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COMMODITY FUTURES TRADING COMMISSION

INDIVIDUAL CUSTOMER COLLATERAL PROTECTION

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

2 (12:57 p.m.)

3 MR. RADHAKRISHNAN: All right. Good

4 afternoon, and welcome to CFTC's Staff Roundtable

5 on the discussion Individual Customer Collateral

6 Protection. My name is Ananda Radhankrishan. I'm

7 with the Division of Clearing and Intermediary

8 Oversight, and I welcome all of you to the CFTC,

9 and I appreciate your participation in this

10 roundtable, and, for some of you, you're doing

11 double duty because you were here this morning. I

12 really appreciate you spending the day with us.

13 A couple of rules. This event is being

14 recorded. A transcript of the proceedings will be

15 on our Web Site. It's a staff roundtable, so, if

16 we offer any opinions, it'll just be our own, and

17 will not reflect the opinion of the Commission or

18 any individual commissioner.

19 I'm going to first go around and have

20 the CFTC staff introduce themselves, and then go

21 around the table and have everybody introduce

22 themselves.

1 So, Martin?

2 MR. WHITE: I'm Martin White with the

3 CFTC Office of General Counsel.

4 MR. WASSERMAN: I'm Bob Wasserman in the

5 Division of Clearing and Intermediary Oversight.

6 MS. SCHNABEL: Nancy Schnabel, Division

7 of Clearing and Intermediary Oversight.

8 MR. PRAGER: Ritchie Prager, BlackRock.

9 MR. THUM: Bill Thum, Vanguard Legal

10 Department.

11 MR. KASWELL: Stuart Kaswell with the

12 Managed Funds Association.

13 MR. HUSTON: Rob Huston representing the

14 National Council for Farmer Cooperatives.

15 MR. SZYCHER: Mark Szycher representing

16 the General Motors Pension Funds.

17 MS. O'BRIEN: Edith O'Brien representing

18 the FIA from MF Global.

19 MS. BURKE: Maureen Burke, Bank of

20 America, Merrill Lynch, representing FIA.

21 MR. ROSEN: Ed Rosen, Cleary Gottlieb,

22 representing FIA.

1 MR. MALOY: David Maloy, Credit Suisse,
2 representing ISDA.
3 MR. MAGNUS: Arthur Magnus, JPMorgan,
4 representing ISDA.
5 MR. MAGUIRE: Hi, I'm Danny Maguire,
6 head of OTC Derivatives Risk at LCH.Clearnet.
7 MS. TAYLOR: Kim Taylor, CME Clearing.
8 MR. EDMONDS: Chris Edmonds, ICE Trust.
9 MR. WASSERMAN: Actually, one or two
10 more technology points. If anyone here at the
11 table has a BlackBerry or the like, please make
12 sure to keep it off the table or it'll interfere
13 with the sound. Also, if folks could, as a
14 courtesy, turn your cell phones to buzz rather
15 than ring.
16 And we are hoping to have Paul Swann of
17 ICE Clear Europe appear on the phone. There may
18 have been a technological difficulty.
19 Paul, are you there?
20 MR. SWANN: No, Bob, I'm on the phone.
21 Thank you for introducing me. I apologize I
22 didn't introduce myself because you didn't give an

1 opportunity for phone-joiners to introduce
2 themselves.
3 I'm Paul Swann, ICE Clear Europe.
4 MR. WASSERMAN: Excellent. That
5 technology did work.
6 Well, thank you, all, for coming. The
7 issue we're confronting here is sometimes referred
8 to as a fellow customer problem. If a customer
9 defaults, who is exposed to the losses? Now, in
10 the industry, the first two answers are very
11 clear; the customer himself and the firm that is
12 carrying that customer. But what happens when the
13 loss exceeds that capital? Well, we come to the
14 question of then who should next bear that loss?
15 Is it the fellow customers at that firm or the
16 clearinghouse which, the way things are organized,
17 tends to ultimately mean other clearing members.
18 And, so, on the agenda today, what I'd like to
19 first do is start out talking about what the buy
20 side, the customer side feels about these issues
21 and what their concerns are. Then move on to a
22 model or models for addressing that, and then talk

1 about how effective those models might be and,
2 very importantly, what the costs of those models
3 are.
4 So, without further ado, Richard, if
5 you'd like to begin.
6 MR. PRAGER: Thanks, Bob. I mean, I
7 think the reference point that we choose to start
8 from is where we're coming from, which is the OTC
9 market, and while this sometimes turns out to be a
10 future's discussion, that certainly was not our
11 intent. Our intent was to seek on behalf of our
12 clients to maintain the same level of protection
13 they now enjoy in the bilateral market if they
14 choose to enter into a tri-party agreement to
15 secure their exposure. So, as we migrate into
16 this new, brave world and look at Dodd-Frank and
17 the rationale for adopting the new regulation,
18 which BlackRock is strongly in favor of, there is
19 this one issue here that we're confronting, which,
20 on behalf of our clients, we think we need to
21 maintain that aspect of the market structure for
22 this account class.

1 So, today, we have an environment where
2 not all our clients choose a tri-party, but those
3 that do have that ability, they understand that
4 there's incremental costs associated with that
5 security, and we contract those costs, we pay that
6 cost today, and while we do hear a lot of support
7 for our concern, we also hear a lot of concern
8 about the cost associated with achieving the
9 segregation. So, in that vain, I think it's
10 important that when we look at what we're seeing
11 is this associated cost, we really need to look
12 again at our starting point, which is we know the
13 cost today of the tri-party arrangement, and we
14 think that should be the right benchmark. We also
15 want to highlight that there is cost to the new
16 regulation, and that the retooling of the entire
17 OTC market, as we go from the unclear to the clear
18 world, has costs, and it has costs for all
19 participants, and we don't think that these
20 retooling costs should all be associated with this
21 one issue that we're highlighting, which is the
22 need for a segregated account.

1 So, really, I think those would be our
2 opening comments, Bob.
3 MR. WASSERMAN: Bill?
4 MR. THUM: Yes, it's Bill Thum here from
5 Vanguard, and I think I could echo just about
6 everything that was said on behalf of BlackRock.
7 Our concern really relates to the existing
8 platform and the customer protections that apply
9 in the OTC bilateral world and how that will
10 translate into the cleared world. And while
11 Vanguard is very supportive of the aims and
12 objectives of Dodd-Frank and, indeed, clearing
13 standardized derivatives, our concerns relate to
14 the protection of the margin that we will be
15 posting on behalf of our clients and how that
16 margin will be held, and, ultimately, how that
17 margin that we will be handled in the event of a
18 default involving another client of our
19 derivatives clearing member. So, we want to talk
20 through the differences between the existing state
21 and the future state, our aim in terms of
22 achieving a different approach for the cleared

1 derivatives compared to cleared futures trades,
2 and then, obviously, talk about the implications
3 that that would have.
4 MR. KASWELL: I actually have a formal
5 statement. Is it okay if work through that?
6 Okay, great.
7 Well, again, I'm Stuart Kaswell with the
8 Managed Funds Association, and we appreciate the
9 opportunity to be here today, and we hope to
10 assist the CFTC in implementing the Dodd-Frank
11 Act.
12 For those of you who don't know, MFA is
13 the voice of the global alternative investment
14 industry. Our members include the vast majority
15 of the largest hedge funds in the world, who
16 manage a substantial portion of the $1.5 trillion
17 invested in absolute return strategies. MFA
18 strongly supports Dodd-Frank's goals of enhancing
19 transparency and reducing systemic risk for the
20 OTC Derivatives Market. It is of utmost
21 importance that the CFTC develop rules for OTC
22 derivatives in general, and the segregation of

