't
19 do that. You've got to follow normal trust law,
20 however complicated it might be.

21 And the rest of it I will cover later.

22 COMMISSIONER SOMMERS: Thank you, Bob.

1 We have Roger Liddell from LCH, who is also going
2 to speak on this subject from what happens from
3 the Libby side and from LCH.

4 Roger?

5 MR. LIDDELL: Thank you very much, Madam
6 Chairman. I will be brief for two reasons: First
7 of all, I think Ron did a great job of describing
8 the general sort of activities and not just U.S.
9 activities, so I won't repeat all of that.

10 And, second, I think it's pretty more
11 productive to leave time for some questions or
12 discussion which is, I think, is the way this
13 discussion seems to be going.

14 But let me just a little bit more
15 current and give you a little bit more specifics.
16 I think you know, what we experienced in the first
17 hours in the first couple of days were some events
18 that we hadn't anticipated and certainly hadn't
19 experienced. I think some of those were, you
20 know, some of the specific differences in the
21 bankruptcy regimes in different countries and the
22 relative protections that they offered to

1 customers and the relative difficulties they have.
2 So the fact, you know, they are different is an
3 issue.

4 The other related issue, though, is that
5 it is a large, you know, fully-integrated
6 financial institution like Lehman Brothers, it's
7 an integrated network. And to separate out
8 regional pieces of activity and handle in
9 isolation, you know, really doesn't work that well
10 these days. We think it raises so much broader
11 issues.

12 You know, there are issues around the
13 single pot which, you know, Bob referred to a bit
14 earlier. They complicate things with from a
15 liquidation perspective which can be a problem.
16 It's also, frankly, a huge benefit, alternatively,
17 so gross having a single pot of collateral
18 covering a whole range of different asset classes
19 meanted [sic], as we were, to liquidate some more
20 quickly than others. The hedge room that that
21 liberated was effectively usable to us to create
22 more protection against some of these other asset

1 classes. So there are pros and cons with that.

2 But in terms of the, you know, specific
3 events, the first issue, of course, was that, you
4 know, we didn't have good access to data. But the
5 reason that was important, actually, the primary
6 reason that was important, was because a high
7 proportion of the futures clients of Lehman
8 Brothers International Europe, a high proportion
9 of them -- and I think the number was probably
10 around 60 percent by value -- had opted out of
11 segregation protection in the U.K. Many of these
12 were U.S. customers. I think about 50 percent of
13 them were U.S. customers.

14 Now, we were not explicitly aware of
15 that because, basically, the activity that we had
16 with the Lehman Brothers International Europe was
17 traditional futures clearing member activity house
18 account with a lot of positions in it and
19 declining omnibus account with a lot of positions
20 in it.

21 So as the events started to unfold
22 actually over the weekend but then on the Monday

1 morning, we started the process of identifying the
2 risk in the house account to hedge it, and in
3 identifying the client positions in order to
4 transfer them.

5 What became apparent within the first
6 hour or so was that a lot of the positions in the
7 house account were in fact clients and really
8 realized this because we recognized some of the
9 names.

10 So then it became obvious that we
11 obvious that we couldn't hedge any of the house
12 positions because we would be potentially hedging
13 some of the client positions that needed to be
14 transferred. So that created an immediate
15 requirement first to understand from the books
16 records of Lehman Brothers precisely which of
17 those positions were in fact house accounts and
18 which were client accounts.

19 And, you know, just scanning down this
20 list and looking at the names, it just isn't
21 obvious because a lot of internal trading desks in
22 big financial institutions look like small funds,

1 look like hedge funds, you know, West Coast
2 commodities, you know, desk, and things like that.

3 So we realized that we needed this
4 information from Lehman Brothers and tried to get
5 it. And that where we ran into the problem that
6 Ron referred to earlier which was under the U.K.
7 regime with administrative, and with the potential
8 liabilities that they had individually. They were
9 very nervous about even giving information away.

10 So after an hour or two of trying to get
11 information electronically, we actually sent
12 people down physically to just go and get it. And
13 that wasn't easy either. They were turned away,
14 there were security guards preventing them going
15 in. You know, we were threatened with police
16 action because we were trying to sort of get
17 through the (inaudible) and lots of stuff.

18 So, eventually, after a long time, a few
19 months ago (inaudible) June afternoon and started
20 to sit at the terminals inside the Lehman offices,
21 started to print from screens client positions and
22 so on and so forth. In the meanwhile -- and again

1 this is probably sort of the more extreme, you
2 know, examples of the mismatch between the
3 insolvency regime and the need to have an orderly
4 liquidation of important client positions --
5 meanwhile the administrators were sort of giving
6 interviews on the TV and whatever.

7 They're saying, "Look, this is what's
8 happening," and explained the process. And, by
9 the way, you know, none of the staff for the
10 Lehman Brothers is going to get paid. So all of
11 the people that we were working with to try and
12 get all this information just sort of disappeared.

13 So the next morning we went down to get
14 into this again, managed to persuade all this
15 stuff that had on to come back and gave them
16 contracts of employment just so to hire them, and
17 went to try and get these positions to do the
18 transfer on the Tuesday.

19 By this stage the lawyers had been in
20 there, and I realized a high proportion of the
21 people in that room are lawyers and I won't be
22 disrespectful, but that wasn't a healthy step in

1 the process. And the administrators were there
2 for very nervous about giving us access to data.
3 All of the terminals that had this information had
4 all of their ports blocked to prevent our people
5 from getting anything to be able to download
6 information to bring back to our offices to use,
7 which is really quite an incredible sort of state
8 of affairs.

9 Meanwhile, we had some screen prints
10 from the night before, so we knew exactly which
11 reports we needed and where all the data was.
12 And, thankfully, we were able to speak to the
13 folks in the New York office, Ron and some of his
14 ex-colleagues, and say, "Look, you know, we really
15 need some help here. Can you get these files for
16 us and send them electronically?"

17 So while we were having big arguments
18 with the lawyers and the administrators in London,
19 we were actually working in a much more
20 collaborative way with the staff in New York who
21 were able to transfer all these files to us, or
22 all the data that we needed in order to transfer

1 customer positions. So that was great.

2 Ron, I think you referred to the
3 restrictions that the administrators faced on in
4 terms of being willing to allow us permission to
5 move assets. Ultimately, actually, they were not.
6 Actually, we could not get them to agree to allow
7 us to move clients' futures positions, not the
8 client's futures positions, and they wanted us to
9 sign all sorts of disclaimers that if, you know,
10 that we'd move it more it back under certain
11 circumstances, none of which was compatible with
12 the futures (inaudible), generally. So what
13 actually happened was because we had this
14 information, the electronic information from the
15 States, that we not only needed the data from the
16 U.K., we chose not to require the permission from
17 the administrators to move it. So, basically, we
18 moved all of the positions, our positions, without
19 the permission.

20 Over a fairly concentrated period of
21 time -- and actually that introduced an awful low
22 more risk than would have been the case had we got

1 access to the right information within the right
2 sort of time frame. Now, this was obviously a
3 huge problem and a huge source of frustration.
4 Thankfully, it went okay in the end. This will
5 require changes to the U.K. insolvency regime and
6 the bankruptcy legislation, no doubt.

7 In the short term, however, I'm
8 confident that there has been a good level of
9 understanding reached between the local
10 regulators, the courts, and the primary insolvency
11 (inaudible) so that in the event that the similar
12 circumstances happen again, we would -- I'm
13 confident we would be allowed access to the data
14 that we need, and things would move much more
15 quickly.

16 But again, it was a combination of the
17 lack of availability of data to us and the fact
18 that a lot of clients had chosen -- how obvious it
19 was to them that they'd chosen or not, you know,
20 we don't really know -- but they'd chosen to opt
21 there a segregated protection, which meant that we
22 had to treat the firm and the house collectively.

1 I could go on a lot more, but I think I
2 won't. I think it's pretty best if I just close
3 thee and invite any questions.

4 COMMISSIONER SOMMERS: I think we do
5 have some questions for you, Roger.

6 CHAIRMAN GENSLER: Hi, Roger, it's good
7 to see you again. I had a question. You were
8 talking this through, but this was more broadly
9 than just futures. We this also futures and the
10 swaps? Or were you narrowly talking about just
11 one book of business?

12 MR. LIDDELL: I was narrowly talking
13 about just the futures. The same problem didn't
14 occur in swaps at all, or elsewhere.

15 CHAIRMAN GENSLER: Do you want to take,
16 you know, maybe it's two minutes, but tell us
17 about how you transferred the swap book.

18 MR. LIDDELL: Yes, I will, and I'll try
19 not to -- I'll try to avoid a commercial. The
20 first thing is the swap book only involved
21 interbank activity, so we basically were sitting
22 between the Lehman Brothers trades and each of

1 their interbank counterparties. And I'll describe
2 briefly how it happened. But after Thursday,
3 there were no customer positions that needed to be
4 transferred.

5 What this has meant, however, is that,
6 as we know of preparing to get involved with real
7 customers' business, we obviously aren't happy
8 that this regime does not work well, you know, for
9 real customers in OTC derivatives. So what
10 actually have put in place now for swaps in
11 particular is a regime which allows us to actually
12 bypass the administrator and to actually liquidate
13 collateral in the omnibus account that the bank
14 will have with us on behalf of its clients, and to
15 sell that collateral, and to move it to the
16 incoming clearing member that's inheriting those
17 positions, and to bypass this entire process
18 which, as Ron quite accurately described, has not
19 yet unfrozen.

20 CHAIRMAN GENSLER: So you have an
21 approach in the future to be able to deal with
22 customer, or what some people here call end-user

1 clearing, by having the omnibus account or the
2 Collateral Act, LCH, rather than over at the bank
3 where the administrator might freeze it.

4 MR. LIDDELL: No, the accounts are still
5 in the bank, but the omnibus account of all of the
6 bank's clients is with those as usual futures.
7 But what we've developed is a regime that would
8 allow us to sell the collateral in it and to
9 allocate it, proportionately, to all the clients.

10 But it hasn't changed the situation with
11 regard to the futures activity; that remains the
12 way it is today. So we haven't solved the futures
13 problem, but we have actually made provisions for
14 those derivative markets.

15 But the way the swap defaults actually
16 was handled was that, basically, because there's
17 no means of us liquidating it over exchanges, we
18 introduced the default management process that had
19 been developed over the years which really
20 entailed us calling in nominated individuals that
21 had been preassigned by, you know, five of the
22 main 12 swaps dealers to come in and trade under

1 our instruction and on our behalf in order to
2 liquidate the portfolio, which is what happened.

3 COMMISSIONER SOMMERS: Does anybody else
4 have any questions for Roger at this point? Ron?

5 PROFESSOR FILLER: Jill, can I just -- I
6 want to clarify one little point that Roger just
7 mentioned, and at least this was the situation
8 when I was there. Things might have changed, but
9 we did not have any U.S. futures have a direct
10 account with LBIE. Every U.S. base futures
11 account had an account with LBI, and then LBI had
12 an omnibus with LBIE. I think what Roger is
13 referring to when he said several U.S. Clients
14 quoted, opted out were really were offshore hedge
15 funds whose money managers were based here in the
16 States, but the entities themselves were offshore.
17 They were doing their OTC equity derivatives with
18 London, and if they're doing the OTC equities
19 derivatives, they were doing their futures as
20 well.

21 So I don't in my mind, even though the
22 money managers are based here, the funds being

1 offshore, I never looked at them as, quote, "a
2 U.S. account." In fact, if any client ever asked
3 me, "Do you allow us to opt out," it was no way.
4 I'm just not an opting out person.

5 So to the best of my knowledge, unless
6 things change, no U.S. person opted out, but some
7 of our offshore hedge funds, because of the
8 capital and the way you play the game over in
9 London was a lot cheaper than you could play it
10 here, a lot of the actual hedge funds did have
11 direct account, so if they could do the OTC in
12 London, they might as well do the futures and all
13 the other products there.

