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COMMODITY FUTURES TRADING COMMISSION

OPEN MEETING OF THE COMMISSION

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P R O C E E D I N G S

(10:33 a.m.)

CHAIRMAN MASSAD: Good morning. This meeting will come to order. This is a public meeting of the Commodity Futures Trading Commission. I'd like to welcome members of the public, market participants, members of the media, as well as those taking part on the phone or via webcast. Today we have gathered to consider three important measures. The first two are proposed rules on system safeguards, which will address concerns in our markets that relate to cybersecurity and technological or operational risk. In addition, we will consider a final rule on margin for uncleared swaps.

Now, before I discuss these rules specifically, I want to take this opportunity to thank the CFTC staff for all their hard work and dedication. I'd also like to thank my fellow Commissioners and their staffs for their collaboration and constructive input. I'm very pleased that we have avoided the obstruction and

division that we too often see in Washington in favor of working together constructively on behalf of the American people.

I would also like to take just a moment to look back at some of the things we have accomplished this year. Our enforcement division has continued to do an excellent job holding entities accountable for their behavior. We brought or resolved actions related to integrity of benchmarks, improper behavior such as spoofing, traditional scams such as Ponzi schemes and failure to comply with reporting obligations. Over the past fiscal year, the CFTC's total monetary sanctions topped more than $3.2 billion. This included an $800 million sanction -- the largest in Commission history -- and 69 new enforcement actions. The Commission has also been very focused on the resiliency of clearinghouses. With the increased significance they have taken on in the financial system, it is important that we make sure they are strong and stable. And in addition to our domestic efforts in this regard,

we are leading substantial work taking place internationally.

We've also focused on automated trading -- issuing a proposed rule just a few weeks ago. We've continued to implement the Dodd-Frank Act reforms and, in particular, Commission staff has taken a number of actions to fine tune our rules, including in the area of SEF trading. SEF trading is still new and we still have significant work ahead of us and our objective is to not only achieve the statutory goals of transparent and competitive trading of swaps on SEFs, it's also about making SEFs -- SEF trading -- attractive to build participation and create a strong foundation on which our markets can thrive. We've also taken steps to improve and enhance the reporting of swap data, as with our proposal on cleared swap reporting.

And finally, we have continued to focus on making sure commercial end users can use these markets efficiently and effectively. For example, we amended our rules so that publicly owned

utility companies can continue to effectively hedge their risks in the energy swap market, which helps them provide reliable, cost-effective service to their customers. We approved a modification to the residual interest rule, which can affect when customers must post collateral with clearing members. We clarified the treatment of contracts with embedded volumetric optionality. We have also issued some proposals that I hope we can finalize soon pertaining to the treatment of trade options and exempting end users from certain recordkeeping requirements. And in that same vein, the final rule on margin for uncleared swaps that we will consider shortly, exempts end users. We included this exemption in our initial proposal and, in the course of working together to harmonize our rules, the bank regulators agreed to change their rule to do so as well.

I won't attempt to preview all that we will be doing next year, but I know we will get off to a busy start. I hope, in particular, that we can finalize a number of SEF registrations

early in the new year and take up certain changes to SEF trading rules, including the made available to trade determination process later in the year. We are also continuing to work toward harmonization and mutual recognition with Europe and other international regulators. And we're continuing to work on ways to ensure the data we collect for swaps is more standardized and complete.

These are just a few highlights. There is obviously work going on in many other areas. But regardless of the area, we will continue working to ensure these markets are working well for the commercial end users who depend on them.

Thank you and I now recognize Commissioner Bowen for her opening remarks.

COMMISSIONER BOWEN: Thank you, Mr. Chairman, and good morning, everyone. I also thank the staff for their hard work -- the time that they spent with me and my staff on today's rulemakings.

The two subjects before us today may be

the most important rulemakings our current Commission will tackle. They go to the very heart of our clear mandate. As regulators, we are charged with protecting the safety and soundness of our financial markets and we must do so in a way that mitigates the risk we faced during the 2008 financial crisis. The lens through which I view my role is to make sure that the voiceless and the most vulnerable, our consumers, investors, and the public have a seat at the table.

To cut to the chase, I support the two rule proposals on system safeguards which are focused on cybersecurity. We know that without effective cybersecurity, we cannot be confident that important data will not be compromised, therefore raising doubts about the integrity of our markets. Therefore, I support both of these proposals.

I cannot, however, support the final rule proposal on margin for uncleared swaps. It fails to fulfill our clear Congressional mandate and I believe its shortcomings could make the

financial markets we regulate less safe. We know that without rigorous margin requirements it is possible that firms will make bad bets that would then throw the company's overall financial stability into question -- one that could provoke a spillover contagion panic, which forces us again to grapple with the specter of a new Bear, a new AIG, a new Lehman.

Let me first turn to the two rule proposals on system safeguards, which I'm happy to support. Entities in our markets are facing an unrelenting onslaught of attacks from hackers with a number of motives ranging from petty fraud to international cyber warfare. In recent testimony before Congress, the Director of the Center for Cyber and Homeland Security stated that one bank they queried noted that in one week it averaged an attack every 34 seconds.

Under our current rule structure, many of our registrants have system safeguard requirements. Yet, I believe the scope of the current cybersecurity risk we face today require

us to do more. While some firms are clearly engaging in best practices, we have no guarantee that all of them are. And as I've said before, we're collectively only as strong as our weakest link and so we need a high baseline level of protection for everyone.

And while I think the staff has put together two thoughtful proposals, and there are many aspects of these proposals that I particularly like, however, I view this as only a first step since all of our registrants -- not just exchanges, SEFs, SDRs and DCOs -- need to have clear cybersecurity measures in place. I'm also very eager to hear what the public has to say about these proposals. Thus, I will be voting in favor of both. Excuse me one second.

Now to turn to uncleared margin for swaps. I think it's important for us to step back and ask ourselves a basic question. What is the purpose of mandating margin -- uncleared margin -- and what was Congress asking us to do? I think the answer is clear -- to protect against the next

financial crisis, to do our best to prevent the incredibly high cost our taxpayers and our global financial markets have suffered and continue to suffer today.

In 2008, our financial system was brought to its knees as a tidal wave of losses washed away the savings of many and destroyed confidence in our financial markets. It also swept away misplaced confidence about the ability of large, sophisticated, financial players to manage their own risk. We learned -- or should have learned -- how vulnerable our financial system is to excessive leverage and poor risk management. If more margin had been required for swaps, some firms would have had the money they needed to unwind some of their bad bets. Fewer firms may have needed bailouts and the entire crisis may have been mitigated. Instead, with no margin for these swaps, Washington had to step in in a way that still rankles just about everyone. The large players were bailed out by taxpayers and returned to regular profits.

Our taxpayers had no similar help. No recourse to the financial institutions that harmed them. No help to pick up the pieces and rebuild a financial future. Margin requirements for uncleared swaps are a critical safeguard against repeating those mistakes. They provide the covered entities we regulate for protections against counterparty default. In essence, initial margin and variation margin appropriately align incentives to reduce systemic risks and excessive leverage to ensure that parties, in fact, have the capacity to meet their obligations.

In 2010, the Dodd-Frank Act created the categories of swap dealers and major swap participants. And Congress recognized the higher risks swap dealers faced from using uncleared swaps. While this rule does have some benefits, it is inadequate when compared to our own September 2014 proposal and the rule passed by the prudential regulators. It puts the very swap dealers we regulate in even greater risk in times of financial stress because of its treatment of

inter-affiliate margin.

This final rule provides an exemption for swap dealers -- excusing them from collecting initial margin for inter-affiliate transactions they enter into with most affiliated parties. This exemption only really affects the very largest financial institutions, those that are central to our financial infrastructure and at the heart of the last crisis. I think this exemption is a mistake for three reasons.

First, how will we know whether the entities that will receive this exemption are able to understand and communicate internally where their risks are? The large financial institutions that benefit from this exemption have tremendously complicated organizational structures with webs of hundreds, sometimes thousands, of affiliates spread across the globe. The difference in political, financial, and legal systems across these interconnected, international affiliate webs makes if difficult -- likely impossible -- to fully predict how risk will unfold across the

global entity in a period of severe financial stress.

This is a major deficiency. As Basel and IOSCO highlighted, the increased risk posed by uncleared derivatives create the same type of systemic, contagion, and spillover risk involved in the 2008 financial crisis.

Second, even if these entities do understand the risk, not requiring initial margin for inter-affiliate transactions removes a key safety feature that protects both the financial system and the individual firms in a crisis. By not requiring initial margin for this large swath of trades, it places the swap dealers we regulate and their customers at unnecessary risk in times of financial stress. Without this initial margin, we lose a vital financial shock absorber that is intended to protect an institution against the risk of default.