1 collateral in particular that would enhance the
2 financial market and maximize customer protection.
3 On the issue of segregation, MFA favors
4 the segregation of customer initial margin and
5 separate individual customer accounts as opposed
6 to combining customer assets in an omnibus
7 segregated account.
8 The failure of Lehman Brothers is a key
9 example of why segregation is necessarily. It is
10 well-known that Lehman's customers lost billions
11 of dollars, and those customers include MFA
12 members. Losses from Lehman include customers who
13 had posted margin that was not segregated.
14 However, omnibus segregation, while an
15 improvement, still exposes customers to
16 substantial risk of losing their margin.
17 Customers cannot quantify their risks since they
18 do not know the risk profiles of the FCM's other
19 customers. There is no way for customer A to know
20 whether customers B, C, and D are solvent or
21 exposure the FCM to risk. Customers who can't
22 protect themselves against risk are less likely to

1 invest generally and less likely to want central
2 clearing.
3 We appreciate that the CFTC must take
4 into consideration a range of concerns when
5 adopting rules on segregation for cleared swaps.
6 We respect the CFTC's need to explore fully the
7 potential benefits and drawbacks of all available
8 segregation options. However, we want to ensure
9 that all alternatives remain on the table and that
10 the CFTC does not prematurely eliminate individual
11 segregation as an option.
12 We understand that those who favor
13 omnibus accounts suggest that the cost of
14 individual accounts, the central clearing party
15 will be too high, the infrastructure changes will
16 be too complex, and the implementation will take
17 too long. We respectfully urge the Commission to
18 examine that view carefully. We also urge the
19 Commission to consider both direct costs and
20 external costs, such as the cost of buying CDS
21 protection to protect against the failure of an
22 FCM.

1 As a general matter, our members do not
2 want to delay the move to clearing or incur
3 unreasonable costs to obtain the benefits of
4 individual segregation, but we think those who
5 oppose the greater protection collateral should
6 have the burden of proof of showing why individual
7 accounts are not practical. If after careful
8 review the CFTC determines that the cost in
9 infrastructure complexities of individual
10 segregation are prohibitive, we are open to
11 discussing an alternative model that would
12 optimize customer protection, but we think it is
13 premature to consider lesser alternatives.
14 For uncleared swaps, we believe that the
15 right to individual segregation of customer
16 initial margin is essential for effective OTC
17 derivatives regulation. We respectfully request
18 that adopting rules related to uncleared swaps,
19 the CFTC should clarify two points on the meaning
20 of segregation with an independent, third-party
21 custodian.
22 First, we suggest that an affiliate of

1 the dealer counterparty be precluded from serving
2 as custodian. Second, we recommend that the FCM
3 segregate collateral in separate, individual
4 customer accounts pursuant to contractual,
5 tri-party agreements.
6 Some may interpret the segregation
7 provisions of Dodd-Frank more loosely, permitting
8 the dealer counterparties affiliates to serve as
9 custodian. They also imply that a bilateral
10 contractual arrangement solely between the dealer
11 and counterparty and the custodian is efficient.
12 Without segregation and an unaffiliated custodian
13 or tri-party agreement, there is no true
14 segregation from the interests of the dealer.
15 Absent these protections, the dealer maintains
16 exclusive control over its customers' collateral.
17 Lastly, we recognize that the Dodd-Frank
18 Act does not require the CFTC to adopt rules
19 jointly with the SEC related to segregation of
20 collateral. We strongly recommend that the CFTC
21 coordinate with the SEC to ensure that, to the
22 extent possible, the agencies' rules result in

1 consistent, if not identical, outcomes.
2 Thank you for the opportunity. I'd be
3 happy to answer questions.
4 MR. WASSERMAN: I just would note that
5 actually, and even though this roundtable is a
6 CFTC roundtable, on your last point, we are
7 working fairly closely with our colleagues at the
8 SEC in discussing these issues.
9 Rob?
10 MR. HUSTON: Thank you very much. My
11 name is Rob Huston. I represent the National
12 Council for Farmer Cooperatives. We represent
13 over 3,000 farmer cooperatives in the United
14 States, with over $116 billion in sales. Roughly
15 70 percent of the farmers are associated with a
16 cooperative. We have over $6 billion in exports,
17 provide over about 250,000 jobs in the United
18 States, with a payroll of about $8 billion a year.
19 And our concern, and we appreciate the
20 opportunity to be here today, but it's
21 specifically related to agricultural swaps, and
22 our concern is that we're putting the cart before

1 the house a little bit. We've had a system in
2 place for decades that have allowed for the
3 collection or margin and don't see an immediate
4 need for change. The cleared agricultural swaps
5 that are traded today in the form of calendar
6 swaps have their place. The majority of the them
7 are traded in between market hours, on weekends,
8 and in between the times that the Chicago Board of
9 Trade is open or the CME Group is open for
10 business, but, as an aggregator of end-users, in
11 exchange traded futures and uncleared swaps
12 provide an effective tool for the American farmer
13 to hedge price risk in today's volatile markets,
14 and I concur with the statement from BlackRock,
15 that we're concerned about the costs associated
16 with the new regulations and then how that might
17 effect the American farmer.
18 MR. SZYCHER: Good afternoon and thank
19 you. My name is Mark Szycher, and I'm vice
20 president in charge of enterprise risk management,
21 GM Asset Management, representing the GM Pension
22 Funds. My duties include overseeing risk

1 management of all derivatives activities conducted
2 on behalf of the GM pension plans.
3 By way of background regarding GM
4 Pension Plans, the GM plans cover over 650,000
5 active and retired workers and their family
6 members, both union as well as salaried employees
7 and former employees. The GM plans distribute in
8 excess of $7 billion to retirees and to their
9 surviving spouses. And for many of those retirees
10 and their surviving spouses, the GM pension
11 benefits represent the lion's share of their
12 monthly income. In addition, it's also during
13 this conversation important to bear in mind that
14 the GM Pension Funds fall fully subject to ERISA,
15 and our principal regulator is the Department of
16 Labor, although, of course, our activities in the
17 markets also put us in contact with a variety of
18 other regulators.
19 As an ERISA fiduciary, we're held to
20 what is widely accepted to be the highest standard
21 of care and the duties of loyalty of any market
22 participant. I appreciate the opportunity to

1 speak to you today regarding our concerns and the
2 concerns that we share with many plan sponsors
3 regarding the potential loss of protections that
4 we enjoy today unless swap clearing models are for
5 certain collateral protection features. And those
6 features that we enjoy today in our arrangements
7 in the uncleared or over-the-counter swap markets
8 include the following: Full segregation of
9 collateral both from the counterparty, as well as
10 from other clients of our counterparty. In
11 addition, an independent, third-party collateral
12 custodian who holds any posted collateral support.
13 Our counterparty has no access to the collateral;
14 that is no access to either reinvest that
15 collateral or to re-hypothecate it. Furthermore,
16 the counterparty is required if they are out of
17 the money to post collateral support to that
18 third-party custodian, as well as our doing so as
19 needed. In addition, the collateral that is held
20 is subject to U.S. bankruptcy law. And, lastly,
21 and very importantly, that we do have certainty as
22 to the precise quality and the nature of the