14 COMMISSIONER SOMMERS: Don?

15 MR. WILSON: Yeah. Roger, this is Don
16 Wilson from DRW. It's my understanding that LCH's
17 new swap clearer structure is -- really only
18 offers clearing for the dealer members. In other
19 words, large users of the market, and even major
20 liquidity providers who currently operate
21 exclusively in centrally-cleared markets will not
22 have the option of clearing their trades but will

1 instead faith their children prime broker in
2 traditional bilateral arrangements. And although
3 LCH has attempted to mitigate some of the risks
4 traditionally associated with bilateral trades,
5 the trades nonetheless remain bilateral. So it's
6 not really a central counterparty; it's merely a
7 clearing between dealers.

8 And the other flaw that I see in LCH's
9 new proposed swap clearing model is that by virtue
10 of this structure, users of the market will only
11 be permitted to trade with LCH dealer members. In
12 other words, the market in interest rate swaps
13 will not receive the benefit of the liquidity
14 provided by nonbank liquidity providers. And
15 rather than taking the opportunity to reduce the
16 reliance on, you know, too big to fail banks and
17 the LCH's model instead perpetuates this
18 structure.

19 And so, you know, I just -- you can
20 correct me if anything that I've said is wrong,
21 but I wanted to highlight those concerns because I
22 don't think that that structure is in the best

1 interest of the marketplace.

2 MR. LIDDELL: Okay. Well, I mean
3 essentially the situation is similar, almost the
4 same of the futures markets, which is that we're
5 directly the members. We don't care whether we
6 trade -- they can trade with any way they want as
7 long as they clear it through a clearing member.
8 So as long as both parties turns out to a
9 transaction, each have a clearing member to clear
10 on their behalf, then that's fine. We can clear
11 any trade that comes from anywhere. It doesn't
12 matter.

13 MR. WILSON: So you're saying that one
14 customer of the market could trade directly with
15 another customer for the market as long as both of
16 those trades -- as long as both of those customers
17 cleared their trade through an LCH swap clearing
18 member.

19 MR. LIDDELL: Yeah. Absolutely.

20 CHAIRMAN GENSLER: But I think Roger's
21 point is, will you allow nondealers to become
22 clearing members? Will you have open access to

1 clearing members as we've proposed in our
2 regulatory regime in front of Congress that the
3 clearing houses allow nonswap dealers to be
4 clearing members?

5 MR. LIDDELL: Yeah. I mean there are
6 criteria that needs to be met in order to become a
7 clearing member. The criteria does not include
8 the type of institution that any particular firm
9 is. They do, however, include their regulatory
10 stages, their level of capital, and also the size
11 of the stock portfolio that they have.

12 And the reason for that is that,
13 ultimately, in default situation, you know, we,
14 the clearing house, don't have the ability to just
15 go out and close out across an exchange and need
16 to have a complicated hedging mechanism where the
17 banks within the service effectively mutualize
18 that risk amongst themselves.

19 So all the firms that need to
20 participate in that process needs to have access
21 to a lot of liquidity and needs to have the
22 capability internally of having a big portfolio.

1 So the rules are fairly onerous and
2 stringent, but they don't determine the type of
3 organization that can become a member.

4 CHAIRMAN GENSLER: Could a nondealer
5 realistically meet those? Or are they so written
6 that if they just, you know, the dealers are going
7 to be --

8 MR. LIDDELL: It would be very
9 difficult, frankly. It needs to be a regulated
10 entity, and the size of the portfolio needs to be
11 at least a trillion dollars. These are the rules
12 that have been in place for 10 years.

13 CHAIRMAN GENSLER: Yeah, and just to
14 repeat what I've probably said just one per -- I
15 think that swap clearing is very important. It
16 helps lower risk, but I think it best benefits
17 markets if it's opened up more than what you've
18 just probably described.

19 MR. WILSON: Just to touch on the first
20 point that I made, I mean is my understanding
21 incorrect that the trade that the customer make
22 are technically not cleared trades? They're still

1 bilateral trades even though there is kind of a
2 centrally-cleared element to the component that's
3 between the dealers related to those trades?

4 MR. LIDDELL: I'm not sure I understand
5 the question fully, but again, we have two kinds
6 of policies. Whoever they are can transact. As
7 long as the transactions are submitted via two
8 clearing members, or even a (inaudible) member,
9 then they'll come to the system and will be
10 subject to the same protection, the same margin
11 regime as all the transaction.

12 COMMISSIONER SOMMERS: Tom, did you have
13 a question?

14 MR. LIDDELL: Now, getting on the books
15 of the clearing member that has those
16 transactions, effectively they have a back to
17 back, one with us and one with their member. So
18 the protection that that client will get will be
19 exactly what I described before, which will be the
20 portability of initial margin and the ability to
21 transfer s position outside of the regime of the
22 defaulting member.

1 MR. WILSON: Yeah, I guess that's my
2 point. If that it is a back-to-back trade, it's a
3 bilateral trade between the customer and the
4 clearing dealer, and then, you know, yes, then the
5 other side of the trade is with the clearing
6 house. But I mean, for instance, if a customer of
7 a dealer who clears, let's say, J.P. Morgan, calls
8 up Goldman Sachs to transact a swap, then they can
9 transact the swap with Goldman Sachs. The result
10 of that trade will actually be a cleared trade
11 between Goldman Sachs and LCH, another cleared
12 trade between LCH and J.P. Morgan, and a bilateral
13 trade between the customer and J.P. Morgan.

14 MR. LIDDELL: Yeah, but the key element
15 is that this is a sort of one-way protection
16 right. So, effectively, the process protects the
17 clearing house and the clearing system and the
18 rest of its members from the risk of a defaulting
19 member.

20 So that from the -- the clearing member
21 bears the risk of the original customer, whereas
22 the customer of that clearing member doesn't bear

1 the risk if it's a clearing member. Though if the
2 clearing members goes under, then we bypass the
3 clearing member and access and move the initial
4 margin, the variation margin of the end customer
5 to an incoming clearing member.

6 MR. WILSON: Right, as long as
7 (inaudible) --

8 MR. LIDDELL: It's kind of one way.

9 MR. WILSON: -- agrees to take those
10 trades. So I just -- I think it's important to
11 point out, it is a bilateral trade, however, you
12 put some clever mechanisms in place to hopefully
13 lower the risk in the event that the, you know,
14 the clearing member files for bankruptcy. So it
15 has --

16 MR. LIDDELL: Yeah, but the only issue
17 is the one that I think you alluded to, which is
18 that if there is no clearing member willing to
19 take on those positions, then there's nowhere for
20 those positions to go, in which case that position
21 has to be liquidated.

22 MR. KLEIN: If I can ask Roger what I

1 hope was a clarifying question, I've been involved
2 in a lot of discussions, as have many people,
3 about the difference between clearing on an agency
4 basis and clearing on a principle basis, but I
5 guess the fundamental question is, is the legal
6 model that LCH has established for clearing
7 nonclearing member swaps significantly different
8 than the legal model that LCH believes exists for
9 clearing futures contracts?

10 MR. LIDDELL: Well, I mean I guess it
11 depends where, because futures contracts are
12 different in different locations around the world.
13 But, broadly speaking, I think from a client
14 perspective the regime goes well beyond what
15 exists in most futures markets round the world,
16 particularly in Europe.

17 COMMISSIONER SOMMERS: Tom?

18 MR. CALLAHAN: Roger, it's Tom Callahan.
19 We've discussed in some detail in this meeting of
20 the potential complications that arise out of
21 cross-margining and crossing arrangements in the
22 event of a client or member firm default.

1 But you also said in your introductory
2 comments that there's another side of the story
3 that in a default scenario there's a benefit to
4 seeing, essentially, the whole of a defaulting
5 member's position. So I was wondering if you
6 could just elaborate that, on that a little bit
7 further in the context of what I believe was a \$9
8 trillion liquidation that LCH managed without
9 touching any default or guarantee funds, which is
10 a remarkable achievement. But was portfolio
11 margining a factor in that successful liquidation?

12 MR. LIDDELL: Well, ironically, I didn't
13 -- the \$9 trillion was the size of the swap
14 portfolio and in Lehman Brothers' case, they
15 actually used a different entity for that to all
16 of the rest of the activities. So everything else
17 they did with us was in one (inaudible), and the
18 short portfolio was in a different one. So there
19 was no benefit in that particular case to us of
20 the portfolio effect. With the rest, though,
21 there was. And that made a significant
22 difference.

1 But I think, you know, as we talk more
2 about cross-product margining, that effectively
3 the benefit that we were able to enjoy outside of
4 the short portfolio, arguably, moves away from the
5 clearing house and toward the client once you
6 offer a more comprehensive cross-product
7 margining, which is why I think that we need to be
8 particularly thoughtful as to how we eventually do
9 that.

10 An the issue, I think, really, frankly,
11 is less to do with cross-product margining and
12 more to do with cross-product default management,
13 because it's easy when you can take individual
14 portfolios and liquidate them separately.

15 But if you go, if you're allowing
16 cross-product margining and giving relief because
17 there's natural offsets, then you have to have a
18 much more integrated, organized liquidation
19 process, and that's the sort of stuff we're
20 looking at now.

21 COMMISSIONER SOMMERS: Thank you. We
22 are running just a little bit behind schedule, so

1 I think what I might suggest at this point is Bob
2 had a few more slides left on what the CFTC staff
3 has proposed that the CFTC's effort with regard to
4 these kind of issues going forward and of eight
5 lessons learned on these issues. You all have
6 these in your packet. So if you have any further
7 questions on these particular issues, you can let
8 us know at a later time.

9 We are going to take about a ten-minute
10 break and come right back to start discussion of
11 the U.S. and E.U. OTC derivatives proposals.

12 Thank you, Ron. Thank you so much,
13 Roger and Bob, for participating in this
14 discussion. Thank you.

15 (Recess)

16 COMMISSIONER SOMMERS: We're going to go
17 ahead and get started if everybody can take their
18 seats. As I mentioned in my opening comments, the
19 CFTC is very honored to have with us our
20 colleagues from the European Commission here
21 today. This is a very challenging time for market
22 regulators and more important than ever, really,

1 for us to be coordinating with our counterparts in
2 Europe. And we are so pleased to have David
3 Wright here with us today to talk about these
4 issues.

5 Patrick Pearson is also to his right at
6 the table, will be participating in the
7 discussion, and I'm going to go ahead and start
8 with David and to let him give an overview of the
9 communication that the E.C. put out in October,
10 and maybe, David, if you could go over the
11 timetable with us to give us an idea of where
12 Europe is headed.

13 Thank you.

14 MR. WRIGHT: Commissioner Sommers,
15 Chairman Gensler, Commissioners of the CFTC, thank
16 you very much indeed for inviting us from the
17 European Commission to this Global Markets
18 Advisory Committee. We have worked very closely
19 with the CFTC over many years, and we very greatly
20 value our close relations and very much welcome
21 all our contacts with Jackie Mesa and your staffs.

22 We were very honored, as Gary said

1 earlier, to have him over and explain in
2 considerable detail your policy, the U.S.
3 administration's policy on OTC derivatives in a
4 public hearing we had in Brussels, Belgium earlier
5 this year in September. And I'm here today not
6 just as a gentele act of reciprocity, but also
7 because we in the European Commission, the
8 organization in Europe that proposes European law
9 in the European Union. We believe very strongly
10 that on this subject of OTC derivatives, and
11 indeed on many others, it is absolutely essential
12 that we have a common view and convergent policy
13 outcomes between the United States and the
14 European Union.

15 That, indeed, is the spirit of the G20
16 with which we concur. As we all know, the U.S.
17 and the EU have by far the biggest capital markets
18 in the world. By some measures we believe in the
19 European Union; we could be bigger than the United
20 States, but, of course, that's not the point. For
21 derivatives almost all the trading, major trading,
22 is carried out in our jurisdictions.