Third, by not requiring initial margin for inter-affiliate swaps, we're going against the spirit and, arguably, even the text of Dodd-Frank.

Our mandate is to promote the safety and soundness of swap dealers and to harmonize our rules to the maximum extent practicable with our prudential regulators. I see no compelling reason not to do otherwise.

We are charged to worry about the financial health of those entities registered with us -- swap dealers. The risks we are dealing with may be remote, but with huge consequences. Financial wizards have shown that they are not good at gauging and protecting against these disastrous events. This action today seems to be a return to blindly trusting in large financial institutions' ability and will to manage systemic risk. And we've already seen where that leads.

Dodd-Frank was intended to mitigate against that risk. Our failure to provide comparable protections for our swap dealers, in any shape whatsoever, makes little sense to me. I have seen the devastating effects of the last financial crisis on everyday citizens who lost their life savings as a result of excessive risk

taking by these complex financial institutions. Memories of the crisis may fade, but risks spring eternal. I cannot vote for a rule that places the swap dealers we regulate -- and most importantly their customers and the general public -- at risk. Accordingly, I will be voting no today.

CHAIRMAN MASSAD: I recognize Commissioner Giancarlo.

COMMISSIONER GIANCARLO: Thank you. You may recall, Mr. Chairman, that during one of our very first conversations over a year and a half ago, we discussed the growing risk that cyber threats posed to trading markets. We agreed that cyber and overall system security is one of the most important issues facing markets today in terms of trading integrity and financial stability.

Earlier this year I called for a bottom-up approach to combating cyber threats -- an approach that involves a close and dynamic relationship between regulators and the marketplace. It requires the continuous

development of best practices, defensive strategies, and response tactics through the leadership of market participants, operators, and self-regulatory organizations. As I see it, the job of the CFTC is to encourage, support, inform, and empower this continuous development so that market participants adopt fully optimized and up-to-date cyber defenses. It is appropriate that we are now taking up the subject of system safeguards. I commend Chairman Massad and the CFTC staff for putting forth today's proposal. I believe it generally reflects the bottom-up approach I advocate and I'm pleased to support it.

It is right that the proposal covers not just designated contract markets, but also swap execution facilities. From my experience, SEFs are as concerned with cybersecurity as our DCMs. Nevertheless, it is true that the rules will impose additional costs on some SEFs at a time when they are struggling to implement the myriad new Dodd-Frank requirements and obligations. Because system and cybersecurity should be a

priority on registrant's precious time and resources, the CFTC must find ways to alleviate unnecessary regulatory costs. The best way to do this is to correct the flawed swaps trading rules that remain fundamentally mismatched to the distinct liquidity and trading dynamics of global swaps markets. Complying with misbegotten swaps trading rules absorbs technical and human resources that SEFs need to devote to cybersecurity.

Given the constantly morphing nature of cyber risk, the best defenses provide no guarantee of protection. Therefore, it would be a perverse and unfortunate result if any final system safeguards rule were to have a chilling effect on robust cybersecurity efforts. Market participants who abide by the rule should not be afraid of a double whammy of a destructive cyberattack followed shortly thereafter by a CFTC enforcement action. Being hacked, by itself, cannot be considered a rule violation subject to enforcement. The CFTC should offer clear guidance

to market participants regarding their obligations under the rule and designate safe harbors for compliance with it.

As market regulators, we can have no naïve illusions that cyber belligerents -- foreign and domestic -- view the world's financial markets as anything other than 21st century battlefields. Cyberattacks on trading markets will not diminish any time soon. They will be relentless for years, if not decades, to come. Cyber risk is a threat for which Dodd-Frank provides no guidance whatsoever. Together, market regulators and the regulated community must make cyber and system security our first priority in time and attention.

Today's proposal is a constructive step toward that goal. I look forward to reviewing thoughtful comments from market participants and the public. I'd now like to turn to margin requirements for uncleared swaps.

Today's final rule regarding margin requirements for uncleared swaps is far from perfect. The Commission had the unenviable task

of harmonizing its rule with the prudential regulators' rules and with the BCBS/IOSCO standards. Nevertheless, I think the final rule is far better balanced than the previous proposal. I direct the public to my detailed written statement that will be included in the Federal Register, but right now I want to focus on just two aspects of the rule -- inter-affiliate margin and the economic impact of today's rule.

An honest discussion of margin requirements for inter-affiliate swaps must begin with the recognition that inter-affiliate swaps do not involve transactions between distinct financial institutions that were at the heart of the 2008 financial crisis. They do not pose the systemic risk that the Dodd-Frank Act was ostensibly designed to address. Congress expressed no particular intention to subject inter-affiliate transactions to clearing or inter-affiliate margin.

Accordingly, the CFTC adopted a rule in April 2013 to exempt certain inter-affiliate swaps

from mandatory clearing. That rulemaking, supported by former Chairman Gensler and Commissioners Wetjen, Chilton and O'Malia, recognized that inter-affiliate swaps provide an important risk management role within corporate groups. They enable use of a single conduit on behalf of multiple affiliates to net down trades and reduce the overall risk of the corporate group and the number of outward-facing swaps into which the affiliates might otherwise enter. This, in turn, reduces operational, market, counterparty credit and settlement risk. Rather than increasing risk, inter-affiliate swaps allow entities within a corporate group to transfer risk to the group entity best positioned to manage it.

Moreover, in 2013, the Commission found that the exemption promotes responsible financial innovation, fair competition and is consistent with the public interest. It further found that the exemption, which was conditioned on having certain risk mitigating measures in place, would not have a material effect on the Commission's

ability to discharge its regulatory responsibilities.

I believe the Commission's 2013 findings remain valid. I am aware of no facts that have come to light in the interim that would change the original assessment made under former Chairman Gensler. In fact, since issuing the proposed rule for notice and comment, an independent cost-benefit analysis recommended, among other things, exempting inter-affiliate swaps from initial margin requirements as a means to reduce the excessively onerous impact of the rule on competition, price discovery and overall market efficiency without additional systemic risk. I concur with that recommendation.

Earlier this year, in Congressional testimony, I explained that the cost of imposing initial margin on inter-affiliate transactions would have two likely impacts. First, it would raise the cost of commercial risk hedging for American end-users. And second, it would encapsulate risk in the U.S. marketplace and thus

increase -- not decrease -- risk of systemic hazard in American financial markets.

Today's final rule is not naïve or reckless. It recognizes that inter-affiliate swaps transactions are not without risk and sets appropriate safeguards. First, it requires operation of a centralized risk management program. Second, the rule requires variation margin. And third, it requires the collection of initial margin for non-U.S. affiliates not collecting initial margin for their own outward-facing swaps with financial entities. These measures appropriately address the risks associated with uncleared inter-affiliate swaps.

Now let me turn to the broader topic of economic impact. From my perspective, the most objectionable aspect of today's rule is its foundation in the superficial logic that if the cost of margining uncleared swaps is forced high enough, then market participants will use more cleared instruments. That foundation is not supported by either reason or experience. If no

clearinghouse is willing to clear a particular swap, no amount of punitive cost -- no matter how onerous -- will enable it to be cleared.

I know something about swaps clearing because I was involved before the financial crisis in one of the first independent efforts by non-Wall Street banks to develop a clearinghouse for credit default swaps. I am a longstanding supporter of increased central counterparty clearing of suitable swaps. Yet I also recognize -- as do an increasing number of others -- that central counterparty clearing is no panacea for credit risk. As regulators, we must be intellectually honest and adopt a balanced view acknowledging that there are legitimate and vital needs for both cleared and uncleared derivative products.

In a modern, complex, $18 trillion economy, uncleared swaps allow businesses to avoid basis risk and obtain hedge accounting treatment under U.S. GAAP for more complex, non-standardized exposures. Uncleared swaps are an unmatched tool

for customized risk management by businesses, governments, asset managers and other institutions whose operations are essential to American economic growth. Their precise risk transfer utility generally cannot be replicated with standardized cleared derivatives.

Today's rule also reflects a disingenuous reading of the Dodd-Frank Act to favor cleared derivatives over uncleared swaps. In fact, there is nothing in the law directing regulators to set punitive levels of margin in an attempt to drive market participants toward cleared products. Imposing punitive margin levels will lead to a range of adverse consequences including raising the commercial cost of risk hedging, reducing trading liquidity in uncleared swaps markets, and incentivizing the movement of products otherwise unsuitable for clearing into clearinghouses into which counterparty risk is already increasingly concentrated. More critically, punitive margin on uncleared swaps will increase the amount of inadequately hedged

risk exposure on America's corporate balance sheets exacerbating volatility in earnings and share prices.