1 collateral that is posted by either our plans or
2 to the third-party custodian via the counterparty,
3 as this is agreed to by ourselves and the
4 counterparty.
5 I think the essence of our concerns are
6 really that, potentially, under some of the models
7 being discussed, we could be exposed to two risks
8 that we're not currently subject to today. The
9 first risk is the risk of default by another
10 client of the FCM. And, furthermore, default by
11 the FCM due to poor investment choices, or,
12 perhaps, a situation involving an affiliate or a
13 subsidiary of that FCM. And, in doing so, we
14 recognize, and the one of the other panelists
15 brought up the example of Lehman Brothers, and we
16 can certainly say from our experience that the
17 approach that I had described a moment ago served
18 us extremely well and protected our plan assets
19 against what could have been a very significant
20 loss of plan assets upon the Lehman bankruptcy.
21 In closing, if we're looking at the
22 intent of the act to be reducing risk, in essence,

1 we are being asked to take on a certain number of
2 risks that, first off, we don't have today, that
3 we believe for our pension beneficiaries have
4 absolutely no benefit whatsoever to take that
5 risk, and, lastly, that we lack the transparency
6 to make a business assessment whether we would
7 want to take such risks.
8 Thank you.
9 MR. WASSERMAN: Before we go on to
10 talking about models, I'd like to throw it open to
11 the rest of the table to react or discuss what
12 we've been hearing to this point.
13 MR. MAGNUS: I'd just like to comment on
14 one point regarding the uncleared swaps, to just
15 get that off the table quickly, and that is to
16 provide a letter to the CFTC outlining its view,
17 which supported that dealers should provide the
18 option to the buy side for a variety of
19 segregation, including independent tri-party, but
20 that it should not be required to provided
21 independent tri-party, and allow the buy side to
22 choose the model that worked best for them, given

1 the cost of that various model. And some of you
2 and some of the buy side clients would chose the
3 "independent," as you described it, non-affiliate
4 tri-party relationship, and others would
5 potentially choose affiliate and/or choose other
6 models in between, and we just feel that all those
7 should be available, and it is fair for the
8 dealers to have to offer a tri-party and an
9 independent dealer, but not be required to offer
10 that.
11 MR. KASWELL: I guess this means me,
12 right? Yes, well, and we appreciate that. I
13 think we'd say that there should be some minimum
14 rules of the road here, and that the opportunity
15 is for a race to the bottom or for people to make
16 decisions that might, in the short-term, be
17 advantageous, but in the long run, it might
18 jeopardize the investors' position. We think that
19 the tri-party should provide the two features that
20 we discussed.
21 MR. RADHAKRISHNAN: What kind of rules
22 of the road would you have us provide, because I'm

1 not taking a side, but it seems to me that if, in
2 a bilateral role, somebody offers a choice and
3 lays out the cost of the choice, or maybe one
4 independent, here's how much it's going to cost.
5 I'm trying to understand what the worry is,
6 because I think what you're asking is for the
7 government basically to say you must mandate X or
8 Y. So, I'd like to know why.
9 MR. KASWELL: I think it's because we
10 think that there can be situations where, in the
11 short-term, you might say well, I don't think I
12 want to pay the higher cost, and that could create
13 competitive advantages in the marketplace. One
14 firm's costs are lower, and, therefore, it has
15 competitive advantage. But when things get ugly,
16 that deal may not look like such a happy bargain
17 after all, and that we think that the system is
18 better served by saying there are some things --
19 we say cars have to have seatbelts. We don't say
20 some cars can have them and some can't. We've
21 tried that, sometimes it works, sometimes it
22 doesn't. I think in this setting, we think that

1 the overall financial system is better served.
2 MR. RADHAKRISHNAN: So, let's get
3 specific. Would you want the CFTC to promulgate a
4 rule that would say if the end-user choose
5 segregation, are we going to give the choice of
6 segregation or is it going to be mandatory or
7 bilateral?
8 MR. KASWELL: Well, but the bilateral,
9 we have to give the choice of --
10 MR. RADHAKRISHNAN: Okay. All right.
11 So, we give the choice, but the collateral must be
12 held in a bank that is now affiliated with a
13 dealer, right? So, the rule, of course, we cannot
14 specify which bank it is. Well, we already have,
15 and that it cannot be the bank affiliated with the
16 dealer. It could be some other bank.
17 What kind of rules would we impose? I'm
18 just trying to get a sense of would it have to be
19 a bank where the -- well, we can't use credit
20 ratings anymore because the law says you can't do
21 that, right? Would it have to be a minimum
22 capital? Would it have to be location-specific?

1 I'm just trying to get a sense.
2 MR. KASWELL: I don't think we got into
3 that level of detail. I think we were just trying
4 to set out two basic parameters to saying these
5 are sort of the minimums we think are necessary in
6 order to make it safe, that if the whole idea is
7 that it's separate, then the counterparty
8 shouldn't be able to touch it and that it's in a
9 separate place, and separate really should mean
10 separate.
11 Now, the other factor, and this is sort
12 of maybe a side benefit, this will have the
13 tendency to spread stuff around, and there's some
14 advantage in not keeping all the eggs in one
15 basket. That can create benefits and competition
16 and so on. I understand it can also create
17 complexities that you may say well, is there
18 someone who's available in order for me to find
19 somebody else who really is independent? And that
20 may get complicated in some setting. We'd rather
21 take that chance than risk that when a situation
22 gets ugly that, all of a sudden, that collateral

1 that you thought was there really isn't.

2 MR. THUM: It's Bill Thum of Vanguard.

3 I think, as well, there's an important distinction

4 that can be made between the present bilateral

5 derivatives model and the existing futures model,

6 and that relates to the issue of loss

7 mutualization. So, while there can be a mandate

8 that a dealer needs to offer segregated tri-party

9 accounts to hold collateral that's being posted to

10 cover derivatives positions, bilateral derivatives

11 positions, the missing problem, the problem that

12 does not exist in the bilateral derivative world

13 at present is the concept that if another client

14 of the dealer fails to satisfy its margin

15 obligations, the margin that's being posted by

16 another client is not being used to satisfy that

17 obligation.

18 So, I think from Vanguard's perspective,

19 the issue really gets the problem of loss

20 mutualization connected with the futures model and

21 applying that concept to margin being held to

22 cover exposures related to cleared derivatives.

1 MR. RADHAKRISHNAN: Just to be clear
2 though in case people are not clear, the prospect
3 of a non-defaulting client losing its margin only
4 will apply if the clearing member defaults to the
5 clearinghouse in the customer origin. And if the
6 clearinghouse chooses the margin, I just want to
7 make it clear that that's what we're talking
8 about, because, otherwise, in a case where the FCM
9 is fine and one customer has defaulted to it, our
10 seg rules prevent the FCM from using another
11 customer's seg deposits to cure the other
12 customer's default. So, what we're talking about
13 right now is a situation where, and I don't think
14 it has ever happened. Well, has it happened maybe
15 once?
16 MR. WASSERMAN: Yes.
17 MR. RADHAKRISHNAN: Maybe once, but
18 where client defaults to a clearing FCM. That
19 causes a clearing FCM to default to a DCO, and
20 CFTC to an Interpretative Letter in 85 said that
21 the DCO, if it wants to, can attach all of the
22 collateral of the defaulting FCM to satisfy the

1 loss.