1 We have, of course, very different
2 policy processes. We have different timing and
3 sequencing, and I will say something about that.
4 We have different political forces. You have your
5 Congress, and we have our member states in the
6 European parliament who decide. But jointly we
7 must, I believe, work very closely together to
8 assure our common goals and objectives, so this
9 would be easy; but as I said, I think it's
10 essential.

11 If we do not do this, if our policy
12 outcomes on derivatives show very wide variance,
13 the results will be very simple: It's going to be
14 regulatory arbitrage, unacceptable potential risk,
15 even the seeds for future financial trouble.

16 We can't afford this and we shouldn't
17 accept. This financial crisis will resolve this
18 year in the European Union of a loss of four
19 percent of GDP, growing unemployment, and a
20 burgeoning public sector deficit which in the
21 European Union as a whole means that our public
22 sector deficit will have grown by 20 percent of

1 GDP in three years.

2 And the same, I believe, say magnitude
3 of destruction has happened here in the United
4 States as well.

5 So the system has got to be repaired,
6 and we need on this issue more than ever two
7 mechanics, the United States and the European
8 Union, acting together, acting as one.

9 Already, ladies and gentlemen, there are
10 strong signs that some would like to divide on
11 these issues. I'm quoting from The Financial
12 Times of the 2nd of December headline: "Europe
13 and U.S. Split Over the Reform of Derivatives."
14 Some of our companies apparently as accusing you
15 of being unwilling to relax the proposed reforms
16 referring to the issue, of course, whether to
17 exempt end-users from the reforms. And somebody
18 is quoted as saying, "Well, if that results in
19 divergence between the E.U. and the U.S., so be
20 it."

21 So the warning signs for both of us are
22 there, and we better take care that we can avoid

1 them.

2 Let me briefly set out the goals we have
3 with our forthcoming OTC derivatives reform
4 package. The timing, as far as I know it -- and
5 let's focus on some of the difficult issues where
6 convergence, our convergence, will be most tested.

7 Now, we made a major policy statement on
8 derivatives on October the 20th. Now this
9 document is being distributed to you in your
10 package here. It forms part of a policy process
11 which will result in us proposing legislation in
12 next year, and I can tell you that our President,
13 President Barroso, confirmed now for a further
14 five years as president of the Commission, has
15 made it very clear in his testimony to Parliament
16 that this Commission, his new commission, will
17 propose an ambitious initiative next year. Our
18 starting point is exactly the same as yours, and
19 I'd like to quote Chairman Gensler's testimony
20 before the House Committee on Energy and Commerce,
21 Subcommittee on Energy and the Environment, on
22 December the 2nd. So you can see here we look

1 very carefully, and we follow all your comments.

2 CHAIRMAN GENSLER: I'm very honored.

3 MR. WRIGHT: You said, Chairman, "Though
4 there are certainly many causes of this crisis, I
5 think most would agree that the unregulated OTC
6 derivatives marketplace played a crucial role."
7 We fully agree. We believe these markets
8 exacerbated the crisis, the leverage levels into
9 connectedness, lack of transparency catalyzed this
10 deep financial crisis, and, frankly speaking, I
11 believe very nearly decapitated the whole of the
12 financial system. Credit derivatives did not
13 dispose risk -- disperse risk; they concentrated
14 at risk and concealed it.

15 Now let's look at what we are planning
16 to do. And let me say here that we have a change
17 of administration coming, as I told you. We have
18 a new Commissioner for the Internal Market and
19 Financial Services who will take office, if all
20 goes well, on the 1st of February next year. That
21 is Michelle Barnie from France. But we have a
22 strong presumption that the policy I'm about to

1 outline to you will perform the core of our
2 thinking in the months ahead.

3 First of all, in terms of general
4 considerations, we are talking about a paradigm
5 shift. We not so going to tinker around the
6 margins while Rome burns. We want a comprehensive
7 policy; we want strong international cooperation;
8 and we will include the nonfinancial part of the
9 industry.

10 The first part of our policy is to
11 reduce counterparty risk. We will propose
12 legislation to ensure that CCPs are safe and sound
13 with common safety, regulatory and operational
14 staff.

15 We will propose to improve the
16 collateralization of bilaterally-cleared contracts
17 both in terms of initial margin and variation
18 margin. We will propose to raise significantly
19 capital charges to bilaterally-cleared as compared
20 with CCP-cleared transactions; and we will propose
21 mandating CCP clearing for so-called standardized
22 contracts.

1 The second strand of our policy is to
2 reduce what we call "operational risk." And by
3 that I mean we want to encourage further
4 collective action by the industry to promote
5 standardization of the legal terms of contracts
6 and of contract processing. We want also to
7 assess the need to reshape operational risk in the
8 capital requirements directive for translation of
9 the parcel process in order to prompt
10 standardization of contracts and electronic
11 processing.

12 Now I can tell you we're going to use
13 the Pigon, if necessary, and we're going to set
14 very tough deadlines for industry action.

15 The third strand of our policy concerns
16 improving transparency. What does that mean? It
17 means mandating the reporting of positions and all
18 transactions to trade, we hope.

19 It means reposing -- proposing
20 legislation on trade repositories and the
21 supervision of them. It means mandating trading
22 of standardized derivatives on organized trading

1 venues, and it requires improving and increasing
2 pre and posttrade transparency as part of the
3 upcoming review of our investment services
4 directives, so called "method" today. And this is
5 for all derivatives markets, including commodity
6 derivatives.

7 The fourth part of our policy is to
8 strengthen market integrity and oversight. What
9 do I mean? I mean curbing insider dealing and
10 market manipulation by extending our market abuse
11 laws. We will, I believe, also in the future,
12 look at ratcheting up, collectively, in the
13 European Union, the overall level of sanctions.
14 We must also give regulators the possibility to
15 set position limits to counter disproportionate
16 price movements and concentrations of speculative
17 positions.

18 So that is the basic approach, basic
19 building blocks of our policy.

20 Now in terms of timing, first of all we
21 have to do something which we believe is very
22 important as we our final proposals. We have to

1 carry out obligatory and impact analysis.

2 And that means before we make our formal
3 proposals we have to look in great detail at
4 whether those strands of those policies that I've
5 been outlining are the right ones. We have to
6 look at the economics of the benefits and the
7 cost, and we have to make judgments about some of
8 this fine detail that will form the final part of
9 our proposal.

10 We try to do our work in a very open
11 way, and I am a big believer that the more open
12 than transparent the policy process the better it
13 gets. And so our intention -- and we have to see
14 now according to the new Commission which takes
15 office, again, on the 1st of February -- but our
16 intention would be to start testing some legal
17 texts early next year with our member states and,
18 of course, with the industry. And we will
19 certainly be seeking views from the United States
20 and indeed particularly from the CFTC.

21 Thereafter, around the middle of next
22 year we hope to finalize the first part of our

1 legal text which would basically cover the CCP
2 issues and the trade repository issues.

3 That's Part 1; final proposals, we hope
4 by around the middle of next year. Thereafter we
5 will bring forward the amendments on the capital
6 requirement side and on the investment services
7 side towards the end of next year. So we're going
8 to do this in two parts. That is the best timing
9 I can give you today.

10 I hope that will be confirmed. The
11 president, as I said, has made it perfectly clear
12 that this is top priority for his new commission.

13 Let me now raise, if I may, ladies and
14 gentlemen, some of the difficult issues that it
15 seems to us still need to be discussed and indeed
16 resolved. And some of them we know, having been
17 here for 24 hours, and 24 hours is always a long
18 time in Washington. But we know, a long -- a lot
19 of these issues have already, are already being
20 actively discussed.

21 The first issue I want to raise with you
22 is the following, and that is the issue of scope.

1 We favor, as I said, a comprehensive approach
2 interalia to avoid regulatory arbitrage. We do
3 not favor exclusions for specific segments of the
4 market, some of the forex markets for examine. We
5 think CCP, per se, is desirable, and we believe
6 the burden of proof is on those who believe that a
7 segment X or Y should be excluded.

8 Why should they be excluded? And,
9 frankly speaking, we have not heard any convincing
10 arguments of why one part of this market should be
11 included and other parts should not. So we like
12 the idea of a comprehensive approach.

13 Let me now say a few words on the big
14 issue, and this is a big issue here and,
15 certainly, will be and is already in Europe, which
16 is the so-called end-user issue. Now, this issue
17 has come quite late in a sense to the debate. We
18 are on the record in our 20th of October
19 communication. We have said the following and I'm
20 quoting: "The costs of strengthening OTC
21 derivatives markets should not be carried by the
22 taxpayer but by those who directly enjoy the

1 economic benefit of using derivatives." Some of
2 it can be expected to fall on nonfinancial
3 institutions.

4 In other words, what we're saying is
5 that there's been a general underpricing of risk
6 in these markets, and so the burden has to be
7 shared to a degree by everybody. We've said that
8 we're going to carry out a full impact analysis on
9 how on how we allocate these charges. We
10 recognize that most -- and again I'm quoting here
11 -- "Most financial institutions are not of
12 systemic importance." And we will strive to
13 ensure that in our response we make sure that
14 nonfinancial institutions who use these markets to
15 hedge their risks will be able to continue to do
16 so.

17 There is no intention to close off
18 markets or close off participants in those
19 markets, but what is clear here is that we are not
20 going to try -- we certainly, we will not accept a
21 policy which is full of the holes of an Emmental
22 cheese. We do that to make sure that we have a

1 consistent approach across all segments.

2 So we don't have any firm positions yet.
3 Some of the questions were going to be very
4 important that we have to answer is how to
5 separate the end-users that are purely managing
6 risk from those who are managing speculative
7 positions. How do we avoid another Emmental
8 gesellschaft in Europe? How do we avoid regulatory
9 arbitrage allowing financial firms to shift their
10 risks into the unregulated area of oversight? In
11 other words, we want to avoid the build-up here of
12 another new shadow financial system.

13 And how do we achieve the same objective
14 in the United States and Europe because we're
15 going to have, probably -- we have different legal
16 instruments, and at the moment we have different
17 legal definitions than your definition of the
18 major swap participants, the MSPs. It's going to
19 be very important in shaping that argument.

20 The third issue which preoccupies us in
21 a technical sense is the future role of the CCPs.
22 We fully share the view that it should be

1 mandatory to clear so-called standardized,
2 clearable derivatives through CCPs. Indeed, the
3 G20 has fully agreed that. But who is going to
4 decide on what is so-called standardized or
5 clearable? The regulators? The CCPs? Both?

6 How? Should the CCP not be able to
7 decide whether it thinks product X or Y could be
8 cleared safely?

9 In other words, CCPs might not be
10 directed to clear products if they feel they are
11 unsuitable to be cleared. I think we feel at this
12 stage the decision on whether a contract accepted
13 for clearing by a CCP could be subject to the
14 general clearing requirement should be left to the
15 authorities. So we clearly see a role here in the
16 general decision on whether a product should be
17 cleared.

18 Another issue in Europe concerns the
19 ownership, governance, and robustness of CCPs.
20 Now, this ownership issue, which we know has come
21 out strongly in the United States, is less of an
22 issue for us for several reasons: First of all,

1 we don't necessarily think that excluding some
2 dealers from ownership of CCPs is necessarily the
3 right policy. There could be very strong
4 incentives for those dealers who do own CCPs to
5 make sure the CCPs are efficient and indeed safe
6 and sound. But that's one argument.

7 A second argument for us is basically my
8 institution doesn't determine the shape or
9 composition of companies. We do not determine
10 ownership in any activity that we carry out in the
11 European Commission, and indeed, it's against our
12 treaty.

13 Member states can decide the types of
14 structures they want for the CCPs.

15 Now we are concerned in Europe that any
16 movement towards clearing -- and we all support
17 that -- should be robust enough to withstand any
18 financial Armageddon. There are and will be more
19 systemic institutions -- and we have in Europe not
20 just one but several CCPs, as many as eight --
21 that could be clearing this business, clearing
22 trillions of dollars in euros of various

1 derivatives. So who should be the regulation
2 supervisor here? What role for the CCP Risk
3 Committee should we see? And, indeed, should
4 there be a backstop if there are difficulties and
5 trouble in a CCP? -- something, of course, that I
6 know is very unpopular to contemplate, something
7 that is very present in your discussions in
8 Congress? But it's an issue we have to look at.