Yet, I know that my voice alone cannot reverse the course of the present prevalence of macro-prudential regulation -- an approach that prioritizes systemic stability over investment opportunity, market vibrancy and American economic growth. Only time will show that systemic risk cannot be managed through centralized economic planning. In fact, rather than being managed, systemic risk is being transformed today from counterparty credit exposure to jarring volatility spikes and liquidity risk across the breadth of financial markets, with ramifications that will be even harder to manage in the future.

Unfortunately, today's rule will not reverse those trends. Yet I will vote for the rule, not because it is the right prescription for uncertain markets, but because it is much better than originally proposed and less harmful to the U.S. economy than likely alternatives.

I must commend the CFTC staff for their hard work, thoughtfulness, and, ultimately, the generally improved rulemaking that is before us today. Thank you.

CHAIRMAN MASSAD: Thank you. For each of the items on today's agenda, the staff will make presentations to the Commission. After each presentation, the floor will be open for questions and comments from each of the Commissioners. Following the close of discussion on each matter, the Commission expects to vote on the staff recommendation as presented. All final votes conducted in this public meeting shall be recorded votes. The results of votes approving the issuance of rulemaking documents will be included with those documents in the Federal Register.

At this point, I ask unanimous consent to allow staff to make technical corrections to the documents voted on today prior to sending them to the Federal Register. Without objection, it is so ordered.

At this time I would like to welcome

Vince McGonagle, Rachel Berdansky, Susan Stewart, and David Taylor from the Division of Market Oversight and Julie Mohr, James Ortlieb, and Jeff Bandman from the Division of Clearing and Risk for their presentations on two proposed rules related to system safeguards.

MR. TAYLOR: Good morning, Mr. Chairman and Commissioners. Before I begin, I would like to thank my fellow Division of Market Oversight team members including Rachel --

CHAIRMAN MASSAD: Make sure you speak very close to the mic.

MR. TAYLOR: Yes, I've learned that. Before I begin, I would like to thank my fellow Division of Market Oversight team members including Rachel Berdansky, David Steinberg, Shifra Katz, Susan Stewart, Chris Russell-Wood, Mike Bartlett, and Kyle Miller, and my systems safeguards colleagues in the Division of Clearing and Risk, as well as Dave Reiffen from the Office of the Chief Economist and Dhaval Patel and Susan Nathan from the Office of the General Counsel for

their hard work in preparing the proposals we are presenting to the Commission today.

Today staff is recommending that the Commission approve two parallel notices of proposed rulemaking or NPRMs, addressing cybersecurity and system safeguards requirements for designated contract markets or DCMs, swap execution facilities or SEFs, swap data repositories or SDRs, and derivatives clearing organizations or DCOs. My DCR colleague, Julie Mohr, and I will share the task of making the presentation.

The proposed rules would enhance and clarify existing Commission rule provisions relating to cybersecurity testing and system safeguards risk analysis and oversight, and add new provisions concerning certain aspects of cybersecurity testing. Most importantly, the proposed rules clarify the existing rules by specifying and defining the types of cybersecurity testing that DCMs, SEFs, SDRs, and DCOs must conduct in order to fulfill their regulatory

system safeguards testing obligations.

Staff is recommending these rules concerning system safeguards testing at a time when cyber threats to the financial sector continue to expand significantly. While preparing the proposed rules, staff considered relevant information discussed during the March 2015 Roundtable on Cybersecurity and System Safeguards Testing and the June 2015 meeting of the Commission's Market Risk Advisory Committee. Participants highlighted a number of noteworthy aspects of current cyber threats. Examples include an escalating volume of cyberattacks, coming from increasing numbers of more dangerous cyber adversaries with worsening goals, including disruption of operations, theft of data or intellectual property and corruption or destruction of data or automated systems; advanced persistent threats designed to remain undetected over a long period of time; and an expanded cyber threat field that includes mobile devices, the cloud, phishing and other social engineering

attacks, and insider threats. Cybersecurity testing by DCMs, SEFs, SDRs, and DCOs can harden their cyber defenses; mitigate their operations, reputation, and financial risks; and maintain and increase their cyber resilience and their ability to detect, contain, respond to, and recover from cyberattack.

As set out in detail in both NPRMs, cybersecurity testing is a well-established best practice both generally and for financial sector entities. Such testing is becoming a requirement for obtaining cyber insurance and it is also supported internationally by both financial regulators and standards bodies. Its importance is increased by the nature of the cybersecurity threats faced by the financial sector. It is for these reasons, and in light of this background, the staff is recommending approval of these NPRMs.

As we will outline for you, the central point of the proposed rules is the proposed requirement for all DCOs, all DCMs, all SEFs, and all SDRs regulated by the Commission to conduct

five important types of cybersecurity testing that are essential to an effective program of system safeguards risk analysis and oversight. One, vulnerability testing. Two, penetration testing. Three, controls testing. Four, security incident response plan testing. And five, enterprise technology risk assessment.

The Commission's existing system safeguards rules require these entities to conduct testing to ensure the reliability, security, and capacity of their systems. Best practices establish that it would be impossible to fulfill the purposes of that requirement without conducting these five types of testing. In this respect, therefore, the proposed rules clarify what is already required of these entities.

As we will note in presenting each of the five types of testing, the proposed rules would also establish minimum testing frequency and independent contractor testing requirements for all DCOs and all SDRs and for covered DCMs. As defined, covered DCMs are those whose total annual

trading volume is five percent or more of the total annual trading volume of all DCMs regulated by the Commission. These requirements are also consonant with best practices.

The proposed rule for DCMs, SEFs, and SDRs also includes an advance notice of proposed rulemaking, which notes that the Commission plans to consider whether, in a future NPRM, it should define certain SEFs as covered SEFs and make them subject to the minimum testing frequency and independent contractor testing requirements. The request for comments section of the proposal includes a number of questions about whether and how this could most appropriately be done.

MS. MOHR: Before I begin, I want to make sure everyone can hear me. Okay. As I begin the next section of the presentation, I would like to thank my DCR colleagues, Jim Ortlieb, Tammy Roust, Eileen Donovan, Laura Astrada, Eileen Chotiner, and Joe Opron, along with Carlene Kim and Brian Trackman from OGC for their hard work on these proposals that we are presenting to the

Commission today. We will briefly describe for you this morning each of the five types of cybersecurity testing required by the proposed rules, beginning with vulnerability testing.

Vulnerability testing is the process of scanning your systems for weaknesses. As software is developed and deployed, new weaknesses are created, which are called vulnerabilities. These vulnerabilities are created due to various reasons. For example, adding new features to existing software generates transaction paths and logic that create future opportunities for unwanted users to exploit these features in unintended ways. Moving software or hardware around within existing environments can create interconnections between systems or paths through existing systems that offer fresh opportunities for intruders to enter and exploit.

In addition, existing software is constantly being tested and probed in new ways by existing deployments including both research efforts and real world attacks. As a DCM, SEF,

SDR, or DCO deploys, modifies, and runs its systems, it must remain cognizant of the fact that external entities are constantly probing its defenses looking for these vulnerabilities. If the organization can discover its vulnerabilities before the attackers do, it can attempt to fix them before they are exploited.

Vulnerability testing is covered by generally accepted practices and standards such as those published by the National Institute of Standards and Technology or NIST, the Federal Financial Institutions Examination Council or FFIEC, and others. Such generally accepted best practices call for vulnerability testing at a frequency determined by an appropriate risk analysis and, in some cases, also provide that the frequency of such testing should be no less than quarterly.

The proposed rules address the frequency at which vulnerability testing should be conducted. As a fundamental principle, they call for all DCMs, SEFs, SDRs, and DCOs to conduct

vulnerability testing at a frequency determined by an appropriate risk analysis. For all DCOs, all SDRs and covered DCMs, the rules also include a minimum vulnerability testing frequency requirement calling for the testing to be conducted no less frequently than quarterly.

In addition, the proposed rules call for vulnerability testing by all DCOs, all SDRs, and covered DCMs to be performed by independent contractors during at least two of the quarterly tests each year. Independent contractors provide an external insight into an entity's vulnerabilities and weaknesses. Having a fresh external perspective, one that has been formed through experience with other industry players, can be vital to informing those critical financial organizations about how, where, and why they are vulnerable.

The second type of cybersecurity testing that the proposed rules would require is penetration testing. Penetration testing is the process of simulating an attack on a system in

order to discover and exploit its weaknesses. There are two main forms of penetration testing. They are external and internal. The proposed rules define external penetration testing as attempts to penetrate the entity's automated systems from outside its boundaries to identify and exploit vulnerabilities. The proposed rules define internal penetration testing as attempts to penetrate an entity's automated systems from inside their boundaries for the same purpose.

Generally accepted best practices, such as NIST, FFIEC standards, and the Payment Card Data Security Standards, call for organizations to conduct both internal and external penetration testing and to conduct such tests annually. The proposed rules also call for all DCOs, DCMs, SEFs, and SDRs to conduct penetration testing at a frequency determined by an appropriate risk analysis.