2 MR. PRAGER: I mean, from our

3 perspective, Ananda, we do acknowledge we're

4 talking about an extraordinary event of both a

5 customer default and a FCM default, and while we

6 have the ability to monitor the FCM to some

7 extent; I mean, we do see financials posted and we

8 do see there are capital levels that clearinghouse

9 has -- we have no visibility to the other

10 customers, so, we do acknowledge it's extreme, but

11 there's no tools available to allow us to risk

12 manage this, even though it is extreme event. I

13 mean, it's not impossible, and there's just no

14 visibility to the other customers.

15 MR. KASWELL: Right, and just as a

16 footnote to that, I mean, 724 Dodd-Frank says that

17 you can't use one customer's money for another. I

18 mean, and I understand there are later exceptions

19 in the statute, but the basic premise that

20 Congress is setting out here is that each

21 individual customer should stand on its own and

22 that one shouldn't be subsidizing another for,

1 again, the very reason that he can't check on my
2 credit and vice versa. We all look to the FCM to
3 do that, and that's not a great position for us to
4 be able to say oh, well, we can look out for
5 ourselves here. We really can't.
6 MR. ROSEN: Thank you. First, I want to
7 want to defend the dignity of this fine
8 commission. Just to point out that the customer
9 loses that occurred in Lehman didn't occur on
10 American soil. The regime that the CFTC
11 administered worked very well for the protection
12 of customers. It is impossible not to be
13 sympathetic to the position of any fiduciary who
14 wants to minimize the circumstances in which their
15 beneficiaries might incur losses. It's just
16 impossible not to be sympathetic to that, but I
17 think we have all learned from experience you
18 cannot eliminate risk, you can transfer it, and if
19 you're transferring it, the question is: To where
20 is it being transferred, what are the scenarios in
21 which it will manifest itself, and what are the
22 ramifications of that? And I think you can't

1 ignore that part of the costs, and I think it also
2 expands the constituencies that we ultimately need
3 to think about in evaluating the risks and the
4 benefits and the costs of changing the structure
5 of this regime, and we can come back to that a
6 little bit later because this agency is charged
7 not with protecting us or you or the clearinghouse
8 or other clearing members, this agency is charged
9 with protecting the public interest. And, under
10 certain scenarios, it is the public that I think
11 could be affected by the judgments that we make
12 here today.
13 The one thing I do think, there's both
14 an analogy to the OCC market that I think should
15 be drawn, and I think a limitation to the analogy
16 from the bilateral transacting in swaps to the
17 clearinghouse, and that is it is true that you
18 don't have visibility into the other customers of
19 an FCM, but when you deal bilaterally with a swap
20 dealer, you accept the credit risk of transacting
21 with the swap dealer, and the swap dealer's credit
22 worthiness is a function of other unrelated

1 transactions with a panoply of other customers
2 that can present credit risk for the
3 clearinghouse. So, I'm not sure there's such a
4 paradigm shift in the credit risk evaluation that
5 large, institutional customers are confronted with
6 in the context of clearing swaps.
7 I think the other parameter to the
8 analogy that needs to be drawn on the other hand
9 is that there's a difference between the risk of
10 loss that arises in a single bilateral
11 relationship where you can protect your assets to
12 a segregation of the independent amount quite
13 effectively and immunize it, but in the bilateral
14 context, you don't have the cross pollination of
15 risk, and what everybody regards as a helpful risk
16 diversification mechanism in terms of
17 mutualization of risk and a clearinghouse becomes
18 a risk concentrating factor in extreme
19 circumstances, which, as you say, Ritchie, and I
20 think you're right, those are the scenarios that
21 we are talking about, and I think when we talk
22 about costs and constituencies, we have to think

1 about the other end of that spectrum because I
2 think it really is quite consequential at the end
3 of the day, and I think others can speak to a sort
4 of quantitative costs and benefits, but what I'm
5 concerned about is that Congress has just adopted
6 a statute whose principal purpose is to mitigate
7 systemic risk, and my fear is that in the worst
8 scenario, this proposal will have exactly the
9 opposite effect.
10 MR. WASSERMAN: Okay, at this point,
11 let's start talking about models. The issue has
12 come up. And it seems to me two have already been
13 mentioned. One, as Rob mentioned, is the current
14 system that we're operating under, that on the
15 future side, and one that I think is likely to
16 continue on the future side, even past any
17 immediate proposals, and under that system, of
18 course, there is the collateral is handled in an
19 omnibus manner, and the risk is managed in an
20 omnibus manner, and, so, in the event of a default
21 in a customer account, it has to be the
22 clearinghouse has every right to look at the

1 entire omnibus collateral to protect itself, and,
2 indeed, that's how it risk manages. Although, to
3 a certain extent, I think clearinghouses already
4 do look at the account level. They are in a legal
5 sense and a formal sense, they only know the
6 omnibus. And that is the current system.
7 Another system, as was pointed out by
8 Stuart and Mark is one could have complete
9 individual segregation, and that would essentially
10 go up the line, it would somewhat more
11 administratively complex, as essentially the
12 customer would post their collateral at the
13 broker. That collateral would have to be going to
14 the clearinghouse in essentially an identified sub
15 account and keep separately, and, thus, there
16 would be quite a lot more in the way of
17 transactions as things move day by day, and, of
18 course, in the cleared world, everything is done
19 at least once a day, frequently twice a day, and,
20 indeed, in extreme circumstances, perhaps, even
21 more, and one would need to monitor and reconcile
22 all those transactions.

1 I want to mention a third model, and
2 this is the model that staff here have been
3 working on, which is an attempt to sort of
4 navigate between the two. Actually, before I do
5 that, I do want to talk a little bit about an
6 understanding of the statute because, as someone
7 mentioned, the statute does say you cannot use one
8 customer's collateral to margin guarantee or
9 secure anyone else's positions. It also says that
10 you're not supposed to commingle these funds.
11 There is an exception with respect to commingling,
12 and it says well, for convenience, the property of
13 swaps customers collectively, I mean, plural that
14 is to say, may for convenience be commingled and
15 deposited in the same account or accounts with a
16 bank or trust company or with a DCO. There's
17 nothing in that exception that says and also you
18 can use one customer's money to margin guarantee
19 or secure another's positions. And, so, given
20 this permission for commingling, we're trying to
21 be, I think, faithful to the statute both in terms
22 of protecting customers, one from another,