9 I noted that Jerry Korrigan, who's
10 immensely knowledgeable about these matters, has
11 suggested that CCPs should be placed -- there
12 should be enough safety in CCPs that if two major
13 participants fail, the system can still continue
14 and not collapse. So what is failsafe? How do we
15 define that?

16 And how will the default mechanisms work
17 both in the CCP, and let's think about even more
18 complex issues between CCPs, not necessary just in
19 Europe but a default mechanism between a European
20 CCP connected with a U.S. CCP? Who's going to
21 call out? Who's going to make those decisions?

22 And we have other issues in Europe that

1 perhaps you do not have here in the United States,
2 one of them being how do we get interoperability
3 of clearing houses in Europe? We do not have a
4 mandatory obligation for that today. Should this
5 be a right? An obligation? Well, I think, so
6 we're going to have to mandate this in law.

7 And then comes another question: Is
8 this in only equities or do we include
9 derivatives? I certainly hope, and I believe we
10 should be bold here and require interoperability
11 across all financial products cleared on NCCPs in
12 the European Union.

13 Ladies and gentlemen, we have other
14 issues before us, issues of definition, issues of
15 data reporting and data protection, issues of
16 margin requirements and margin imposition in
17 segregation. We've been hearing about that
18 already, very interestingly, today.

19 I come back to my basic point here.
20 This issue is of tremendous importance for both
21 the European Union and the United States. We are
22 going to go the extra mile to try and converge our

1 positions with you without positions emerging in
2 Congress as far as we can. I believe that's
3 right. We believe that we will end up with safer
4 financial markets, markets that will grow with a
5 degree of safety that it did not have before.

6 And I believe there's almost an ethical
7 duty, and I say that very strongly, between us to
8 try and get this legislation to converge to the
9 maximum extent possible.

10 And once again, Commissioner Sommers and
11 Chairman Gensler, thank you very much for giving
12 us the opportunity to put forward our views on
13 these crucial matters in Washington today.

14 COMMISSIONER SOMMERS: Thank you, David.
15 I'm sure there's probably lots of questions, but
16 at this point I'm going to turn to Terry Arbit
17 from our Office of General Counsel, and Ananda
18 Radhakrishnan is also here from the Division of
19 Clearing and Intermediary Oversight. And Terry is
20 going to give an overview of the proposals in the
21 U.S.

22 MR. ARBIT: Thank you, Commissioner

1 Sommers, Chairman Gensler, and commissioners. I
2 will try to be relatively brief so that we can
3 leave more time for discussion among the committee
4 members.

5 Staff at the CFTC has been working hard
6 on the legislative matters, not just general
7 counsel and clearing divisions but all of our
8 other divisions as well -- market oversight,
9 legislative affairs, international affairs. We
10 appreciate the support of the commissioners that
11 we've had for many, many months dating back to
12 Commissioner Dunn's tenure as Acting Chairman
13 earlier this year.

14 In the materials, I think there's a
15 short -- some call it a chart, some call it a
16 table, but we've tried to summarize some of the
17 issues that would be most relevant to trying to
18 compare what's going on in Congress with the
19 issues that we just heard about in the
20 international perspective. This by no means is
21 all of the provisions in the 200-page material.

22 CHAIRMAN GENSLER: Terry, I am just

1 going to help. It looks like this. It's a side
2 by side some people might call it.

3 MR. ARBIT: Side by side by side by
4 side.

5 CHAIRMAN GENSLER: Yeah.

6 MR. ARBIT: And I think it's seven pages
7 long. And I'm going to try to just walk through
8 those issues without getting into a great layer of
9 depth on any of them. I think most people have
10 some familiarity with them. Much of this side by
11 side I think now is actually just of historical
12 interest for those who've been following the
13 events on Capitol Hill.

14 We have several columns to talk about,
15 various bills from the House Financial Services
16 Committee, House Agriculture Committee, but the
17 key at this point in time this week is the
18 right-hand column, which would be the
19 Peterson/Frank Substitute Bill which, as I
20 understand, or this legislative process, will be
21 the vehicle to go to the floor of the House of
22 Representatives later this week. And that will be

1 the OTC bill that people will be voting on and
2 offering amendments on.

3 So that's the column that I'll be
4 focusing on primarily in talking about this.

5 Just one other introductory comment on
6 the chart. What we've tried to do here at the
7 staff level is highlight those where there have
8 been disagreements during the debate.

9 And so you will see that there are some
10 provisions that are vitally important but that
11 actually are not listed in the chart, swap
12 repositories being a good example. There are
13 provisions on repositories in the legislation, but
14 they've remained the same from the
15 administration's original proposal all the way
16 through to the Peterson/Frank Substitute.

17 They are not very detailed, actually, in
18 the legislation about repositories but leave it up
19 to the CFTC and the FCC and our rulemaking
20 authority to implement those.

21 But the chart, we tried to focus on
22 those issues that had generated debate and

1 controversy over time, and actually, a good and
2 other example on the flip side of the repository,
3 so another issue that is not in the chart because
4 there has not been a difference among our
5 committees on it. But following up on the first
6 half of today's meeting is bankruptcy. That's,
7 from what we heard this morning or later today,
8 obviously, a critical issue, and yet none of the
9 bills that have been offered have included
10 bankruptcy provisions in them. So that remains a
11 gap, really, across the board, and that's why you
12 won't see them in the chart. We have nothing to
13 compare.

14 But in terms of what is here and the
15 issues that have come up, these really do, I
16 think, track what's going on in Europe. Certainly
17 all the discussions we've had at the staff level,
18 with counterparts overseas, the same issues are
19 coming up, and there seems to be harmony of
20 approach at the staff level.

21 What I'll try to do is summarize where
22 Congress seems to be at, at least at the House of

1 Representatives side.

2 The first question, which always is sort
3 of who's in and who's out, and there we have
4 definitions of swap dealers and major swap
5 participants. They are in. I'm not going to
6 really focus much on swap dealers because I do
7 think the critical one is probably the major swap
8 participant issue. And the relevance here is
9 primarily who will be subject to the capital
10 rules, the margin rules, the business conduct
11 rules, the reporting and record-keeping rules.
12 That's the significance, primarily, of whether you
13 are or are not a major swap participant.

14 And the same issues that are being
15 confronted out in Europe are certainly being
16 confronted here, the smaller the category of major
17 swap participants and, some would argue, the
18 larger the loophole from the regulatory regime, on
19 the other hand, sweeping in entities and firms
20 that, arguably, should not be swept in is also not
21 good public policy.

22 I've heard there seems to be, at least

1 in meetings I've been in, a fair amount of
2 agreement on kind of what the concept is, but is
3 reflected by the side by side. There have been an
4 awful lot of efforts to capture that agreement,
5 and the totalers to determine whether they've hit
6 it yet.

7 The general sense is that true risk
8 management, true commercial hedgers should
9 perhaps not be swept in unless that failure of a
10 hedger, a firm like that could have implications
11 for other counterparties that are sufficient but
12 they need to be brought into the regulatory
13 regime. That seems to be the goal that most of
14 these bills have been trying to hit, but they each
15 have done it a little bit differently.

16 The Peterson/rank Substitute of the
17 formulation that hasn't appeared before in some
18 respects has got some similarities, some
19 differences. The key phrase that is generating
20 debate this past week seems to be the references
21 to operating and balance sheet risk, which would
22 be a means to exclude firm from the definition of

1 major swap participant which again would then
2 exclude them from the requirements of business
3 conduct, record-keeping, capital, and margin.

4 So that's the general issue of who's in
5 and who's out. We then get to a couple of issues,
6 the clearing requirements and the transaction
7 execution requirements, which are critical to the
8 entire regime. Again, first on clearing
9 requirement, there does seem to be the general
10 consensus that as many transactions as possible,
11 as many swaps as possible, should be cleared
12 consistent with the G20 declarations. But we have
13 the same questions here: Who is going to decide
14 what is clearable?

15 And what are going to be the standards
16 for making those decisions? And again, if you
17 just look across the columns of this chart, there
18 have been a lot of proposals fashioned to do that.

19 The current version, the Peterson/Frank
20 Substitute, does not specifically rely on notions
21 of standardization, but it does have the concept
22 of an active role of the regulatory agencies, the

1 CFTC and the FCC. The regulators will determine
2 whether a swap must be cleared based on various
3 factors that would be in the legislation, and that
4 can be done either at the request of a clearing
5 house or at the Agency's own initiative.

6 But there does have to be a regulatory
7 determination that the swap must be cleared in
8 order for it to go forward.

9 You then get to the issue of it's a
10 clearing requirement, but what exceptions are
11 there to the clearing requirement? And this is
12 what we were just talking about, the so-called
13 end-user exception. It's similar to the major
14 swap participant definition issue but a little bit
15 different. This goes to the question of who must
16 clear their swaps. It's not so much the question
17 of who's subject to capital and margin
18 requirements. The question is, should there be
19 any exceptions to the clearing requirements, and,
20 if so, how extensive should they be?

21 Certainly, some have argued that there
22 should be no exceptions at all; others have argued

1 that there may be room for some exceptions as long
2 as they are narrowly tailored to try to capture
3 purely commercial firms.

4 Again, I think where the Peterson/Frank
5 Substitute comes out is again the critical
6 language probably about balance sheet risk and
7 operating risk. There's also a sort of odd
8 requirement to staff here that, in order to take
9 advantage of the exception, there has to be a
10 notification to the CFTC of how a non-dealer or
11 non-major participant addresses its obligations
12 with noncleared swaps. There's actually no
13 requirement that we do anything with that. We
14 don't have to decide anything; we simply have to
15 be notified of it in order for the participants to
16 take advantage of the end-user exception.

17 That, then, leads into the question of
18 an exception from the trading requirement.
19 Generally, swaps are mostly traded on trading
20 venues, either contract markets here or the swap
21 execution facilities. But the question came up,
22 if the swap doesn't have to be cleared, does it

1 still have to be traded on one of these trading
2 platforms? Some have argued that the two are
3 distinguishable, and even if it's not cleared, the
4 swap should still be traded on a trading platform.
5 Most of the bills -- in fact I think all of the
6 bills -- have not taken that route.

7 They have all provided, one way or
8 another, that if the swap is out of clearing, it's
9 also out of the trading requirement.

10 CHAIRMAN GENSLER: Terry, where I don't
11 expect you to take a point of view as the Deputy
12 General Counsel, but are they distinguishable?
13 Just that point, is a clearing requirement and a
14 trading requirement from a technical-legal point
15 of view, could you distinguish the two?

16 MR. ARBIT: I think they could be
17 distinguished.

18 CHAIRMAN GENSLER: Okay.

19 MR. ARBIT: The Peterson/Frank
20 Substitute, while like its predecessors does link
21 the two, but it does make clear that reporting is
22 required. If the swap is not cleared, it doesn't

1 have to be traded on one of the organized venues
2 but does still need to be reported.

3 I'm really going to quickly just touch
4 on the others. I think those are the key issues,
5 the critical ones that probably are the most
6 interesting for discussion. But just a couple of
7 the others, or of the ones that are in the chart
8 and have international implications, the
9 Peterson/Frank Substitute would give us here in
10 the CFTC and the industry a new set of DCO core
11 principles.

12 These principles are consistent with
13 international standards today. They were designed
14 to respond to criticism by some that the existing
15 core principles from the CFMA nine years ago were
16 not sufficiently robust. But in addition, under
17 the Substitute, the CFTC would also have
18 rulemaking authority to supplement or change or
19 adapt the rules for clearing houses as time goes
20 on.