In addition, the proposals call for penetration testing at least annually by all DCOs, all SDRs and covered DCMs. The proposed rules

also provide that the annual external penetration tests required of all DCOs, all SDRs, and covered DCMs must be performed by an external independent contractor. David will now go over the remaining three tests.

MR. TAYLOR: The proposed rules also call for all DCMs, SEFs, SDRs, and DCOs to conduct controls testing, including testing of each control that is included in their programs of system safeguards risk analysis and oversight. Controls are the safeguards or countermeasures used by an entity to protect the reliability, security, or capacity of its automated systems or the confidentiality, integrity, and availability of its data and information. Some controls provide safeguards against automated system failures or deficiencies, while others guard against human error, deficiencies, or malicious action.

Controls testing assesses each control to determine whether it is implemented correctly, is operating as intended, and is enabling the

organization to meet system safeguards requirements. Such testing is called for by generally accepted best practices and standards.

The proposed rules address the frequency at which controls testing should be conducted. As a fundamental principal, they call for all DCMs, SEFs, SDRs, and DCOs to conduct controls testing at a frequency determined by an appropriate risk analysis. For all DCOs, all SDRs, and covered DCMs, the rules also include a minimum controls testing frequency requirement calling for testing of each control no less frequently than every two years. Since system safeguards involve large numbers of controls, the rules would permit this to be done on a rolling basis over the course of the minimum two year period or the period dictated by appropriate risk analysis, whichever is shorter.

The proposed rules also call for all DCOs, all SDRs, and covered DCMs to have independent contractors test each of the regulatee's key controls, as defined in the rule,

no less frequently than every two years. Key controls are those controls that risk analysis determines to be either critically important for effective system safeguards or intended to address risks that evolve or change more frequently and, therefore, require more frequent review to ensure continued control effectiveness. Such independent assessments are consonant with best practices.

The fourth type of testing that the proposed rules would require is security incident response plan testing. Best practices call for financial sector entities to maintain and test a security incident response plan or SIRP, which I would venture to predict you will hear referred to as a SIRP. Such plans are crucial to cyber resilience. The proposed rules define security incident as a cyber or physical security event that actually or potentially jeopardizes automated system operation, reliability, security, or capacity, or the availability, confidentiality, or integrity of data. They would require each DCM, SEF, SDR, or DCO to maintain and test an SIRP

defined as a written plan documenting the entities' policies, controls, procedures, and resources for identifying, responding to, mitigating, and recovering from security incidents.

The rules note that SIRP testing can take a number of possible forms from checklists and tabletop exercise to simulations and comprehensive exercises. The proposed rules also address the frequency at which SIRP testing should be conducted. As a fundamental principal, they call for all DCMs, SEFs, SDRs, and DCOs to conduct SIRP testing at a frequency determined by an appropriate risk analysis. At a minimum, the proposed rules call for all DCOs, all SDRs, and covered DCMs to have SIRP testing performed no less frequently than annually. SIRP testing could be done either by independent contractors or regulatee employees not responsible for development or operation of the systems or capabilities being assessed.

Finally, the proposed rules would

require each DCM, SEF, SDR, or DCO to conduct enterprise technology risk assessments or ETRAs. An ETRA is a written assessment including identification and analysis of threats and vulnerabilities and the harm they could cause in the context of mitigating controls. In an ETRA, a DCM, SEF, SDR, or DCO may draw together and use the results of the other types of cybersecurity testing in order to identify and mitigate its cybersecurity risks. Conducting ETRAs is consistent with best practices regarding system safeguards.

As a fundamental principle, the proposed rules call for all DCMs, SEFs, SDRs, and DCOs to conduct an ETRA as often as indicated by appropriate risk analysis. At a minimum, the proposed rules call for DCOs, covered DCMs and SDRs to have ETRAs performed no less frequently than annually. They would permit regulatees to conduct ETRAs by using either independent contractors or employees not responsible for development or operation of the systems or

capabilities being assessed.

MS. MOHR: The Commission's current regulations specify various elements, standards, and resources to be included in a registrant's program of risk analysis and oversight with respect to its operations and automated systems. The proposed rules clarify existing rule provisions for all DCOs, DCMs, SEFs, and SDRs concerning (1) the categories of risk analysis and oversight that must be addressed, (2) books and records obligations, (3) the scope of system safeguards testing, (4) internal reporting and reviewing of testing results, and (5) the remediation of vulnerabilities and deficiencies disclosed by the testing.

The proposed rule provision addressing the required scope of cybersecurity testing is especially important because adequate testing depends upon the identification of an appropriate scope. The proposed rules would require that the scope of all testing and assessments required by Commission regulations be broad enough to include

testing of automated systems and controls necessary to identify any vulnerability which, if exploited or accidently triggered, could enable an intruder or unauthorized user or an insider to (a) interfere with the registrant's operations or with fulfillment of the statutory and regulatory responsibilities, (b) impair or degrade the reliability, security, or capacity of the registrant's automated systems, (c) add to, delete, modify, exfiltrate or compromise the integrity of any data related to the registrant's regulated activities, or (d) undertake any other unauthorized action affecting the registrant's regulated activities or the hardware or software used in connection with those activities.

Another important clarifying provision relates to the governance of cybersecurity and system safeguards, by requiring that reports on testing protocols and the results be communicated and reviewed by both the registrant's senior management and its board of directors. Registrants would also be required to establish

and follow appropriate procedures for remediation of the issues identified, and for the evaluation of the effectiveness of the testing and assessment protocols. Each entity would be required to analyze testing and assessment results, in order to identify all vulnerabilities and deficiencies in its systems, and to remediate those vulnerabilities and deficiencies to the extent necessary to enable the entity to fulfill its statutory and regulatory obligations.

Also, the Divisions recommend that the proposed rules be open for a 60-day public comment period. This concludes our presentation and we are happy to address any questions.

CHAIRMAN MASSAD: Okay. Well I want to thank all of our staff for those informative presentations and again thank all the staff that worked on these proposals. To begin the Commission's discussion and consideration of these rulemakings, I will now entertain a motion to adopt the Division of Clearing and Risks proposed rule relating to system safeguards as presented by

the staff.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: Okay. I would now like to open the floor to allow the Commissioners to make any statements or ask any questions that they may have and I will first turn to Commissioner Bowen.

COMMISSIONER BOWEN: Yes, thank you, Mr. Chairman. Thank you so much. A great presentation. As we discussed, this rule covers SDRs, DCMs, SEFs, and DCOs. And I'm wondering whether the staff intends to send proposed rules to us with cybersecurity guidelines to cover other market participants such as FCMs, introducing brokers, major swap participants?

MS. BERDANSKY: Commissioner, oversight of the entities you mentioned falls under the Commission's Division of Swap Dealer and Intermediary Oversight. However, I would note that in October 2015, the National Futures Association adopted a cybersecurity interpretative notice to three of its compliance rules defining

the core components of an effective information system security program or ISSP for short. The notice, which applies to futures commission merchants, swap dealers, major swap participants, introducing brokers, FOREX dealer members, commodity pool operators, and commodity trading advisors, requires such firms to adopt and enforce an ISSP appropriate to the firm's circumstances.

The approach is principles based and provides that an ISSP should cover several key areas, including a security and risk analysis; a description of the safeguards against identified system threats and vulnerabilities; and the process used to evaluate the nature of a detected security event, understand its potential impact and take appropriate measures to contain and mitigate the breach and a description of the members ongoing education and training related to the information system security for all personnel. The notice further requires that ISSP must be approved within the member firms by an executive level official and requires members to monitor and

review the effectiveness of the ISSP at least annually, including the effectiveness of the safeguards the firm has deployed.

Finally, I would just note that the National Futures Association's notice also directs firms to look to industry best practices, in particular, the NIST cybersecurity framework when developing and adopting an ISSP.

COMMISSIONER BOWEN: Thank you, Rachel.

CHAIRMAN MASSAD: Commissioner Giancarlo.

COMMISSIONER GIANCARLO: Thank you. And I want to thank Julie and David and Jeff and Vince and their teams for their thoughtful approach to cybersecurity, which is a tremendous, if not the largest, challenge we face today. And it is quite a heavy lift to come up with a thoughtful proposal, so I commend you for that. David, I also note the new acronym of SIRP, S-I-R-P. I guess that's our holiday gift for the community to roll out a new acronym at the end of the year, so we'll all be puzzling over that.

I don't have questions for you, but I do want to direct the public to my written statement in which I have a number of comments on the proposed rule and I look forward to the public's commentary and discussion on this. Thank you.