1 permitting commingling, and, as was alluded to,
2 there are some costs, and I'm sure we'll be
3 getting into discussing that later on.
4 So, let me tell you about this approach.
5 The idea would be, first off, one change. Right
6 now, we have, in some cases, firms, carrying
7 customers post collateral on a gross basis, in
8 some cases, it's on a net basis, in some cases,
9 it's on a somewhat modified gross basis. In order
10 for this to work, it would have to be gross basis
11 strictly for all customers and for all
12 clearinghouses and for all sources. I will note
13 that some of my colleagues have been looking at
14 that for reasons separate from customer
15 protection, and, so, the cost of that may arguably
16 not be part of the costs of this initiative, but
17 we'll leave that off to the side.
18 Right now, clearinghouses, to a certain
19 extent, know customer exposures through large
20 trader and have some very excellent systems that
21 are used to monitor that information. However,
22 under this approach, every day every clearing

1 member would need to send up to the clearinghouse
2 information on each customer's portfolio positions
3 or rights and obligations at that clearinghouse.
4 And, so, if I am an FCM and I have 132 customers,
5 I would be sending up information on the portfolio
6 of customer 1 and customer 2 and so on, down to
7 132. From that information, one can calculate
8 that that array of positions, what the required
9 collateral is for that set of positions. And the
10 amount of customer collateral that I, of ICM,
11 would have to have on behalf of the customer
12 account up at the clearinghouse is the sum of
13 those 132 calculations. The FCM would post that
14 collateral just as it does today. In other words,
15 right now, collateral is not identified with very
16 limited exceptions and not really applicable here.
17 It's not identified to a particular customer.
18 Now, the firm might owe the customer back that
19 collateral when he or she asks for it, but in
20 terms of where that collateral can be put, I could
21 have a customer whose positions are all on CME,
22 but I send their collateral up to LCH. That's

1 perfectly fine, and, so, that would not change,
2 and one would not, therefore, need to keep track
3 of the collateral on a customer-by-customer basis.
4 The place where I'm going on that is what the
5 customer is entitled to in the event of an
6 insolvency is not the specific collateral; it's
7 the value, and what we're looking at here is that
8 the value of the collateral for that set of
9 positions is what the clearinghouse would be
10 looking at for each customer. So, all of this
11 would be going on just as it does today.
12 Now, in the event of a default by the
13 FCM and the customer account, the clearinghouse
14 would then be required to treat each customer
15 separately. And, so, they would be allocating to
16 each customer the dollar value of the collateral
17 that's associated with their position that they've
18 been informed of. The clearinghouse then would be
19 able to look at each set of collateral. And, so,
20 for instance, if I have customers 1 and 2, each of
21 whom has a collateral of $1 million up, customer
22 1, his position has lost $50,000. Customer 2, her

1 position has lost $3 million. Under the present
2 system, the clearinghouse would take $2 million
3 and then $1 million would go down, $1,050,000
4 would go down the waterfall. Under this proposal,
5 customer 1 would be entitled to that $950,000
6 back. Customer 2, of course, has lost all of his,
7 and he's looking forward to lawsuits. The
8 clearinghouse then would have the opportunity if
9 they so chose to transfer each customer's potions
10 and the associated collateral to a willing
11 transferee. However, the clearinghouse will have,
12 must have the unfettered right to liquidate
13 positions if they believe that is what's in their
14 best interest. I mean, remember, what we would be
15 dealing with here is a case where up until then,
16 each of the customers is backed by the credit of
17 the clearing member. At this point, by
18 assumption, the clearing member has defaulted,
19 and, so, the clearinghouse may be of the opinion
20 things are simply too risky here, I'm going to
21 just liquidate base or they may want to work with
22 things and try and transfer the positions. In the

1 event that there were no transfer, the
2 clearinghouse would then be sending the money back
3 to the trustee for distribution. So, the customer
4 then would have their claim against the FCM estate
5 just like today except in the event there has been
6 a transfer, it would be adjusted for the fact that
7 the value that was transferred for the customer.
8 Now, that's not to say there's no
9 difference in operations, and I think we'll get
10 more into this, but I would just simply mention,
11 right now, clearinghouses already have some vision
12 into customers, and certainly clearinghouses
13 monitor their members on an intraday basis. One
14 might expect that such monitoring would become
15 somewhat sharper, but that is not something that
16 we're looking at in these rules, but rather would
17 be leaving to the discretion of the clearinghouse
18 as part of their risk management approach.
19 Throw it open.
20 MR. PRAGER: I don't know if you named
21 the third option, but we think of it as maybe
22 legally segregated and operationally commingled is

1 if we understand what you're suggesting. So, I
2 mean, from our perspective, having thought about
3 this and discussed it a lot, we're very
4 sympathetic to the operationally onerous
5 environment of Frank to maintain both legally
6 separate and operationally separate. I mean, that
7 sounds like most people's nightmares. So, we are
8 sympathetic to that concern coming from the FCMs
9 and from the clearinghouses. So, we think that it
10 is potentially an elegant solution to maintain
11 that legal segregation, while having an
12 administratively easier life of operationally
13 keeping things commingled, it obviously sounds
14 very consistent with the statute, as you
15 explained, as well. I think it will potentially
16 have to put an asterisk there in looking at the
17 value aspect to make sure there might have to be
18 some ring fencing or rules around the investment
19 of collateral just to make sure that when it comes
20 to value, we do the best we can to maintain the
21 value in case there had to be a liquidation. But
22 I think that this idea does have merit, and at

1 least from our perspective, gives us that legal
2 certainty of segregation that we would have the
3 visibility to what is ours, so to speak.
4 MR. WASSERMAN: Kim?
5 MS. TAYLOR: Thank you. I wanted to
6 first just put a little bit more framework around
7 what we're talking about because I think, although
8 I agree with Ed, that I'm very sympathetic to the
9 position that fiduciaries are in in providing what
10 they would consider to be the optimal protection
11 for their clients, I do want to encourage us to be
12 thinking about this problem in the overall context
13 in which it occurs, and it seems that we're very
14 focused on one element of the customer protections
15 that exist in the listed derivatives (inaudible)
16 now and are presumed to be existing in
17 over-the-counter cleared derivatives world going
18 forward, and that is the pooled segregation, but
19 there are a lot of other elements that are part of
20 the overall customer protection mechanism that
21 have collectively contributed to a very good
22 outcome for customers over a very long period of

1 time, and that's the combination of kind of the
2 membership standards and the ongoing financial
3 surveillance that clearinghouses perform over
4 their clearing members. It includes the
5 surveillance and requirements that the CFTC has
6 over clearinghouses to ensure that the financial
7 surveillances is adequate. It includes the
8 alignment of interests of everyone in the industry
9 to care about the risk management infrastructure
10 in the industry, and that is something that I fear
11 we lose if we make it too easy for a client to
12 step away from having any risk whatsoever to what
13 happens at its clearing member. So, that right
14 now, clients have an interest in making sure that
15 they choose a financially-sound FCM. FCMs have an
16 interest in providing financially-sound, good
17 capital base, good service and good risk
18 management so that they can attract sophisticated
19 clients, and the clearinghouses have an alignment
20 of interest in making sure that the clearing
21 members are soundly managed.
22 And then there's also the bankruptcy

1 regime here and the way that the regulators
2 operate within that bankruptcy regime leads to a
3 situation where, as I've mentioned, Lehman's
4 parent went bankrupt and no U.S. Customers that
5 were subject to this customer protection regime
6 were at any risk.
7 So, I don't want us to look at just the
8 one element in isolation, but if we are looking at
9 the one element, some of the comments that Ritchie
10 mentioned in his opening statement involved the
11 fact that, even in the over- the-counter world,
12 not all of your clients are willing to bear the
13 costs associated with getting this incremental
14 protection that some of them find valuable of
15 having their assets completely segregated from the
16 risk of any loss, and I'm wondering if there's an
17 option for us to have another model under
18 discussion here which would include a regime where
19 clients could opt to have the extra protection and
20 bear the extra cost of that in the cleared world
21 without forcing all clients to bear the collective
22 costs of having a regime where that had to be

1 provided for every account.