21 The next of these is trading platforms,
22 the swap execution facilities. This is an

1 interesting area because I think that the question
2 that's come up is sort of what model these
3 platforms are going to have. Clearly the
4 administration's bill was focused on a model of a
5 certain platform similar to the Intercontinental
6 Exchange. You'll see if you follow the flow of
7 the chart that over time the definition of these
8 facilities has expanded to encompass different
9 models similar to the alternative trading systems,
10 on the security side. The voice brokerage type of
11 business, and I think how that business relates to
12 the swap execution facility, how that fits in is
13 probably an issue that really isn't fully resolved
14 in the House bill and will probably be debated
15 further when it gets over to the Senate.

16 Position limits. All of the bills have
17 provisions where the CFTC may set aggregate
18 position limits that will include swaps, that will
19 include Foreign Board of Trade contracts that are
20 linked to U.S. contracts. The one thing I
21 highlight in the chart is that the Peterson/Frank
22 Substitute also does include a requirement for the

1 CFTC to set futures and options limits within a
2 short number of days after the bill is enacted for
3 physical commodities, the energy and the
4 agriculture. That's one place where the
5 legislation is extending beyond swaps to cover
6 futures and options as well.

7 Foreign boards of trade. There are
8 provisions on foreign boards of trade. Again all
9 of the bills have consistency that for a foreign
10 board of trade that seeks direct access to U.S.
11 customers, the legislation essentially codifies
12 the Commission's current policy on what conditions
13 will be posed on that situation. Where they've
14 differed, as you can see, is whether actual
15 registration will be required of foreign boards of
16 trade. The administration had proposed that there
17 should be a registration requirement, which I
18 think staff here thought of it as kind of a
19 "registration lite" type of regime.

20 But that is not included in the
21 Peterson/Frank Substitute. There's not a
22 registration requirement.

1 The old concept of the multilateral
2 clearing organizations under FDICIA and the CFMA
3 has disappeared in the Peterson/Frank Substitute,
4 although all of the bills have had provisions
5 where the CFTC can exempt foreign clearing houses
6 that they find are subject to comparable,
7 comprehensive supervision and regulation by
8 appropriate regulators overseas.

9 And last, extraterritoriality, the last
10 one on the chart concerns a swap provision that
11 was in neither the administration bill nor any of
12 the others leading up to it. It actually,
13 explicitly addressed the application of the
14 statute to activities overseas concerned with
15 swaps, and the Peterson/Frank Substitute does
16 include a provision that specifically spells out
17 that the law will not apply to activities outside
18 the U.S. unless those activities have a direct and
19 significant connection with activities in or
20 effect on U.S. Commerce, or if they contravene
21 rules that the CFTC sets up to try to avoid
22 evasion of the new law.

1 I think that's generally consistent with
2 the extraterritoriality provision that already
3 exists in the Federal securities laws.

4 That's the chart. I want to mention
5 just two other things very quickly that didn't
6 make the chart. The one I know is very important
7 to everybody here and overseas, which is
8 governmental access to data in the repositories.
9 And the legislation is very clear that data that
10 is in a U.S. repository is available to foreign
11 financial supervisors, foreign central banks, and
12 foreign ministries subject to the confidentiality
13 provisions that are in the Commodity Exchange Act
14 already to protect futures and options type of
15 information.

16 And last, just to support the comment
17 about how fast things move, it's not really day to
18 day; sometimes it's hour to hour. I finished this
19 chart shortly before the meeting started, and as I
20 came down here I got a message on the BlackBerry
21 that it's already obsolete. There have already
22 been further changes, so I stand by my analysis at

1 least until it changes, but they did the current
2 version of the Peterson/Frank Substitute, does
3 include a provision relating position limits.

4 But the CFTC shall strive to ensure that
5 trading on a foreign board of trade will be
6 subject to comparable position limits, and any
7 limits here will not cause price discovery in the
8 commodity to shift the trading on the foreign
9 board of trade.

10 So that's currently in the
11 Peterson/Frank Substitute. And I think that was a
12 quick run through the general international
13 highlights, and I'll stop so we can get to the
14 discussion.

15 CHAIRMAN GENSLER: Terry, could you just
16 expand on one area that I would think would be
17 interesting to everybody -- but particularly David
18 Wright and his colleagues -- is you talked about
19 extraterritoriality, but when in the bill could
20 the SEC or CFTC, or for that matter the prudential
21 regulators.

22 Under the bill, David, the prudential

1 regulators set the capital standards for these
2 swap dealers.

3 When could the SEC, CFTC, or prudential
4 regulators rely on foreign regulators, because the
5 largest, the 12 or so largest financial firms or
6 swap dealers are all global in nature?

7 When could we rely on them with regard
8 to intermediaries? When could we rely on them
9 with regard to clearing houses and swap execution
10 facilities? There may be three different answers,
11 I don't know.

12 You might want to hit the button.

13 MR. ARBIT: Thank you. One of the
14 answers I'm not entirely sure about. There is --
15 there are provisions for the CFTC to exempt
16 clearing houses and the swap execution facilities.
17 We could exempt these entities if they're
18 regulated by the SEC or by a foreign regulator.
19 That's that language I was talking about, a
20 compre- -- if we find there's comprehensive
21 supervision and regulation by appropriate
22 regulators in the home country of the clearing

1 house or the execution facility, and the CFTC may
2 grant an exemption. It's not automatic.

3 CHAIRMAN GENSLER: So it's comprehensive
4 appropriate regulation, and then we can grant it.

5 MR. ARBIT: Right.

6 CHAIRMAN GENSLER: How about the
7 intermediaries?

8 MR. ARBIT: That, you know, there were
9 versions of the bill that did not include that for
10 intermediaries. It was for the trading platforms.
11 I think that's the case in the final, but I will
12 need to look at the final and make sure of that.
13 But there were versions of the bill that drew that
14 distinction that not the intermediaries but the
15 exchange platforms and clearing houses.

16 COMMISSIONER SOMMERS: There are a lot
17 of issues to cover, and I know many of you have
18 questions and comments about several different
19 portions. So I'll go ahead and open it up.

20 CHAIRMAN GENSLER: I just want to thank
21 Terry Arbit and everybody in the legal staff.
22 It's just an amazing job that -- well, under --

1 and Dan Berkovitz, who is here, too -- I mean
2 providing this type of document for this meeting,
3 but well beyond that providing technical
4 assistance to the House, the Senate, Republicans
5 and Democrats alike. It's just remarkable what
6 you guys have been doing.

7 COMMISSIONER SOMMERS: So I'll go ahead
8 and open up the floor. Jiro?

9 MR. OKOCHI: Hi, my name is Jiro Okochi.
10 Mr. Wright, just for clarity I should say, I
11 represent about 400 end users, so we may have to
12 agree to disagree. But you made a point in your
13 document about how credit may have been
14 undercharged, and some of it was clearly evident
15 in the financial crisis. And then in your opening
16 statement you mentioned that end users should pay
17 for the cost, I guess for the privilege of using a
18 distributive market.

19 I guess I'm trying to understand how you
20 can clarify why the cost should go up, so if I
21 look at, you know, there's 200 swap dealers in the
22 marketplace in ISDA. They're clearly making some

1 profits from entering into derivatives, and from
2 an end-user perspective, when they enter into a
3 swap transaction, they're looking at the overall
4 cost of the banking relationship, and I believe
5 it's vice versa. So you're looking at how much
6 you're paying for your loans, how much you're
7 paying in fees, and related to that how much are
8 you paying for the costs of entering into the
9 derivatives.

10 So I'm just trying to understand if you
11 think derivatives are underpriced for end-users,
12 and the cost for margining and clearing should
13 make up for, you know, the new price under the
14 reform, or if I'm missing something.

15 MR. WRIGHT: Well, in our paper, and
16 it's only an official position, what we clearly
17 state here is that we want, on these markets, we
18 want risks to be priced properly.

19 I think it's a fairly heroic assumption
20 to make that in these markets risk has been priced
21 properly. You may say that. I think that we
22 fundamentally disagree. And if, as we'll, I

1 think, agree on the policy side that we want to
2 drive more of this business to be cleared, drive
3 it on to exchange, make it more transparent, et
4 cetera, et cetera, if that is going to require
5 more cost and a higher price for nonfinancial
6 firms, then we think that is correct.

7 We think that is entirely correct, and
8 we believe that the benefits of that public policy
9 will result in something that's pretty precious,
10 and let's not forget the value of that which is
11 called financial stability. And let us not forget
12 that this financial crisis -- let me talk about
13 the European Union again where so far we have
14 authorized expenditures to bail out the banking
15 system to the tune of 31 percent of GDP.

16 Not all of that has been used.
17 Actually, we've been -- we've used 12 percent.

18 So there's something very seriously
19 wrong here. I think we all know that, and some of
20 that -- not all of it, but some of it -- we think
21 has been because the pricing of risk in these
22 markets has not been entirely correct. So this

1 policy is going to possibly result in more costs
2 for hedging positions.

3 We've made it very clear that we do not
4 want to cut off bilateral trading, bilateral
5 custom-made derivatives, but again, we think that
6 the risks require more capital to be posted.

7 We're going to change our capital
8 requirements directive to make sure that is the
9 case. The firms, whether their market -- whether
10 their dealers or market participants decide that's
11 what they want, nonfinancial firms, so be it. But
12 the cost will go up, and the cost, we think, has
13 to go up in order to make the system safer.

14 So, you know, there's a fundamental
15 question here. We're not dictating prices, but we
16 are saying we want a safer system, yes. Very much
17 so.

18 COMMISSIONER SOMMERS: I think this is
19 an interesting and challenging issue. And as
20 Terry captured it so well, although there may be
21 agreement on which direction to head with the
22 decision-makers on Capitol Hill, capturing that

1 decision in actual language has been the real --

2 On this particular issue, does anybody
3 else have comments? George?

4 MR. CRAPPLE: If the cost of the end
5 user is going up because of the posting of margin,
6 that could be offset by through the transparency
7 and the execution rules that much better
8 executions are become available. Or were you
9 talking about specifically assessing some sort of
10 charge to the users?

11 MR. WRIGHT: I think it's clear that we
12 think that as more and more trading goes on
13 exchange, and you would expect over time those
14 additional costs I was referring to should
15 decline, hmm? That's clear.

16 But I've outlined a policy here which we
17 believe is the right one, and we believe may --
18 may and is likely to require and result in
19 additional costs.

20 Now, the issue then becomes -- and this
21 is the big issue you're debasing, and we've just
22 heard from your general counsel about who's in and

1 who's out, hmm, of this system, hmm?

2 And we've noted very clearly what
3 paragraph 4 in talking about this triple
4 cumulative conditionality about who has to -- who
5 is going to be inside this system and who's not.
6 We will be looking at that as well.

7 We have, I think, an a priori view that
8 we want the exemptions to be extremely narrow.
9 Because we have a view -- it may be wrong, but we
10 have a view -- that if we do not -- if we have an
11 open-ended system here, basically we'll end up
12 with arbitrage and another shadow system with all
13 the dangers that results.

14 And so again I think it's too early to
15 say how these economic effects will play out.
16 We're going to analyze this very carefully, and as
17 we design our exemption regime, if we have one --
18 but let's assume we have one, we haven't said
19 we're not going to have one -- we want to make
20 sure that these new disciplines, and there are new
21 disciplines, apply as widely as possible.

22 COMMISSIONER SOMMERS: David?

1 MR. DOHNALEK: I would like to at least
2 provide the perspective of the business end user
3 since I'm perhaps in the minority in the room
4 here. But I'll just make a few points.

5 As a business end user, we clearly see
6 the benefits of the financial regulatory reform,
7 especially in the areas of increasing transparency
8 and reducing systemic risk, and restoring
9 financial stability. Those are certainly all good
10 things from our perspective.

11 However, we're keenly interested in
12 making sure that any new regulation does not
13 eliminate the important flexibility we think we
14 need to effectively manage risk in our business.

15 And so, specifically, what do we mean?
16 First off, we believe that, you know, business end
17 users do not pose systemic risk to the financial
18 system and, in fact, end users, you know, trades
19 represent only a small minority of the total sort
20 of OTC derivatives market. You know, we're not in
21 the business of speculating and gambling for
22 profit; it's not in our policy or our charter.