CHAIRMAN MASSAD: Okay. Well, thank you. I have no questions either. I, again, want to thank the staff. I know this has been a lot of work on both proposals. And I just want to add my support for the proposed rule. I think the risk of cyberattacks is perhaps the most important single issue we face today in terms of threats to financial market stability and integrity. The examples of cyberattacks are unfortunately all too familiar and frequent -- both within the financial sector and outside. And today we must be concerned about the possibility of attacks not only motivated by profit, but that are intended to destroy information and disrupt or destabilize our markets. So the risk to American businesses in our economy is dramatic and the interconnectedness of financial institutions and markets means that a

failure in one institution can have significant repercussions.

So the proposed rule that we are issuing today is an important step toward enhancing the protections in our markets. It builds on our core principles. Those already require clearinghouses to focus on system safeguards. This rule goes further by setting standards consistent with best practices and it requires robust testing of cyber protection, setting forth the type of testing that must be conducted, the frequency of testing, and whether tests should be conducted by independent parties. And it enhances standards for incident response planning and enterprise technology risk assessments.

So I believe these requirements should come as no surprise. Clearinghouses should already be doing extensive testing and, indeed, we hope that today's proposal sets a baseline that is already being met by many of them. The proposal also complements what we as a Commission already do. We focus on these issues in our examinations

to determine whether an institution is following good practices and paying adequate attention to the risks at the Board level and on down. And as I noted at the beginning, since 2009, clearinghouses have become increasingly important in the financial system, so I believe we must do all we can to ensure their strength and stability and this proposed rule is a critical component of that effort.

Now, of course, we welcome public comment on this proposal, which will be taken into account carefully before we take any final action. If there are no other questions, I would like to just make sure would any other Commissioner like to make any further statements before we proceed to a vote on the motions? Okay.

If the Commissioners are prepared to vote, Mr. Kirkpatrick, will you call the roll?

MR. KIRKPATRICK: The motion now before the Commission is on the adoption of the Division of Clearing and Risk notice of proposed rulemaking on system safeguards testing requirements for

derivatives clearing organizations. Commissioner Giancarlo?

COMMISSIONER GIANCARLO: Aye.

MR. KIRKPATRICK: Commissioner Giancarlo, aye. Commissioner Bowen?

COMMISSIONER BOWEN: Aye.

MR. KIRKPATRICK: Commissioner Bowen, aye. Chairman Massad?

CHAIRMAN MASSAD: Aye.

MR. KIRKPATRICK: Chairman Massad, aye. Mr. Chairman, on this matter, the ayes have three, the no's have zero.

CHAIRMAN MASSAD: Thank you. The ayes have it and the motion to adopt the proposed rule is approved. At this point, I will entertain a motion to adopt the Division of Market Oversight's proposal related to system safeguards as presented by the staff.

COMMISSIONER BOWEN: So moved.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: I would now like to open the floor to allow the Commissioners to make

any further statements and ask any questions that they may have. And I again will turn to Commissioner Bowen.

COMMISSIONER BOWEN: No questions.

CHAIRMAN MASSAD: Commissioner Giancarlo?

COMMISSIONER GIANCARLO: No questions.

CHAIRMAN MASSAD: Okay. Thank you. Well let me just add that I also support this rule. It's obviously very consistent with the DCR proposal. I will add a couple of comments. I previously stated that I did not expect our proposal would apply to SEFs. Now, I said that not because cybersecurity isn't just as important for them, but because many SEFs are still in the very early stages of operation. But, my fellow Commissioners expressed concerns about potential vulnerabilities and both felt that we should propose that the requirements apply to SEFs at this time. I appreciate their views and I am committed to working collaboratively to address this issue and, therefore, we have included it in

the proposal. And as with the DCR proposal, we will carefully consider all public comment before taking any final action. Let me just make sure before we proceed to a vote, would any other Commissioner like to make further statement? Okay.

Then I will ask Mr. Kirkpatrick to call the roll.

MR. KIRKPATRICK: The motion now before the Commission is on the adoption of the Division of Market Oversight proposed rulemaking on system safeguards testing requirements. Commissioner Giancarlo?

COMMISSIONER GIANCARLO: Aye.

MR. KIRKPATRICK: Commissioner Giancarlo, aye. Commissioner Bowen?

COMMISSIONER BOWEN: Aye.

MR. KIRKPATRICK: Commissioner Bowen, aye. Chairman Massad?

CHAIRMAN MASSAD: Aye.

MR. KIRKPATRICK: Chairman Assad, aye. Mr. Chairman, on this matter, the ayes have three,

the no's have zero.

CHAIRMAN MASSAD: The ayes have it and the motion to adopt the proposed rule is approved. Once again, thank you to the staffs of DMO and DCR for these excellent presentations and excellent work.

At this time, I would like to welcome Scott Mixon from the Office of the Chief Economist, Paul Schlichting from the Office of General Counsel, John Lawton from the Division of Clearing and Risk, and Rafael Martinez and Francis Kuo from the Division of Swap Dealer and Intermediary Oversight for their presentations on a final rule on margin for uncleared swaps.

CHAIRMAN MASSAD: Please proceed.

MR. LAWTON: Good morning. The rules before the Commission would implement Section 4s(e) of the Commodity Exchange Act. The rules address margin requirements for uncleared swaps entered into by swap dealers or major swap participants. The rules would apply to SD MSPs that are not subject to regulation by one of the

prudential regulators. That is the Fed, the OCC, the FDIC, the FCA, or the FHA.

In developing the rules, Commission staff worked closely with staff of the prudential regulators. Commission staff also consulted periodically with staff of the SEC and with staff of foreign regulators. The rules are very similar to the rules that were recently approved by the prudential regulators.

In this presentation, I will briefly touch on the following topics: The products that are subject to the rules, the market participants that are subject to the rules, the nature and timing of margin requirements, how initial margin would be calculated, what is the acceptable collateral, what are the custodial arrangements, what is the treatment of inter-affiliate swaps, and what's the implementation schedule.

So turning first to products -- the rules would apply to uncleared swaps entered into after the effective dates of the regulation. As I will describe in a few minutes, these rules would

be phased in and the requirements would not apply retroactively to swaps entered into before the applicable effective date for the parties to that swap.

Turning to market participants -- the rules would apply to those SDs and MSPs that are not subject to oversight by the prudential regulators. We call these firms covered swap entities or CSEs. The rules would impose margin requirements on (1) trades between a CSE and any other swap dealer or MSP, and (2) trades between a CSE and a financial end user. The rules would not impose margin requirements on commercial end users.

In January, after the proposed rules had been published for comment, Congress passed legislation addressing the applicability of these margin rules to certain entities. The legislation required the Commission and the prudential regulators to issue interim final rules providing that certain entities to qualify for a clearing exemption will also be exempt from margin

requirements for their uncleared swaps. This rule set includes provisions implementing that requirement.

Turning to the nature and timing of margin requirements, and turning first to initial margin -- the rules would require two-way initial margin -- both posting and collecting -- on a daily basis for all trades between a CSE and any other SD or MSP. The rules would also require daily two-way initial margin for all trades between a CSE and a financial end user that had over $8 billion in gross notional exposure in uncleared swaps.

The Commission and the prudential regulators had last year proposed that the material swaps exposure standard be set at $3 billion. In response to public comments, however, the rules have raised the threshold at which financial end users become subject to the initial margin requirements. This provision recognizes that financial end users with smaller positions do not pose the same risk as those with larger

positions. The revised threshold is the same as that recently adopted by the prudential regulators and it is consistent with international standards.

Turning to variation margin -- the rules would require daily payment of variation margin for all trades between a CSE and another SD or MSP. The rules would also require daily payment of variation margin for all trades between a CSE and a financial end user. In contrast to initial margin, the gross notional threshold would not apply for variation margin, so financial end users with gross notional exposure below the threshold would still be required to exchange variation margin. Again, these requirements are the same as those of the prudential regulators and consistent with international standards.

Turning to calculation of initial margin -- the rules would permit the calculation of initial margin to be based on models or on a standardized table. Models would be required to use a 99 percent confidence level over a 10 day liquidation time. The rules would permit the

parties to establish a $50 million threshold below which margin would not need to be collected. This threshold is designed to mitigate the costs of these rules while continuing to protect the financial integrity of the financial system. Smaller exposures would be permitted to go uncollateralized, but a significant percentage of all large exposures would be supported by collateral.

The final rules include a provision allowing a registered futures association to approve a CSE's margin model. Commission staff have communicated with NFA staff, which has indicated that it will be prepared to take on this responsibility. I point this out as a point of distinction between the CFTC rules and the prudential regulator rules where the prudential regulators do not have a comparable provision which would permit approval of margin models by a self-regulatory organization. In their case, the approval would be required to be done by the prudential regulator itself.