2 MR. WASSERMAN: I mean, clearly, we

3 should be putting other options on the table as we

4 have them. We may talk a little bit about those

5 costs later and how that actually works. I guess

6 I would ask one thing: As between Richard and

7 yourself, who's in a better position to look at an

8 FCM clearing member and determine what the risks

9 are of that FCM clearing member?

10 MS. TAYLOR: I think with most of the

11 clearing members, that this type of customer would

12 be using, very likely, their public companies, and

13 there's a lot of publicly-available information.

14 I think the clearinghouse has an advantage in

15 being able to see the actual books and records, we

16 have regulatory authority to observe the control

17 environment and we can take actions if we find

18 deficiencies. So, we're in a better position in

19 that respect, however, any one clearinghouse is

20 not in kind of an omnificent position about what

21 the risks are to the clearing member because I see

22 the customer exposures that faced me and the

1 products that I cleared. I don't see the customer
2 exposures directly in the products that face
3 Chris. So, the clearinghouses collectively are in
4 a better position, and any one clearinghouse is in
5 a better position than any one customer to get
6 access to certain information. But I wonder if a
7 way to help alleviate some of the concern might be
8 to find some type of middle ground where there is
9 a better disclosure environment, and does that
10 help alleviate some of the concerns that your
11 clients have as opposed to moving all the way to
12 individual, physically-segregated client accounts?
13 MR. PRAGER: I mean, I just see that as
14 that regime transferring the burden, the due
15 diligence burden onto the fiduciary to then
16 conduct a due diligence of every client you have,
17 and we'd have the same questions you have of do we
18 see their overall exposures to the system? So,
19 and that's not what we do for a living, is to look
20 at your other clients' market positions and access
21 suitability and concentration and other things.
22 So, I think you were right to highlight that you

1 have an advantage to see that, where, I don't
2 know. I'll ask my buy side colleagues if they see
3 it differently, but I don't think we'd have the
4 tools to do that diligence.
5 MR. KASWELL: One of the issues on the
6 proposal, if there's still on bucket of
7 collateral, even if it's legally in pieces, that
8 still creates a problem in the event of
9 insolvency, and, again, we all understand we're
10 talking about remote circumstances, but we all
11 learned in the weekend in September a couple of
12 years ago that remote circumstances sometimes
13 happen. And that if the collateral at the central
14 clearer is still in one bucket, that means that if
15 customer A wants to pick up and take its marbles
16 out of that bucket and go someplace else, it may
17 be very difficult for it to do so. And I think
18 unless you solve that, and I don't know how to
19 solve that problem without having separate
20 buckets.
21 MR. WASSERMAN: Let me answer that
22 point. As I see it, there are three major sources

1 of loss to an FCM's customer account. One of
2 those is fraud defalcation operational problems.
3 I think those are present in any system, and then
4 you have the choice, as we had in the Lehman case
5 in the U.K., of saying well, whoever was the
6 unlucky fellow whose account was insufficient,
7 that's who loses, or you can socialize that I
8 guess I'm inclined to the latter, but that,
9 obviously, folks might differ.
10 The second source of loss is essentially
11 loss in value. Now, we have, as you know, under
12 our Rule 125, restrictions on the investments of
13 customer funds. I think other colleagues are
14 working on some changes to that, and I think one
15 might see changes to a 125 in the near future.
16 But, again, that is sort of a generic issue.
17 The third is fellow customer risk, and
18 what I think we're doing here is addressing that
19 one, and, so, it seems to me the first two are
20 more inherently socialized because watch out, if
21 you don't socialize them, yours might be the
22 account which the thief took.

1 So, I think that's the answer there.
2 MR. EDMONDS: To Kim's point, it still a
3 limited view, right? I mean, it's still a limited
4 view even if that duty of care were to come to the
5 individual clearinghouses at that point in time.
6 It might be that you, the regulator, have better
7 insight on that because of the overarching you
8 have. I mean, we're not going to share
9 information necessarily like that and say hey, how
10 is FCM 123 doing on that point? I mean, it
11 becomes very problematic, as Kim was pointing out,
12 because we still have a limited view of how we
13 could get there.
14 MR. WASSERMAN: I would note two things.
15 I mean, first, there is some sharing of
16 information, for instance, currently with the
17 Joint Audit Committee. In fact, information about
18 FCMs is shared between exchanges and
19 clearinghouses and the like, but, more broadly,
20 you have a couple of things going on. In addition
21 to the fact that neither of you has perfect
22 information, I think it may well be the case that

1 the clearinghouses have much better information
2 that's partly structural in the sense that you
3 guys can ask about fellow customers and get
4 information, not only see information, but you can
5 ask your members, given the supervisory supervised
6 relationship between you and them.
7 Two, there's a concentration of
8 expertise. You folks are their clearinghouse, the
9 risk management folks are in that business, and,
10 so, both from an efficiency standpoint, who's
11 better at this, a dozen clearinghouses or 12,000
12 customers? It's fewer times being done and a
13 concentration of expertise.
14 MS. TAYLOR: I would actually challenge
15 where the concentration of expertise in this
16 particular regard lies, I think is actually mostly
17 with the FCMs themselves or the clearing members
18 themselves if we're talking about customer due
19 diligence, because they're the people performing
20 the detailed customer due diligence, they're the
21 people performing the detailed customer level of
22 risk management, and we are making sure that there

1 is a certain level of surveillance and a certain
2 level of adequacy of their controlled
3 environments, but, actually, the best experts
4 about the financial adequacy of any one client's
5 financial position is actually the FCMs more so
6 than the clearinghouses.
7 MR. WASSERMAN: I'm sorry if I misspoke,
8 what I mean is in looking at the FCM, I mean, the
9 FCM is going to be looking at --
10 MS. TAYLOR: Right. Okay.
11 MR. WASSERMAN: And that's true. You
12 folks supervise them in doing that, but in
13 determining whether the FCM is likely doing a good
14 job of that and is likely to survive that between
15 the customers and yourselves, looking at the FCMs,
16 I think you all are in the better position.
17 MS. TAYLOR: I would agree that we're in
18 a better position than the clients to understand
19 the picture of how the FCM is doing.
20 MR. RADHAKRISHNAN: Danny, go ahead.
21 MR. MAGUIRE: Hi, Danny Maguire,
22 LCH.Clearnet here.