1 We believe it's imperative that end
2 users continue to have the flexibility to enter
3 into bilateral customized transactions that best
4 address the risk profile that we have in various
5 aspects of our business and to mitigate that risk.

6 And so we're clearly in favor of
7 exemptions for business end users from central
8 clearing and bilateral margining.

9 Now, without these exemptions, we think
10 we'd suffer the burdens of losing hedge accounting
11 treatments in many cases for many of the
12 transactions that we would engage in, which
13 introduces significant earnings volatility to our
14 P&L. It would also impose perhaps onerous
15 requirements for taking capital away from what we
16 would deem more productive investments in our
17 business and in growing our business and
18 employment, and divert that precious capital to
19 cover things like margin requirements.

20 So, bottom line, we as a business end
21 user support many of the benefits of the proposed
22 regulatory reform, but we'd like to ensure that

1 that regulation not overreach and end up stifling
2 or inhibiting the important flexibility we need to
3 mitigate the risk in our business and to invest
4 the capital that we need to grow our business.

5 CHAIRMAN GENSLER: Could I just ask,
6 then we might have a rebut response, and thank you
7 for joining the committee, by the way.

8 You mention ability to customize. I
9 asked you if you were familiar that the
10 administration proposal and every bill in Congress
11 that's been submitted so far since May allows for
12 customized transactions. So that's a valid point
13 you're raising. The administration supports it.
14 Chairman Peterson's bill, Chairman Frank, Chairman
15 Dodd's bills -- I think Senator Reid also had a
16 bill -- all supports that exact point.

17 Is it some other point that you're
18 debating? I think it is. I think it's saying
19 that as an end user you don't want standardized
20 transactions to be on clearing houses. I just
21 wanted to separate what I think it is that you're
22 raising. But customized transactions have been

1 fully supported by the administration and by each
2 of the committees. And if I'm correct, then the
3 question of standardized transactions -- by the
4 way, you would still be able to get hedge
5 accounting -- I find that being raised, with all
6 respect, is adequately addressed because you could
7 customize a transaction and be able to get your
8 hedge accounting.

9 I probably come out a different place.
10 I'm where David Wright is. I think that the
11 taxpayers in this country have \$180 billion in
12 AIG. That's \$600 each one of us has in there, and
13 I know that at Boeing you probably had sales go
14 off.

15 You had to look at a year that was
16 probably very much below your current budgets. So
17 it hit Boeing, it hit every shareholder of Boeing,
18 every employee of Boeing. And I don't know how
19 many people you probably would have hired if the
20 employment was better in this country.

21 So this calamitous situation hit
22 everybody at Boeing as well, so I sort of warm

1 with where David Wright is. I think we should
2 have all standardized swaps in clearing. But
3 recognizing maybe the votes aren't there in
4 Congress, maybe the Boeings and the others in this
5 great democracy of ours will convince Congress not
6 to do it.

7 My question for you is, could you, as
8 Treasurer of Boeing, support requiring that
9 standard swaps be brought to a trans-prior in
10 trading venue while you're exempt from a clearing
11 requirement?

12 MR. DOHNALEK: Well, Mr. Chairman, I
13 guess I would have to make sure I understand the
14 technical distinction you're making. I think that
15 --

16 CHAIRMAN GENSLER: Well, I'm here, I'll
17 explain it.

18 MR. DOHNALEK: Yes.

19 CHAIRMAN GENSLER: Trading is where
20 buyers and sellers meet in the marketplace where
21 price discovery occurs, where information deficits
22 that occur in the market right now are exposed,

1 and where a transaction occurs, and then prices
2 are reported: posttrade transparency.

3 Clearing is something that happens for
4 months or years after the trade that has to do
5 with risk mitigation. Risk mitigation because
6 these derivatives values change in value.

7 Right now we have Wall Street, really
8 five banks, that internalize both the trading and
9 the risk management. And what I am strongly
10 recommending for the benefit of economic growth
11 and efficiency in markets is that both are moved,
12 but the trading side benefits. If every treasurer
13 in America, every assistant treasurer in America
14 had a screen and could see the pricing of interest
15 rate, currency, commodity, equity, credit default
16 swaps, the spreads would narrow. And economists
17 say when spreads narrow, liquidity goes up.

18 Wall Street will probably contend, no,
19 not really liquidity won't go up. But I think you
20 benefit as a treasurer of Boeing every time you're
21 thinking about issuing debt that there's something
22 called, you know, that corporate bonds are now

1 reported in a realtime basis. I think you benefit
2 when you do a share repurchase. If you were going
3 to do a share repurchase and you didn't know where
4 your stock was trading, you'd say the SEC wasn't
5 fully doing their job.

6 And if you were hedging something in the
7 futures market, and you were trying to hedge it
8 and didn't know where the last futures price
9 traded, you'd say that we here weren't really
10 fully doing our job.

11 So what we're talking about is not
12 small, it's a big thing. But it would shift an
13 information advantage to you as an end user, and
14 then let you decide with your counterparty whether
15 you would keep -- you might keep the trade on the
16 books with the bank, have your credit arrangement
17 with the banks as you do now, not be required to
18 move it to central clearing but at least have the
19 benefit of the transparency.

20 MR. DOHNALEK: All right, so we --
21 what's important to us is that we be able to have
22 that bilateral discussion with the bank because

1 some of our requirements are unique and long-dated
2 and end up --

3 CHAIRMAN GENSLER: You would have that
4 on all the customized swaps you will want,
5 absolutely.

6 MR. DOHNALEK: Right. So what we're not
7 wanting is to be forced into standardized
8 transactions through an exchange because that
9 won't fit the risk --

10 CHAIRMAN GENSLER: My question is, is
11 you would completely have flexibility to do all
12 the customization you want. But if you happened
13 to do a standard swap, a one-year interest rate
14 swap that is listed on a trading platform, then
15 the counterparty, the big bank, would have to, you
16 know, on that transaction expose it to the price
17 discovery function.

18 MR. DOHNALEK: Well, certainly something
19 that we'll consider. But you understand that
20 what's important to us is to be able to have --
21 and I think, fundamentally, I mean you mentioned
22 AIG, you --

1 CHAIRMAN GENSLER: Mike, [sic] can I ask
2 you, what wouldn't be good for Boeing and your
3 employees and your stockholders of that?

4 MR. DOHNALEK: I'd have to think about
5 it, Mr. Chairman. I think that, fundamentally
6 again, it's the ability to customize, the ability
7 --

8 CHAIRMAN GENSLER: We have that.

9 MR. DOHNALEK: -- to get hedge
10 accounting because that is important to us, the
11 earnings volatility issue. And the ability to not
12 be required to post margin because it does take
13 cash away --

14 CHAIRMAN GENSLER: I've said yes to
15 every one of those.

16 MR. DOHNALEK: Okay.

17 CHAIRMAN GENSLER: I can't understand
18 how this wouldn't be an unabashed good thing for
19 you.

20 MR. DOHNALEK: All right, and I'm not
21 sure that it is, but let me -- let me get back to
22 you on that.

1 CHAIRMAN GENSLER: I'd thank you.

2 MR. DOHNALEK: All right.

3 MR. WILSON: Here it seems to me that
4 the possibility that you raise of trading
5 standardized swaps which are not cleared in a
6 central marketplace really highlights what would
7 then be happening, which is you would then be
8 giving the liquidity providers of those swaps the
9 ability to tie together, simultaneously, the
10 pricing of the derivative and the credit component
11 implicit in not requiring collateral.

12 Some people might say that that's
13 anticompetitive because your tying together
14 multiple services at the same time, and it doesn't
15 seem like the right approach. The better approach
16 seems to me to be to recognize that issue and to
17 split those things apart.

18 CHAIRMAN GENSLER: Thank you. Don, what
19 could come to a judgment.

20 COMMISSIONER SOMMERS: David, did you
21 have a comment?

22 MR. WRIGHT: Well, I very much agree

1 with what the Chairman has been saying here.
2 Again, our position is I want to just read out one
3 or two passages because, maybe to reassure my
4 colleague on the left here, we're not saying that
5 there shouldn't be any customized derivatives
6 trading in the future, but we want that trading to
7 be properly prices. And we intend to, because we
8 believe it is much safer to trade as much as
9 possible and to clear as much as possible, we are
10 going to provide incentives by requiring more
11 capital to be posted for this type of trading in
12 the future.

13 So that is a deliberate policy choice,
14 and it's a policy choice for financial stability.
15 And I repeat that point.

16 So, secondly, let me say that we clearly
17 state in our papers that we do not, will not put
18 forward policy -- which prevents Boeing, in your
19 case, sir, or anybody else -- from managing the
20 risks in your business. We're not saying that.

21 And what we say about variation margins
22 is the following: Variation margin requirements,

1 if needed for financial firms, should be tailored
2 in such a way that they do not undermine the
3 corporate sector's ability to use derivatives for
4 transferring risk, especially in the case of
5 companies whose use of derivatives is below a
6 threshold.

7 So there are signals there that would
8 perfectly understand the issues you are raising.
9 But there is a much broader point, and I come back
10 to the broad point, and I come back to the
11 economic damage and the financial stability issues
12 here. That is what's really important. And we
13 believe, as the Chairman has said, the more
14 transparent the markets are, you and your firms in
15 the end will benefit from that by tighter spreads,
16 by more transparency, by understanding exactly
17 where the market is. So we want to encourage
18 those trends, we want to clear transactions
19 because we believe it's much safer, and we want
20 the CRTC and our parallel regulators and
21 supervisors to have fully information about what's
22 going on in these markets. And that was not the

1 case in this financial crisis.

2 So I don't think we're closing off what
3 you want to do; we're just saying there's going to
4 be an economic price if you don't do it in the
5 more so-called inverted commerce standardized way
6 or through clearable transactions.

7 COMMISSIONER SOMMERS: George?

8 MR. CRAPPLE: Taking this Boeing hedging
9 example that has been discussed, I think I heard
10 two different things. Chairman Gensler was
11 saying, no, they won't have to put up margin for
12 their customized bilateral long-term derivatives;
13 and Mr. Wright is saying, yes, they would.

14 MR. WRIGHT: No. No.

15 MR. CRAPPLE: No?

16 MR. RIGHT: No. You didn't listen to me.
17 I said variation margins, if needed. I said "if
18 needed." So first of all, that's' not a position
19 that's --

20 MR. CRAPPLE: Oh, that's variation
21 margin but you --

22 MR. WRIGHT: Yes.

1 MR. CRAPPLE: -- also talked about a
2 positional --

3 MR. WRIGHT: Asci.

4 MR. CRAPPLE: -- capital --

5 MR. WRIGHT: So it depends. In terms of
6 the U.S., it depends on the definition of this
7 famous category here under No. 4, is it not, about
8 who is covered by the exemption?

9 MR. CRAPPLE: I guess I'm still confused
10 because I thought I heard you say that a, you
11 know, bilateral, negotiated, customized swap
12 transaction that a capital deposit would be
13 required.

14 MR. WRIGHT: Well, clearly, what we're
15 saying is that where there's OTC trading we intend
16 to change the capital requirements rules -- hmm?

17 CHAIRMAN GENSLER: For banks.

18 MR. WRIGHT: For banks. So clearly for
19 banks who will be required to post -- to have more
20 capital for that type of trading, for the stuff
21 that cannot be centrally cleared. And the Basel
22 Committee right now is looking at that. So that,

1 of course, will in a sense add to the cost, and/or
2 potentially add to the cost, and that price you
3 would imagine would increase for the OTC
4 transactions.

5 CHAIRMAN GENSLER: And just to clarify,
6 if you like, the administration and this
7 Commission, because I testified on behalf of the
8 full Commission before Commissioner O'Malia was
9 here, has been supportive of customized
10 transactions that individual hedgers, whether it's
11 Boeing, whether it's small, whether it's large, or
12 even individual speculators would have an ability
13 to tailor their over-the-counter derivatives and
14 enter into bilateral transactions after any
15 legislation moves forward.