So turning to acceptable collateral -- first, for initial margin. The rules would permit initial margin to include cash, sovereign debt, certain government sponsored debt, investment grade debt such as corporate bonds, certain equities, shares of certain money market funds, and gold. This list is the same as the prudential regulators' list and is consistent with international standards.

For variation margin, the rules would draw a distinction between trades that involve two dealers and trades involving a dealer and a financial end user. For dealer-to-dealer trades, the rules would require variation margin to be in cash. For trades between a dealer and a financial end user, however, the rules would permit the same collateral permitted for initial margin. This requirement was modified in response to comments. The proposal had said cash for all variation margin. A number of end user commenters stated that it could be very burdensome for them to post cash as variation margin and so the final rule

would adjust the approach for variation margin for trades between a dealer and a financial end user. Again, the approach taken regarding acceptable collateral for both initial margin and variation margin is the same as the prudential regulators' approach.

Turning to custodial arrangements -- the rules would require initial margin to be held at an independent custodian and it would not permit rehypothecation of initial margin. Again, the approach is the same as the prudential regulators' approach.

With regard to inter-affiliate margin, the rules would require the daily payment of variation margin between CSEs and affiliates that are also swap entities or are financial end users. This aspect of the rule is the same as the prudential regulators' rule. The rules, however, would not require CSEs to collect initial margin from affiliates except in certain circumstances that I will mention in a moment. The CSEs would, however, be required to have a centralized risk

management program to design, to monitor and manage the risk associated with inter-affiliate swaps on a group-wide basis. Collection would be required in certain cases where the affiliate enters into swaps with third parties and doesn't collect margin on the outward-facing swap and then does a swap with the CSE.

With regard to foreign regulators, foreign regulators have not yet finalized their rules in this area yet. Based on participation in international groups and conversations with foreign regulators, staff understands that a number of jurisdictions are not expected to require initial margin or variation margin for inter-affiliate swaps if certain conditions are met which would enable the parties in normal circumstances to meet their obligations.

Finally, turning to the implementation schedule -- the rules establish an implementation schedule under which the requirements would be phased in according to the amount of uncleared swaps trading that the entity engages in. Initial

margin requirements would be phased in in five steps beginning September 1, 2016, ending September 1, 2020 -- moving from the largest market participants to the smaller ones. Variation margin requirements would be phased in in two steps. The largest market participants starting in September of 2016 and the remainder of the market in March of 2017. Again, this schedule is the same as the prudential regulators' schedule and the schedule set forth in international standards.

In closing, I'd like to thank the other members of the staff who worked on this project -- Tom Smith, Rafael Martinez, Francis Kuo, Carlene Kim, Paul Schlichting, Scott Mixon, Steve Kane, and Lihong McPhail.

CHAIRMAN MASSAD: Thank you for that very informative presentation. To begin the Commission's discussion and consideration of this rulemaking, I will now entertain a motion to adopt the final rule on margin for uncleared swaps.

COMMISSIONER BOWEN: So moved.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: I would now like to open the floor to allow the Commissioners to make any statements and ask any questions that they may have. Commissioner Bowen?

COMMISSIONER BOWEN: Yes, thank you. We've spent a lot of time together and I want to thank you so much for the time that you spent with me and my staff. As I understand it, though, inter-affiliate swaps make up a large portion of the uncleared swaps market. Could you tell us what you know about the number or notional amount of the trades that would require no collateral to be posted?

MR. LAWTON: Well, first I'd say looking at SDR data, we've looked at SDR data for interest rate swaps and credit default swaps which we think is the bulk of the market. In that case, inter-affiliates trades represent about 50 percent of the market. I turn it to Rafael for dollar amounts if you have any off the top.

MR. MARTINEZ: I don't have the amount.

MR. LAWTON: I mean we did do some estimates for individual -- well, no, I'm sorry. That's a different. Yes, sorry. I don't actually have dollar amounts, but it's approximately 50 percent of all trades for IRS and CDS.

COMMISSIONER BOWEN: Okay.

MR. LAWTON: IRS and CDS.

COMMISSIONER BOWEN: So if no collateral is actually required for these types of trades, is it likely that this rule will provide incentives for dealers to increase the number of these trades that are uncleared?

MR. LAWTON: I mean I guess I would say that to the extent -- and I think they're not posting IM for these trades now, we probably -- and so that would maintain the status quo. The percentages would probably remain the same. It would probably remain about 50 percent. As the market got bigger, presumably if the percentage stayed the same, then the amount of inter-affiliate trades would grow accordingly with the market. I think a related effect might be

that because the prudential regulators might be -- or would be requiring inter-affiliate IM, you might see some movement of the inter-affiliate business from trades involving prudentially-regulated swap dealers to trades involving CFTC regulated swap dealers.

COMMISSIONER BOWEN: As I understand it, I had a number of conversations informally with dealers and some -- several of them already require collateral from their affiliates. So, in effect, the rule that we're voting on today would actually be a lower threshold -- by requiring zero. Is that right?

MR. LAWTON: Yes. I mean to the extent that dealers currently collect initial margin for some inter- affiliate trades, they might be following a higher standard than the rules would require. I guess I should note that there's various types of affiliates and the inter-affiliate exception that's in this rule applies to those affiliates whose financial statements are consolidated. So, if an

affiliate's financial statement were not consolidated with those of the CSE and if the affiliate were a financial end user with material swap exposure, it might be required -- well, it would be required to post margin in that instance under these rules. I mean an example of that might be if a firm had some sort of money manager within their corporate family, that might be the sort of firm that might be posting margin. But to the extent that those criteria do not apply, and someone is collecting initial margin under this rule, then -- I'm sorry, currently -- then this rule would not require it.

COMMISSIONER BOWEN: Right. And, in fact, in the instance of a severe, let's say, financial crisis, the more collateral you would have under your control, it would seem to me more likely you are going to be able to meet your obligations. To the extent that there's no collateral here, wouldn't our swap dealer be in a better position from a risk standpoint if they had collected initial margin in the first instance?

MR. LAWTON: I mean I guess I'd start by pointing out that we would require variation margin to be exchanged on a daily basis. And so that would -- should prevent losses from accumulating over time. That being said, yes, if they had additional collateral beyond that, that would certainly help them.

COMMISSIONER BOWEN: I just also wanted just to stress, you know, we are mandated to have our rules -- our margin be comparable to the maximum extent practicable with those of our prudential regulators. Is it practicable in this instance to have our CFTC regulated swap dealers not to collect initial margin from their affiliates?

MR. LAWTON: I guess I would start by saying that, noting that the Act required the prudential regulators to issue joint rules, whereas it applied this provision that you're mentioning, to the maximum extent practicable, to the CFTC. So I think there was, within the Act, contemplation that they wouldn't necessarily be

identical. And that I guess that would reflect that there are differences between our general statutory scheme and the banking regulators general statutory scheme and between the nature of some of the entities that are subject to the CFTC statutory scheme and the entities that are subject to the banking regulators' statutory scheme.

COMMISSIONER BOWEN: So do you think -- let's turn a little bit to the harmonization question and could you describe to us how this rule works with our proposed rule on cross border margin, and do they work together?

MR. LAWTON: I guess I would suggest that Paul pick that one up.

MR. SCHLICHTING: So, just to, I guess, explain, is that we have a proposal out for the cross border.

COMMISSIONER BOWEN: Yes.

MR. SCHLICHTING: Right?

COMMISSIONER BOWEN: Mm-hmm.

MR. SCHLICHTING: So, in the proposal, the -- you would -- I would -- we look at it as

this would overlay on top of the inter-affiliate. So for -- you know, and this purely on the proposal. So anybody, you know -- so it's a -- the inter-affiliate moves trade outside, you know, from the outside facing trade.

COMMISSIONER BOWEN: Mm-hmm.

MR. SCHLICHTING: If it's within one of the categories in our proposal -- via day the exclusion or an FCS. So if it's an exclusion, then we would say those trades are excluded. If it's done by an FCS, the outward facing trade, then it would have to have substituted compliance with that outward facing trade. But then when they move the risk over from -- through the inter-affiliate trade --

COMMISSIONER BOWEN: Mm-hmm.

MR. SCHLICHTING: -- well, that would all depend on. So if it was excluded -- the outward facing trade -- then we only apply VM -- variation margin on the inter-affiliate trade. But from the other side, from the FCS, it would be -- is it substituted compliance on the outward

facing trade. And, again, so there would be a collection of IM in that situation because we would have to do a comparability. And if it's comparable, then either they can use the foreign jurisdiction's margin rules or ours, which requires outward facing trades on IM for FCSs. And then when they move it over through the inter-affiliate trade, it would be VM. So, that's how it would apply. But, again, it's still just a proposal in the cross border sense. And, you know, we will look at -- you know, because I think we made assumptions based on the proposed margin rule that we're adopting here on how the inter-affiliate worked. Because initially the proposal was post collect, so maybe, you know, we just have to reexamine how that exclusion works and whether John's anti -- well, I guess the anti-evasion rule that's in the margin rule, we're saying that if you do an outward facing trade in a jurisdiction that does not require IM, then IM has to be collected by the CSE, well we may have to reexamine how that interplays with the cross

border.