1 I mean, from LCH's position on this,
2 we're supportive of client choice around this.
3 Our primary objective here is, regardless of the
4 different account structures, to ensure that we
5 always have our risk exposure measured and
6 covered, and that's really our primary goal here,
7 and it's head of risk, that's what I think about
8 every single day. That's regardless of the actual
9 account structure that we're talking about here.
10 I expect on either gross omnibus accounts, under a
11 segregated account, regardless of the different
12 flavors or structure that we talk about, I need to
13 be able to see through the FCM and down to the
14 client to see not the credit risk, which is I
15 think what we're talking about here, but the
16 market risk of every single client, because, at
17 some point, as a CCP, as a head of risk, I will be
18 potentially in this horrible, double default
19 scenario, on the hook to actually close out that
20 position, and this is closing out potentially 10,
21 20, 30, 40, 50-year risk on OTC derivatives. So,
22 I think any CCP needs to be able to see the market

1 risk at that level, and, likewise, any FCM needs
2 to be able to see that.
3 In terms of the responsibility for
4 credit risk on the client side, that's absolutely
5 the FCM's responsibility and primary
6 responsibility because they hold the primary
7 counterparty exposure and client risk. We only
8 pick that up if the FCM goes down.
9 So, I think we need to make a
10 distinction here between market risk and really
11 credit risk. Market risk for the clearinghouse,
12 absolutely, we need to see that all the way
13 through. Credit risk, I think, primarily, that is
14 the FCM.
15 MR. RADHAKRISHNAN: I think it'd be
16 useful --
17 MR. SWANN: -- if pay would be involved.
18 MR. RADHAKRISHNAN: Oh, is that Paul?
19 SPEAKER: Paul?
20 MR. RADHAKRISHNAN: Paul, did you want
21 to say something?
22 MR. SWANN: Yes, if I could, and my

1 apologies. It's always difficult to do these
2 things when you're joining --
3 MR. RADHAKRISHNAN: Paul, can you speak
4 up because we really can't hear you quite well?
5 MR. SWANN: Can you hear that better?
6 Can you hear better?
7 MR. RADHAKRISHNAN: Just somewhat, yes.
8 MR. SWANN: Thank you. My apologies for
9 cutting from over the phone. It's always
10 difficult when you're outside of the room, but I
11 just wanted to pick up on a point Danny was making
12 in relation to looking through to the customer
13 level is the root of individual segregated
14 accounts was to be promulgated. Actually, the
15 area that I think we should explore further during
16 this discussion is what does that do in terms of
17 the contractual relationships that currently exist
18 between the central counterparty, the FCM, and the
19 FCM and the end-users of the products? And, in
20 particular, in relation to the broader
21 responsibilities market intermediaries currently
22 have in relation to other legislation such as

1 anti-money-laundering responsibilities or know
2 your customer responsibilities. At the moment,
3 the system is designed to ensure that there are a
4 number of layers in the system that are ensuring
5 compliance with those legislations. It's not
6 clear, I think, in an environment where there's a
7 direct recognition at the central counterparty
8 level of individual customers as to where that
9 responsibility lies in the future.
10 MR. RADHAKRISHNAN: I think that's a
11 good question, and I think the question that's
12 being asked is: Are we replacing the legal
13 relationship that now exists? The future
14 (inaudible) legal relationship, the privity of
15 contract is between the customer and the firm on
16 one hand, and then between the clearing member and
17 the DCO on the other hand, because I think all
18 DCOs have rules of disclaim any privity between
19 themselves and the end customer, if that's fair to
20 say. So, Paul is that sort of what the crux is of
21 your question, which is: If we go to this model,
22 are we somehow displacing that?

1 MR. SWANN: Yes, absolutely. I think
2 the crux really is firstly, are we displacing it?
3 If so, how are we displacing it? And then as with
4 the third piece is: What are the fiduciary and
5 legal responsibilities of the central counterparty
6 in that new contractual model, assuming the
7 disclosure at least implies some responsibility.
8 MS. TAYLOR: I mean, it is very hard to
9 have a position or a thought around what would be
10 the outcome of that when we don't know yet what
11 the target is, what the end result is, but I think
12 we had been approaching this with the assumption
13 that this would still be an intermediated
14 transaction between the clearinghouse and the
15 clearing member acting as agent for a now more
16 disclosed principal rather than acting for an
17 undisclosed principal as it operates now.
18 MR. RADHAKRISHNAN: Can we get a sense
19 of cost because there's no free lunch, right? So,
20 I would like to know from everybody what the costs
21 are because I think that may then drive us to
22 which model works because a couple of models have

1 been floated. Bob floated some models, Kim
2 floated a new model, which is choice. So,
3 perhaps, the firms and the DCOs could tell us --
4 MR. PRAGER: Maybe one thing, just to
5 reshape the question slightly, and we have
6 experience at the table. So, we hear lots of
7 costs, and, as I said in my opening comments,
8 we're concerned that they're becoming kitchen sink
9 costs as the entire retooling of the system is
10 being put on this particular issue. But when the
11 dealer community who's been clearing for a decade
12 chose a model, they actually a segregated account
13 model, and I presume in their analysis that they
14 came up with a cost effective way to do that. So,
15 maybe I don't know if I could put you on the spot,
16 Dan. Coming from that background, and I
17 appreciate that's not an FCM model, that's not the
18 statute as it's written today, but there's
19 experience there we can learn from. So, I'm just
20 curious to see. That clearly was a cost effective
21 model if the dealer community, and you have
22 several hundred trillion of notional outstanding.

1 So, they must have found a cost-effective way to
2 do that.
3 MR. MAGUIRE: Yes. So, hi, Dan Maguire
4 here again form LCH.Clearnet. So, I think there's
5 two ways of splitting the costs here. The first
6 one is really the operational and the
7 infrastructure setup of this. Really, without
8 trying to cast over that, I think any FCM or
9 client or any entity that's transacting in these
10 type of financial instruments needs to have the
11 relevant knowledge, trading expertise, risk
12 expertise, technology, operations, et cetera, to
13 be able to handle these kinds of transactions
14 because, ultimately on the FCM side, they could
15 own a client position as a client goes delinquent,
16 so, they should be able to get out of that
17 position, and, likewise, the CCP could own that
18 position from an FCM standpoint.
19 So, I think some of those costs are
20 really just the cost of doing business in OTC
21 derivatives. So, if I just part those for now and
22 really talk about the real cost that people talk

1 about, which is really around default funds,
2 mutualized costs, and the initial margin cost, I
3 think that's generally what people refer to as
4 costs on this.
5 I see them as to leave us basically.
6 When I'm quantifying risk, the quantum on a risk
7 exposure of either a segregated or a omnibus
8 account or other things on that, as long as we're
9 talking on a gross basis, which to Bob's point
10 earlier, I think we're talking in that realm
11 today. There's different ways you can cut this.
12 The LCH model that we built over 10 years, which,
13 to Ritchie's point currently to give some flavor
14 that's across 14 currencies, is out of 50
15 immaturity. It's $250 trillion worth of
16 notionals, so, it's big size, and it worked during
17 Lehman. The whole underlying premise behind this
18 is defaulter pays. That's the whole underlying
19 premise where we started in 1999 through to today.
20 And how does that work? In the first
21 instance, it means that the bar is relatively high
22 in terms of the initial margin costs because we