16 The banks providing that service would
17 have capital charges and possibly margin, but
18 certainly be able to provide those customized
19 tailored transactions to both hedgers and
20 speculators.

21 What I think really the debate is over
22 is that part of the market that can be cleared or

1 that part of the market that's listed on a swap
2 execution facility. It's so standard that it can
3 be cleared, is there a requirement? And what I
4 was raising is I think the two were separable.
5 And as our General Counsel's Office, Terry Arbit
6 said it can be separable with Congress' help.

7 I think that is what I was trying to
8 elicit from David is that I think the legitimate
9 issue that end users have raised about their
10 costs, I side with David Wright, I think it's
11 important not to ship that cost to taxpayers. But
12 if Congress decides to have an exemption for end
13 users from clearing, which I understand may well
14 be what develops -- that's what's part of our
15 great democracy -- I think that the transparency
16 part of it is something that corporate America has
17 an opportunity right now to influence this debate
18 in a positive way, in a positive way to your
19 bottom line.

20 I'm appealing to your fiduciary duty. I
21 think you should ship that information advantage
22 from the Goldman Sachs to your left to the

1 Boeings. And there's five firms right now that
2 are dominant in this country in this business. I
3 would think you would want to ship that
4 information advantage to the thousands of end
5 users.

6 MR. CRAPPLE: I'd just like to clarify
7 that I really agree with everything you both have
8 been saying about the benefits to the end users
9 and, of course, to our financial system.

10 I'm not quarreling with it at all. I
11 agree with it entirely.

12 COMMISSIONER SOMMERS: Is there anything
13 further on this issue? Mike, did you have a
14 question?

15 MR. NEWSOME: Commissioner, this is Jim
16 Newsome.

17 COMMISSIONER SOMMERS: Jim, we can hear
18 you.

19 MR. NEWSOME: Okay, thank you.
20 Certainly, I, even though I'm on the board of the
21 CME I don't speak on their behalf.

22 I think the management of CME has done

1 that quite well throughout this whole debate with
2 both the Commission and the Congress, and I, as
3 well as I know the CME management has supported
4 the overarching goals of the Congress and the
5 administration to reduce systemic risk. And,
6 certainly, I completely understand the
7 conversation here between standardized and
8 customized, but I think on behalf of the clearing
9 house standpoint I wanted to raise an issue with
10 regard to standardized contracts and get both
11 David and the Chairman's view. And I think even
12 behind that the CME has supported the benefits of
13 central party clearing. There's been discussion
14 about whether it should be mandated or whether it
15 should be incentivized, and I won't get into that
16 right now.

17 But contracts that are standardized,
18 even though they are standardized, if they're very
19 infrequently traded, makes it extremely difficult
20 for the clearing house to clear because it's
21 difficult for the clearing house to calculate
22 collateral climates consistent with prudent risk

1 management. How would you deal with even
2 standardized contracts that are very infrequently
3 traded when it creates a lot of difficulties in
4 the clearing house?

5 CHAIRMAN GENSLER: Oh, my god, David
6 Wright wanted me to go first.

7 Hi, Jim, it's good to chat with you even
8 over the phone here like this, and it's an honor
9 to be in the job you once held. I think that what
10 the House bill contemplates, and we support though
11 there's been various alternatives to this, is sort
12 of a two pieces to this: that the regulators, the
13 SEC and CFTC and the clearing houses, have a role
14 to play in these determinations of what's
15 clearable. But both have a role to play where the
16 clearing decision is an important one. But it all
17 has to be under robust risk management standards.

18 And one of the key things, I believe, to
19 robust risk management is that a clearing house
20 can adequately price the transactions because
21 clearing houses market to market transactions on a
22 daily basis and need to have some ability to do

1 that. That's for more accessible in the rate
2 markets, interest rate and currency markets, less
3 so in some of the credit markets and commodity
4 markets. But I think it's central to the question
5 of what is clearable is how well you can risk
6 management of contracts. So I suspect there's not
7 going to be -- I think there will be a mutual
8 interest between regulators and the markets to
9 make sure that the clearing houses are robustly
10 managed and that anything that is deemed to be
11 clearable is done with that in mind.

12 Also the bill contemplates a public
13 comment to it. I think, if I'm right, Terry Arbit
14 can tell us that if a clearing house asks
15 something to be cleared or if the SEC and CFTC
16 wants it to be cleared, we have to put it out for
17 comment for, I think -- 30 days maybe in there,
18 Terry?

19 MR. ARBIT: Right. That's right.

20 CHAIRMAN GENSLER: And though that was
21 recommended by people in Congress, I fully support
22 that. I think that's a good idea so that the

1 marketplace will be able to comment, and then a
2 determination would be made as well.

3 MR. NEWSOME: Mr. Chairman, I think that
4 flexibility, you know, in very unusual
5 circumstances like the one I mentioned would be
6 very useful to both the Commission and the
7 clearing house. And let me finish by saying I'm
8 glad that I'm not sitting in your chair right now.

9 MR. WRIGHT: Very briefly, I think we
10 have a similar philosophy to you here. I think
11 it's clear that there's a role both for CCPs and,
12 of course, ultimately the regulators. We would
13 avoid a situation where we have a so-called
14 standardized product, but the CCPs say, "Look,
15 really we're not -- we think this is -- we don't
16 think it's right that this should be centrally
17 cleared." But, clearly, the regulators at the end
18 of the day have got to make, in our view, general
19 judgments about whether our products should be
20 cleared.

21 So we're struggling with this issue.
22 We're struggling about how it works. We can see

1 some dual responsibility here at the end of the
2 day. Of course I think it is the regulators,
3 supervisors, who have to decide.

4 And let's be clear here. We would pay a
5 lot of attention to the CCP's views because we've
6 got to be extremely careful about this
7 concentration of risk and default, back up and so
8 forth, those points that I mentioned earlier.

9 And so robust standards and robust
10 standards for CCPs are going to be absolutely
11 essential. But I, again, we're thinking our way
12 through this, but I quite like the process of the
13 Chairman and counsel were outlining here.

14 COMMISSIONER SOMMERS: Is there anything
15 else on those particular issues? I know Mike has
16 a question.

17 COMMISSIONER DUNN: Just a statement on
18 that, and then I'll go to another question. And
19 that is I think it's the intent of Congress and
20 certainly this regulator to tell the whole world
21 that the days of cheap risk aversion with the
22 taxpayer as the backstop is over.

1 Now the good news for the end users is
2 the over-pricing of risk management should be over
3 as well, and you should understand more closely
4 what you're paying for and have some options
5 there.

6 Now I'd like to change the subject
7 matter here. David, when you were talking about
8 the E.U.'s process, and you laid out that the
9 first year you will have a proposal ready, that it
10 will probably be adopted sometime mid-year. Let
11 me follow up on that because by the time it gets
12 down to the eventual regulator, the FSA and the
13 Boffin, the CFTC counterparties, what date do you
14 see promulgation of regulations?

15 MR. WRIGHT: Well, Commissioner, it's
16 rather like asking you the exact date when the
17 Congress will agree on your package. But our best
18 -- our best estimate at this stage is that we
19 would hope with good preparation, good
20 coordination impact analysis that if we put
21 forward the main legal text in the middle of next
22 year, we would hope, given the urgency of these

1 issues, that we could get these texts to be
2 entering into force around in 2012 and probably
3 towards the end of 2012.

4 Now that sounds a long time. It's
5 possible -- possible we could go faster. We have
6 different legislative techniques here, and we will
7 certainly want to go as fast as possible, but we
8 have an important deliberative process. We have
9 two chambers member states and our European
10 parliament who have to debate and decide on these
11 matters. So this takes a lot of time.

12 So I'm hoping that within a year of our
13 tabling this work, these tabling these proposals,
14 we could get agreement.

15 And if we put them in the form that
16 they're directly applicable to the member states,
17 that sometimes can speed up matters.

18 So I don't want to promise that the CCPs
19 should be in Europe. So we have an open mind.
20 I'd like to move forward on a broader context.
21 We've done that in the past with the CFTC. We
22 haven't been able to move forward as fast as we

1 wanted with the SEC, but we think the way forward
2 in the future is to build up strong regulatory and
3 supervisory systems both in the U.S. and in
4 Europe, and to mutually recognize each other and
5 trust each other, hmm? That's the right way
6 forward.

7 But for legal reasons in the U.S. and
8 for these are complex areas of policy, we know
9 that, it's going to take time.

10 But on the CCP side, we do have some
11 concerns, systemic concerns, and, you know, we
12 come back to that question I asked:

13 Do we need a backstop for CCPs? Well,
14 if we do, who's that backstop going to be? It's
15 going to be the European Central Bank or the
16 European central banks -- other European central
17 banks one form or another.

18 So that's where we are at the moment,
19 and we're listening to all the arguments.

20 COMMISSIONER SOMMERS: Just to recognize

21 --

22 MR. NEWSOME: Madam Chair --

1 COMMISSIONER SOMMERS: -- that this CFTC
2 has had our mutual recognition program in place
3 for over 20 years, and we have talked about this
4 issue for a lot of years and recognize that we
5 think what we have in place works well, codifying
6 it may be the direction that we're heading.

7 And, Tom, I didn't hear in your comments
8 that you would have a problem with codifying what
9 our current regime is.

10 MR. CALLAHAN: No, I tried to be very
11 specific and say that the current regime we view
12 as effective and appropriate.

13 COMMISSIONER SOMMERS: Thank you, Tom.

14 CHAIRMAN GENSLER: Tom, one form of
15 codification would be just call it a registration.
16 It would be a different registration similar to
17 what I believe the FSA has; it has two forms of
18 registration, one that you're probably familiar
19 with which is their fully-regulated regime for
20 entities there, and another is for these foreign
21 -- from their perspective -- foreign boards of
22 trade.

1 We've had a no action process where one
2 way to codify that no action process is to have
3 Congress make a registration requirement for
4 foreign boards of trade, but it would be
5 consistent with what we've been trying to achieve
6 with some enhancements, of course.

7 COMMISSIONER SOMMERS: I think I heard
8 Jim making a comment. Jim?

9 MR. NEWSOME: Yes, ma'am, thank you.
10 Going back to the administration goal to reduce
11 systemic risk through central clearing, I've got a
12 couple of questions maybe Terry Arbit may be the
13 best to address. And I'm thinking again from the
14 clearing house standpoint.

15 Terry, is there anything in either of
16 the legislative bills that would impair a clearing
17 house's ability to respond immediately to a swap
18 dealer default? And, secondly, would all customer
19 collateral be protected in the event of a swap
20 dealer bankruptcy?

21 MR. RADHAKRISHNAN: Jim, this is Ananda.
22 Could you repeat your first question because we

1 have problems hearing you.

2 MR. NEWSOME: Yeah, I'll be glad to. Is
3 there anything in either of the House or the
4 Senate bills that would impair the clearing
5 houses' ability to respond immediately to a swap
6 dealer default?

7 MR. RADHAKRISHNAN: To a swap dealer --

8 SPEAKER: Default.

9 MR. RADHAKRISHNAN: Default.

10 MR. NEWSOME: Default.

11 MR. RADHAKRISHNAN: No. I don't see,
12 no. No. And your second question is?

13 MR. NEWSOME: Yeah, would all customer
14 collateral be protected in the event of a swap
15 dealer bankruptcy?

16 MR. RADHAKRISHNAN: We haven't seen the
17 -- I think the Chairman alluded to that -- we
18 haven't seen -- or Terry did. We haven't seen the
19 bankruptcy piece of it in the legislation nor have
20 we seen any -- and correct me if I'm wrong, Terry
21 -- nor have we seen any provisions relating to
22 segregation of funds.