CHAIRMAN MASSAD: Can I just ask the staff -- be sure you talk very close to the microphone. There's some trouble hearing you in the back.

COMMISSIONER BOWEN: So back when we were talking about the proposed cross border margin rules, I know we talked about our concern about de-guaranteeing and all the sophisticated players used words to de-guarantee. Given this rule, we don't have to worry about that anymore, do we? That notion goes away since there will be no margin that needs to be collected?

MR. SCHLICHTING: Well, the de-guaranteeing -- that would go -- that's for the inter-affiliate transactions, but the actual outward facing trade --

COMMISSIONER BOWEN: Mm-hmm.

MR. SCHLICHTING: -- I mean, that -- I mean in the proposal, we -- you know, the Commission adopt -- well, the proposal says that if you are a foreign consolidated sub, you still

have to collect margin on the outward facing trade. So -- and -- so the guaranteeing is separate and distinct from that. And, but as I said before, I think the exclusion though is maybe something to reexamine, so -- because if you had a foreign -- a non-U.S. CSE does a trade with a non-U.S. Person --

COMMISSIONER BOWEN: Mm-hmm.

MR. SCHLICHTING: -- that would be excluded from the rule totally. And then when you transfer -- even with that anti-evasion -- so the anti-evasion that's built into the inter-affiliate, that's still excluded out. So then when they do the -- so how the anti-evasion should have worked was, in that sense, there should have been a collection when the inter-affiliate trade occurs. But since it was already excluded out, it doesn't even look at that. So that's something we just need to reexamine.

COMMISSIONER BOWEN: Okay. Thank you.

MR. MARTINEZ: Commissioner, if I may,

one note, a moment ago when we mentioned about 50 percent of the swaps market was inter-affiliate. I want to note that's sort of an upper bound. And one of the --

COMMISSIONER BOWEN: I'm sorry, Rafael. I'm sorry I missed the verb again.

MR. MARTINEZ: In one of your first questions you asked about the size of the inter-affiliate market, and we said that of the swaps market, our estimate is that 50 percent of the swaps were inter-affiliate.

COMMISSIONER BOWEN: Mm-hmm.

MR. MARTINEZ: I want to clarify that that's an upper bound for the swaps that would be exempted from inter-affiliate margin. One of the reasons that we didn't -- couldn't provide you a number, specific in dollar amounts from our SDR is that as we reviewed our SDR, we identified people that have an ultimate parent -- that they share ultimate parents or they're affiliates, but the exemption, I think, in the rule goes to a very specific set of entities which we refer to as

margin affiliates that have some conditions of consolidated risk management and their consolidated report, you know, accounting. And that's not something that we have identified in the SDR. We couldn't be that precise in the SDR data to see which of the affiliates that we had just because they share a common parent would actually satisfy the conditions to get the exemption. So the 50 percent would be an upper bound, but we couldn't really give you more precise numbers from that.

CHAIRMAN MASSAD: Commissioner Giancarlo?

COMMISSIONER GIANCARLO: Thank you. My written statement on this rule contains numerous observations and comments. I just want to highlight a few. I don't have questions, but I do want to say a few things. First, I want to note that the threshold for measuring material swaps exposure has been raised from three billion to eight billion, which brings our requirement roughly in line with the IOSCO standard of eight

billion Euro.

I'm also pleased that the swaps of commercial end-users, agricultural and energy cooperatives that are classified as financial institutions and small banks will not be subject to the margin requirements if they qualify for an exclusion or exemption. And I think that's one small assist to America's remaining small banks to get their heads back above water in the toppling wave of the Dodd-Frank Act.

I disagree, however, with the definition of financial end-user, which is overly broad in the rule. It includes entities that are unlikely to act as counterparties to swaps, such as floor brokers, introducing brokers, and futures commission merchants acting on behalf of customers, among others. These entities may not ultimately be captured by the rule because they're unlikely to have material swaps exposure triggering application, but I question the logic behind their inclusion. Good regulation means precisely crafted rules, not ones that are

deliberately overly-broad.

I also continue to object to the 10-day liquidation horizon that must be incorporated into initial margin models for all types of uncleared swaps. The 10-day requirement is a made up number. It's not tailored to the true liquidity profile of the underlying swaps instruments. We must revisit this issue as we gain more experience with initial margin models.

In addition, I remain concerned about the cross-border implications for this rule, which remain unfinished because they were proposed separately from the rule finalized today. An appropriate framework for cross-border application of margin requirements for uncleared swaps is essential if we are to preserve the global nature of the swaps market. We must avoid further fragmenting markets by imposing another regulatory framework that is inconsistent, confusing, or burdensome. Doing so will only result in yet another competitive disadvantage between American institutions and their international counterparts.

And I close by again commending the team -- John, you and your team -- for your hard work, thoroughness, and ultimately the improved rulemaking that is before us today. Thank you.

CHAIRMAN MASSAD: Thank you. I'd like to follow up just on a few points to make sure we understand and the audience also understood. Rafael, you were talking about the data on inter-affiliate swaps. So just to be clear, what you were saying is right now, our SDR data -- frankly, I think, we're estimating, first of all, how much of it is in inter-affiliate swaps. We have to figure out who is related to whom manually. We don't really have accurate data on that. But, more importantly, when we're talking about not requiring initial margin on inter-affiliate swaps, we are only talking about those swaps between the consolidated affiliates. So, for example, if there is an investment fund managed by an affiliate, that swap is treated as a third party affiliate -- or a third party entity.

MR. LAWTON: That's right.

CHAIRMAN MASSAD: If there is a less than 50 percent owned entity, which is not consolidated, that is treated as a third party swap. So, we have no real sense of the distinction between, you know, the amount of those kinds of swaps and the amount of the consolidated swaps. Is that correct?

MR. LAWTON: That's correct. Yes, that there's some difficulty in identifying who is an affiliate and then once you do identify who is an affiliate, there is some difficulty in identifying whether they're a consolidated affiliate or not.

CHAIRMAN MASSAD: Okay. And just to go back to the de-guaranteeing issue, the de-guaranteeing issue goes to guarantees on outward facing trades. Is that right, Paul?

MR. SCHLICHTING: Yes, that's correct.

CHAIRMAN MASSAD: And our -- I think you were saying our proposal on the cross border deals with that by saying the application of our margin rule to those outward facing trades doesn't turn on whether there's a guarantee, it simply turns on

whether the entity is consolidated.

MR. SCHLICHTING: That's correct.

CHAIRMAN MASSAD: So, the inter-affiliate -- whether we require initial margin for inter-affiliates is unrelated to the application of our cross border rule to the de-guaranteeing issue?

MR. SCHLICHTING: On that end, yes. On the outward facing, correct.

CHAIRMAN MASSAD: Right. Okay. I want to turn to the issue of inter-affiliate transactions -- talking about large institutions. There's a lot of inter-affiliate transactions, I assume, between these entities, right? I mean which we don't even regulate. There's corporate overhead allocation, sharing of leases, sharing of IT, tax sharing and allocation, working capital arrangements, sharing of funding. There's all sorts of things, right? Okay.

MR. LAWTON: That's correct. Yes.

CHAIRMAN MASSAD: Now, here's where -- as I understand it, the prudential regulator

situation is quite different than ours because -- correct me if I don't have this right, but federal law already requires that when you have an insured depository institution engaging in an inter-affiliate transaction, that transaction must be fair to the insured depository institution. Is that right?

MR. LAWTON: That's right.

CHAIRMAN MASSAD: And, in many cases, that insured depository institution must also collect collateral for that transaction -- in some cases. Is that right?

MR. LAWTON: I believe that's right, yeah.

CHAIRMAN MASSAD: And Dodd-Frank made it clear that derivatives are now included in that. Is that -- Paul, I see you nodding, but --

MR. SCHLICHTING: Yes, that is correct.

CHAIRMAN MASSAD: Okay. That framework doesn't apply to us -- to our entities. Is that right?

MR. LAWTON: That's right.

CHAIRMAN MASSAD: Okay. And it doesn't even mean that those transactions -- those very same transactions have to be fair to our entities. Is that right?

MR. LAWTON: No. That's right.

CHAIRMAN MASSAD: Okay. All right. So, our entities can -- I mean they have a lot of things going on and we could have a margin rule that says you've got to collect -- let's say it's $100 million fixed to floating swap. You've got to collect and post margin. Okay. Could they then -- instead of doing that, could they just loan $100 million?

MR. LAWTON: I'm sorry. Would the CSE be --

CHAIRMAN MASSAD: Yeah.

MR. LAWTON: -- making the loan or borrowing the money?

CHAIRMAN MASSAD: Either way.

MR. LAWTON: Um --

CHAIRMAN MASSAD: Well, let's assume it's -- well, frankly, either way -- vis a vis the

fairness to our CSE, right? It doesn't matter.

MR. LAWTON: Right. I mean there would presumably be capital implications, depending on whether they were --

CHAIRMAN MASSAD: Sure.

MR. LAWTON: -- loaning it or borrowing it.

CHAIRMAN MASSAD: Under our capital rule, you're saying?

MR. LAWTON: That's right.

CHAIRMAN MASSAD: Yeah. Of course, which all of these things could have implications under our capital rule. But the point is, in -- that we could require margin on a $100 million fixed to floating interest rate swap where the payments -- given interest rates today are, you know, not all that large. Whereas, the entity could loan $100 million and not take any margin for it.

MR. LAWTON: That's right.

CHAIRMAN MASSAD: Okay.

MR. LAWTON: I mean. Right.

CHAIRMAN MASSAD: The entity could also collect, say, initial margin. If we required initial margin, one entity could collect -- our CSE could collect $20 million let's say in treasury securities from the affiliate. Right? As the margin? Okay. Could it then loan those -- loan some other securities having a value of 20 million back to that affiliate without any fairness or any standards on that transaction?

MR. LAWTON: Again, yes.

CHAIRMAN MASSAD: Right.

MR. LAWTON: The margin would have to be segregated, but, yes, some -- they could do a separate transaction that's --

CHAIRMAN MASSAD: My point is there's a lot of things going on within a consolidated enterprise and I think we've got to think about whether imposing initial margin requirements are really meaningful. Well, let me put it this way. If we have concerns about internal risk management, let's address them directly is my point. So, let me just then say why I support

this rule because, you know, we're spending a lot of time on inter-affiliate margin and I think it's important to step back and think about the bigger picture here.

I mean this rule is really one of the most important elements of swaps market regulation set forth in the Dodd-Frank Act. And I've been saying that for a while. There will always be a large part of the market that is not cleared, and that's appropriate. But we must take steps to protect against such activity posing excessive risk to the system. And that is why we are establishing margin requirements for uncleared swaps.

I believe this rule is strong and sensible. It requires swap dealers and major swap participants to post and collect margin with financial entities with whom they have significant exposures. It requires initial margin, which is designed to protect against potential future loss on a default as well as variation margin. It allows for the use of a broad range of types of

collateral, but only with appropriate haircuts. It requires a greater level of margin than for cleared swaps and it requires segregation of margin with third party custodians and prohibits the practice of re-hypothecation so that institutions cannot use their customer's margin for other purposes.

Another very important feature, as I noted earlier, is that it exempts commercial end users from the rule's requirements. Their swap activities were not a source of significant risk in the financial crisis, so our rule is properly focused on the large institutions who engage in most of the uncleared swaps activity.

Now, since I've been in office, you know, I hear a lot from people about the fact that rules on swaps internationally are not harmonized. And so, shortly after I took office, I committed to working to make the margin rules as similar as we could because, again, they are such an important piece of this framework. And our rule today is practically identical to those of the

United States banking regulators and substantially similar to international rules. And I want to congratulate the staff, because I know that took a lot of work to get to where we are, but that is a very important accomplishment.

Now, the rule is really designed to reduce the risk that a covered swap entity default leads to further defaults by its counterparties. And given the interconnectedness of our financial system, that's an extremely important thing. We became all too familiar with that risk in 2008. Now the issue of how the rule applies to inter-affiliate transactions is really a separate issue. It's received a lot of attention. And I first want to say that, you know, the differences in our views on inter-affiliate margin do not reflect differences in our respective level of concern about the safety of the system or about avoiding the problems of the past.

I spent five years at Treasury helping this country dig out from the financial crisis and a lot of that time was spent on dealing with AIG.

And I think our differences, instead, reflect differences in our analysis of what is the purpose of initial margin -- particularly in the inter-affiliate context -- and what would it accomplish or not accomplish. And so I believe we've got to look at this issue first in terms of the basic goal of the rule, which is to avoid the potential for the buildup of excessive risk from bilateral transactions between unaffiliated parties. Inter-affiliate transactions are not outward facing. They do not increase the risk -- the overall risk exposure of the consolidated enterprise to third parties. And instead they are typically a means for the consolidated enterprise to centrally manage risk related to the activities of multiple subsidiaries -- as it does with a whole host of activities.

So we must make sure that inter-affiliate transactions are not used as a loophole or as a means to escape the basic and very strong requirements of this rule to collect margin in transactions from third parties. And we

have done that. We have imposed a very strong anti-evasion standard. As we have said, a covered swap entity is required to collect margin from an affiliate if that affiliate is directly or indirectly engaging in an outward facing swap in a situation where it should be, but is not collecting margin. And, in addition, as it was noted, our proposal on the cross border application of our margin rule, which is the subject of a separate rulemaking, also addresses this because that provides that any affiliate that is consolidated with a U.S. parent is subject to requirements to collect margin from third parties no matter where that affiliate is located and whether or not it is guaranteed by the U.S. Parent. I'm hoping that we can finalize that part of the rule early next year.

Now, second, we have required the exchange of variation margin in all inter-affiliate swaps. And this provides mark to market protection to both sides and prevents the buildup of the liability owed by one affiliate to

another. And, third, we've required that inter-affiliate swaps be subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with such transactions. And I think at times, we're suggesting that we should use inter-affiliate margin -- initial margin -- to enhance that risk management -- that internal risk management. I think that would be a very costly, and not necessarily effective way, to do that, because of the examples I've cited and because of the complexity of that internal risk management. If we are concerned -- if there is a concern about the adequacy of internal risk management -- centralized risk management -- we should address it directly, not by imposing the requirements of a rule that is designed for trades with unaffiliated parties.

I would also note that the rule is generally consistent with the rule adopted by the Commission in 2013, exempting inter-affiliate transactions from the clearing mandate. If you go

back and look, you will see the Commission explicitly considered whether to require initial margin or variation margin in the context of inter-affiliate transactions at that time and decided that it would not do so. It would not require those as a condition of using the inter-affiliate exemption from clearing. If we were to do so today, that would effectively undercut the inter-affiliate exemption from clearing.

So, I address other aspects of the rule in my written statement, but, in short, I believe this rule is a strong and sensible approach that will contribute to the strength and resiliency of our financial system. Thank you.

If there are no other questions, I would again like to thank the staff for all their work and their presentations. And I would like to ask if any Commissioner would like to make any further statements before we proceed to a vote? Okay. I would then ask Mr. Kirkpatrick to call the roll.

MR. KIRKPATRICK: The motion now before

the Commission is on the adoption of the final rulemaking on margin requirements for uncleared swaps for swap dealers and major swap participants. Commissioner Giancarlo?

COMMISSIONER GIANCARLO: Aye.

MR. KIRKPATRICK: Commissioner Giancarlo, aye. Commissioner Bowen?

COMMISSIONER BOWEN: No.

MR. KIRKPATRICK: Commissioner Bowen, no. Chairman Massad?

CHAIRMAN MASSAD: Aye.

MR. KIRKPATRICK: Chairman Massad, aye. Mr. Chairman, on this matter the ayes have two, the no's have one.

CHAIRMAN MASSAD: The ayes have it and the motion to adopt the final rule is approved. Is there any other Commission business? There being no further business, I would entertain a motion to adjourn the meeting.

COMMISSIONER BOWEN: So moved.

COMMISSIONER GIANCARLO: Second.

CHAIRMAN MASSAD: All those in favor,

say aye.

COMMISSIONER BOWEN: Aye.

COMMISSIONER GIANCARLO: Aye.

CHAIRMAN MASSAD: Okay. The ayes have it. Again, I want to thank the CFTC staff for all their work and on behalf of all of us at the Agency, I want to wish everyone a happy holiday with family and friends and a wonderful new year. Thank you.

(Whereupon, at 12:17 p.m., the PROCEEDINGS were adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

DISTRICT OF COLUMBIA

I, Carleton J. Anderson, III, notary public in and for the District of Columbia, do hereby certify that the forgoing PROCEEDING was duly recorded and thereafter reduced to print under my direction; that said transcript is a true record of the testimony given by witnesses; that I am neither counsel for, related to, nor employed by any of the parties to the action in which this proceeding was called; and, furthermore, that I am not a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

(Signature and Seal on File)

Notary Public, in and for the District of Columbia

My Commission Expires: March 31, 2017