1 MR. ARBIT: Well, there is some on
2 segregation.

3 MR. RADHAKRISHNAN: Beg your pardon?

4 MR. ARBIT: There is some on
5 segregation.

6 MR. NEWSOME: Thank you.

7 MR. RADHAKRISHNAN: There is some
8 segregation but we haven't seen the bankruptcy
9 piece, I think.

10 MR. ARBIT: Right, yes.

11 MR. RADHAKRISHNAN: Because --

12 MR. NEWSOME: Do you think there will be
13 a bankruptcy piece, or would that be punted until
14 another time?

15 MR. ARBIT: Jim, this is Terry. We --
16 yeah, I don't think it's going to happen on the
17 House side if they're going to the floor this
18 week. We've had discussions with Judiciary
19 Committee staff on the House side. Chairman
20 Gensler, in his letter to the Hill last August,
21 supported bankruptcy provisions and provided some
22 sample text that we on the staff level very much

1 supported. So, and we would do everything we
2 could, but as to whether it happens, it's out of
3 my hands, but --

4 CHAIRMAN GENSLER: And, Jim -- Gary here
5 -- I think on the first question some earlier
6 versions of the resolution authority, not the
7 derivatives bill but the resolution authority,
8 stayed any obligations under contracts up to 5
9 o'clock on the day after a default, which I was
10 asked to testify on broader matters but raised in
11 Congressional testimony in front of the House
12 Agriculture Committee a very real concern that
13 that should be -- that should no go to margin and
14 obligations under clearing houses; that that
15 would, in fact, undermine the clearing house's
16 ability to move quickly.

17 What I don't know is whether that's been
18 modified. We recommended the modifications to the
19 Hill. We still believe those modifications should
20 be -- that clearing obligations of defaulting swap
21 dealers should be able to be quickly closed out,
22 and that it is actually destabilizing if there's a

1 36-hour stay.

2 MR. ARBIT: If I could just add just one
3 more note on the bankruptcy, the Peterson/Frank
4 Substitute does include a provision that the
5 Financial Services Committee had adopted, I think
6 it's 180 days the SEC and the CFTC need to report
7 to Congress on changes that we think should be
8 made to the insolvency regime with respect to
9 swaps. So, but that's as far as it goes at this
10 point.

11 MR. RADHAKRISHNAN: Well, I think, as
12 the discussion earlier demonstrated, if we had a
13 segregation and insolvency regime for cleared
14 swaps which is very similar to if not the same as
15 that for futures, then we could possibly take care
16 of the default situation in a similar fashion to
17 that which happened in Lehman. But absent one of
18 those, then I don't -- it might just be making the
19 situation worse if not -- as opposed to making it
20 better.

21 MR. NEWSOME: I agree. Thank you,
22 Ananda.

1 COMMISSIONER SOMMERS: Commissioner
2 Chilton?

3 COMMISSIONER CHILTON: I was going to
4 ask a question about timing, too, but Commissioner
5 Dunn sort of asked it, and it was helpful.

6 But I did want to not only join my
7 colleagues in thanking David and your colleagues
8 for being here, but say how impressed I am with
9 the document that you have, and I'm stuck by the
10 similarities in a lot of them. And so I'm
11 particularly pleased to hear you talk about the
12 comprehensive fashion, you talked about forex.
13 We've talked about metals a lot of times -- I
14 think we need to include metals -- but just a very
15 impressive document. And I think part of, you
16 know, my message, my takeaway from this is we're
17 actually moving in tandem on a lot of these
18 things.

19 Like I said in my opening statement, I'm
20 not as concerned about who goes first, sort of
21 like everybody's jumping in the pool, everybody's
22 sort of scared at first. I wanted to make a

1 clarification, too, because the Chairman talked
2 about the timing on the legislation, which I think
3 he's probably right.

4 It's probably the end of the first
5 quarter when we might see legislation from the
6 Hill dealing with the OTC market. But that
7 doesn't mean that we may not move forward -- and
8 none of us can prejudge what the Commission will
9 do -- but with regard to position limits on
10 current markets. And so I didn't want anybody to
11 think that we were talking about, you know, a year
12 from now there.

13 And, as I said, I think, you know, if
14 you go forward in a reasonable way, if you, for
15 example, err on the high side that this potential
16 of regulatory arbitrage, which I think is a real
17 concern -- Commissioner Dunn's raised it a number
18 of times -- that maybe that's not as large a
19 concern if you're not clamping down so
20 devastatingly tight that people say, "I gotta go
21 someplace. I gotta go to the OTC market before
22 it's regulated," or, "I'm gonna go overseas."

1 essentially cleared will be defined and regulated
2 as a swap dealer. And yet the Treasury says in
3 their discussion of regulatory reform, which was
4 kind of the precursor to all of this legislation,
5 that derivative dealers who create large exposures
6 to counterparties should be subject to a robust
7 regime of prudential supervision regulation. And,
8 you know, an enhance this whole concept of a swap
9 dealer, but clearly a market participant that
10 exclusively makes markets and cleared swaps, and
11 does not make markets in bilateral swaps -- which,
12 coincidentally, is the category in which DRW falls
13 -- should not come under this new set of
14 regulations which is being created to prevent
15 another so-called AIG.

16 CHAIRMAN GENSLER: Maybe, Don -- we've
17 agreed on a lot of things today, but this one I
18 might take a little bit different side -- and it's
19 just one person's view. I'm not speaking for the
20 Commission. But I think just as we regulate all
21 broker dealers, whether they're the largest of
22 multinationals or the smallest -- and there's

1 about 6,000 broker dealers that hold themselves
2 out -- we regulate futures commission merchants.
3 I don't remember our count, but it's the largest
4 to the intermediate size. Somebody holds
5 themselves making market in swaps, we want them to
6 be under the full recordkeeping and reporting with
7 an audit trail, the business conduct standards,
8 and may well be that the capital standards would
9 be quite low if they're all cleared. As you said,
10 it might all go to clearing.

11 But I think to bring the registration
12 and regulation only to the five big houses and not
13 to other swap dealers, if they're really swap
14 dealers -- they're dealing in swaps and holding
15 themselves out to the public making markets in
16 swap -- the business conduct recordkeeping,
17 reporting are valid and as a way to get consistent
18 uniform rules to a marketplace.

19 MR. WILSON: I mean I'm particularly
20 focused on the instance where, you know, a market
21 participant may just be making electronic markets
22 in swaps. So there's no issue of holding out,

1 necessarily, although they may enter into a
2 market-maker agreement with an exchange. And but
3 they're just posting prices electronically just
4 like they do in futures markets. And, by the way,
5 you know, in that instance from an economic
6 perspective there's probably not a lot of
7 difference between something called a swap, which
8 is cleared, and something which is called a future
9 and is also cleared.

10 CHAIRMAN GENSLER: Well, I'd imagine
11 that we'd allow ourselves a chance to debate this
12 as we would go forward in rulewriting. But as I
13 think the statutory language allows us define swap
14 dealer as well, but, conceptually -- and I can't
15 speak for future rulewriting. I think that it's
16 more than just the five big swap houses if you're
17 really holding yourself out to the public making
18 markets.

19 But, you know, I haven't thought through
20 the specific of, you know, as you say, electronic
21 marketmaking of some sort.

22 COMMISSIONER SOMMERS: We only have

1 about 10 more minutes left of the meeting today,
2 if anybody else has any issues they'd like to
3 bring up.

4 MR. WRIGHT: If I may I have one
5 comment, thank you very much for your kind
6 comments, Commissioner, about our position, which,
7 you know, I've been doing this work for 10 years
8 and I believe that this is a classic area where if
9 we can do a good job together, and I mean that
10 converge out outcomes to the maximum extent
11 possible given the differences in our political
12 systems, we actually de facto set the world
13 standards here, hmm?

14 This is not just the E.U.-U.S. anymore,
15 it's G-20, we have emerging countries. We have
16 the lion's share between us of these huge markets.
17 So this isn't just a bilateral discussion,
18 actually, it's a global discussion, it's a G-20
19 discussion. And what is true here, by the way, is
20 true in many other areas -- I could list many of
21 them -- accounting standards, investment services,
22 banking -- you name it.

1 And I do think here that this is perhaps
2 one of the best examples where we have a unique
3 opportunity to do a job of work to make the
4 financial system more stable. I'm repeating what
5 I've said earlier, but from my position, from our
6 position, that's how we see this. And we are
7 going to do everything we can and, hopefully,
8 convince you about on or two points, and you will
9 certainly convince us on some other points that we
10 end up in a closely synergistics sort of outcome.

11 And, you know, neither of us can promise
12 what our political systems can deliver, but I
13 think if we say, well, look, you know, we've --
14 our position both justified economically and
15 justified politically, and justified strategically
16 is very similar to the United States, and vice
17 versa, I think it sustains -- I think it sustains
18 our positions with our political authorities.

19 COMMISSIONER SOMMERS: Thank you, David.
20 Do any of my fellow commissioners have a closing
21 comment?

22 COMMISSIONER CHILTON: Well, just a -- I

1 mean one other point I was thinking about as you
2 were saying that, David, is that reduces the
3 ability for regulatory arbitrage at other places
4 around the globe, that it won't be a race to the
5 bottom.

6 And even if it is, it would be temporary
7 and short-sighted. So if we do these things in
8 general together, as you say in tandem, I think
9 that's going to be great for the world. Thanks.
10 And Thank you, Jill, thank your staff, Marcia and
11 Andy, for doing a great job on this.

12 CHAIRMAN GENSLER: Yeah. I want to
13 thank all the participants. It's my first GMAC
14 meeting, I want to thank Jill for hosting this
15 meeting.

16 I particularly want to thank David and
17 Patrick and Sebastijan and Peter for making the
18 trip this far. I think it's really added to both
19 our knowledge and our debate here at this critical
20 time as our House takes up critical legislation in
21 the Senate. It no doubt will follow with the
22 House, as I surely would recommend that they do,

1 as in passing this historic reform. And I am -- I
2 continue to be very optimistic that we have a
3 consensus here to bring the transparency and lower
4 the risk to the system.

5 In moving forward, I want to thank the
6 members of the Press Corps, and maybe David didn't
7 understand that they were all here, but I think
8 they probably, too, heard --

9 SPEAKER: (Inaudible)

10 CHAIRMAN GENSLER: -- what's that? --
11 that we really do have quite a consensus here
12 grappling with similar issues, and though
13 different political systems that it's important
14 that we end up -- it won't be exactly the same,
15 but largely the same will be a very important
16 accomplishment for both of our publics.

17 COMMISSIONER DUNN: Let me join my
18 colleagues in thanking Commissioner Sommers for an
19 excellent meeting. I have found this most
20 informative and very, very, very helpful.

21 David, I will let it be known that we're
22 letting you off a lot easier than you let our

1 Chairman off when he -- but I do -- the question I
2 ask you, what assistance you would provide us if
3 we did see regulatory arbitrage, and I'd like you
4 to seriously think about that and see what kind of
5 feedback you can give us in that arena.

6 Again, for all of your staff, Madam
7 Chairman, and the staff of the International
8 Division, and our General Counsel's Office. and
9 our DCIO group, thank you all for putting together
10 this fantastic meeting.

11 COMMISSIONER O'MALIA: David, thank you
12 very much for coming. Your testimony and your
13 observations were very informative about how our
14 two countries and, well, at least the E.U. and
15 this country can go down a path together. So I
16 appreciate that.

17 And thank you, obviously, to all the
18 participants, International and DCIO, that gave us
19 some good presentations on Lehman.

20 And then, obviously, Jill, and your team
21 that put this together, this is very, very
22 informative.

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5 direction; that said transcript is a true record
6 of the proceedings therein referenced; that I am
7 neither counsel for, related to, nor employed by
8 any of the parties to the action in which these
9 proceedings were taken; and, furthermore, that I
10 am neither a relative or employee of any attorney
11 or counsel employed by the parties hereto, nor
12 financially or otherwise interested in the outcome
13 of this action.

14 /s/Carleton J. Anderson, III

15

16

17 Notary Public in and for the

18 Commonwealth of Virginia

19 Commission No. 351998

20 Expires: November 30, 2012

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