1 see the market risk exposure and the anticipated
2 amounts of time and risk that we have to close out
3 during the default event. So, we spend our time
4 modeling and considering what is the closeout's
5 time in this, what is the notional (inaudible) in
6 the market, come and actually get out of these
7 concentrated risk positions? And, on top of that
8 initial margin, we may find that there are
9 positions which are heavily concentrated in a
10 liquid or less liquid maturity. So, we also have
11 market risk multipliers on top of that to factor
12 in this concentration risk. So, the first thing
13 we always do is look at every single individual
14 clearing member and we look at the specific risk
15 and whether we can actually close it out under the
16 assumptions of our margin model. And I think the
17 key point on the margin model is we have a worse
18 case loss. We look at a five-year history, and we
19 take the worst case loss over a given holding
20 period.
21 So, that means in the first instance,
22 that the bar is relatively high for each

1 individual clearing member. It's the same for
2 each, but it's a high number, so, it means the
3 likelihood of going through that initial margin
4 and into the waterfall, be it client funds, member
5 funds, the whole waterfall and LCH's capital is
6 reduced.
7 To give some flavor for that, September
8 15, 2008, we talked about Lehman quite a bit. We
9 closed that out. I was there closing that
10 position out, and that was a $9 trillion position.
11 It was 5 currencies, and it was 66,000 open
12 positions and trades that we had. We closed that
13 position out within the dealer markets.
14 Obviously, it's very dealer-centric in the first
15 instance, but we closed that out, and we wrote it
16 35 to 40 percent of the initial margin held by
17 Lehman. So, what I meant is that none of the
18 losses that were incurred were mutualized in any
19 way or passed on to anybody else within the
20 clearinghouse. So, I guess proven to work by
21 having that high confidence interval in that
22 margin approach is the first thing. And then the

1 other lever is the more mutualized part, which is
2 the default fund. I think there's many ways to
3 coagulate a default fund, but, really, generally,
4 it's the stress, losses, the extreme scenarios,
5 detailed risk that goes over the initial margin,
6 and that's held. Unlike every DCO, like
7 ourselves, we're doing that on a daily basis.
8 We're using historical scenarios and theoretical
9 scenarios to stress that and look at different
10 events that could happen. But what we find in our
11 existing model today is we have a much larger
12 initial margin pool, albeit to a point, to use a
13 phrase we're using here today, segregated because
14 there's no commingling at that initial margin, but
15 we have a smaller default fund because the
16 majority of the risks are covered in the margin
17 rather than mutualized the default fund.
18 So, that's the model. That's just a
19 statement of fact. That's the model we arrived on
20 over the period over the last 10, 11 years for the
21 OTC derivatives side.
22 MR. RADHAKRISHNAN: Let's get the FCMs

1 to describe for us that, right now, you have a
2 particular model, which is the omnibus model, and
3 let's say we were going to move to a model where
4 there is individual client segregation at the
5 clearinghouse level. So, I'd like to know what's
6 involved in that, and what the costs are, what the
7 complexities are.
8 MS. BURKE: Sure, this is Maureen Burke
9 from Bank of America, Merrill Lynch, once again,
10 representing FIA.
11 But we did do quite a bit of work as an
12 industry, and just working with your first
13 proposal here, Ananda, I'm staying focused on
14 that. We did look at what it entailed to --
15 because the industry as a whole is 100 percent
16 sympathetic to protecting customer funds. That's
17 paramount. I mean, the whole structure that's set
18 up is set up to protect customer funds. The
19 safeguards that are in the system that we have set
20 out that have worked are there to protect customer
21 funds, and if we can look to enhance them, we
22 should do that because understood that you're

1 moving into a world where you may not have had to
2 post any margin.
3 So, there's going to be a cost, a
4 posting margin, number one, and if that had been
5 held in third party, you may have felt more
6 protected, but the intent in Dodd-Frank was to
7 reduce systemic risk. So, we did do quite a bit
8 of work, and I have to tell you there were a lot
9 of heads that went down and put pen to paper and
10 did an enormous amount of work when he first came
11 down and met with Bob here in D.C., to look at
12 individual seg.
13 What it does operationally, it
14 exponentially increases the amount of accounts
15 that a clearing firm would carry, as you could
16 guess, because there is multiple accounts that
17 even in a BlackRock relationship, you'd have to
18 segregate down to the underlying account owner in
19 a true individual seg. So, we ran through some
20 numbers, we looked at the amount of accounts that
21 would have to be opened up out on the street. You
22 got to start right from the clearing firm as the

1 beginning part because if you're really trying to
2 protect, you have to start going from the clearing
3 firm, the funds being directed into the clearing
4 firm, and then moving along those funds to the
5 clearinghouse and working with the multiple margin
6 calls that we work with today.
7 We would have to increase our staff by a
8 great level, and that's of course we can do that.
9 We projected out costs on how much it would cost,
10 just wire transfer cost, receive and deliver fees,
11 and in many, many clearing firms, the funds don't
12 come directly into the same account where you're
13 going to send them to for the margin requirement.
14 So, you have the funds coming into a depository
15 account, moving each cash or securities or
16 custodial account, and then they need to get wired
17 out twice a day, today in the futures model, where
18 we get two margin calls that are sent out to the
19 clearinghouse, and, in many instances, we may,
20 where in volatile periods, receive other calls.
21 So, today, we do that in totality, look at our
22 total amount of margin obligations of the customer

1 in-house and meet those margin calls.
2 The multiples, we actually have some
3 numbers here, but it went from, I think, multiples
4 for 1 account, 1 client trading on 3 different
5 exchanges where we would have maybe 10 accounts
6 went to 80 accounts, and you take and you multiply
7 that out to the number of accounts that you
8 actually have for all your individual clients. It
9 makes it operationally burdensome, and concern,
10 are we creating more prone to error operations,
11 prone to error? I mean, we would have to trace
12 back a particular security that is sent from each
13 client and make sure that we're sending it to the
14 exchange that they're clearing on, clearinghouse
15 because the clients come in, they trade on
16 multiple clearinghouses that come into the
17 customer seg pool. You need to direct it to the
18 trade that they're doing on that particular day to
19 know where the underlying trade resides and where
20 can we send this security? Today, we look at it
21 in total because it's a total seg pool.
22 The estimate that we went through, and

1 this isn't a full-blown estimate, for a size of a
2 firm like Bank of America, Merrill Lynch, it would
3 be $75 million to $100 million incremental cost on
4 the yearly basis to open the accounts, receive and
5 deliver fees, the wired transfer fees. We would
6 have to perform daily segregation computations
7 because if you're now going to start with
8 individual seg, you will have to produce a seg
9 computation to ensure that what we have in from a
10 particular client is segregated appropriately.
11 We'd have the clearinghouse who would extend the
12 burden out to the clearinghouse. The staff that
13 they have at the clearinghouse would have to
14 increase because they're either going to have the
15 same requirement. It's not just on our books and
16 records. The clearinghouse is going to have to
17 have a similar multiple of expansion in their
18 staff to support this.
19 We support full customer protection.
20 The question is: What's the cost and where is
21 that cost going to be borne? It's going to have
22 to be borne by the industry as a whole, and we can

1 look at there's three different proposals, Ananda
2 and Bob, that you've put out here is, one, you
3 have the model we have today. We can talk to
4 everything that's there; potentially enhance some
5 of those protections that we have, enhance some of
6 the safeguards from what we would potentially have
7 to put in place.
8 We have the margin grace period today
9 that if a client's in deficit, $1, if their
10 account liquidates to a deficit $1 that we haven't
11 collected, any new trace that they put on that we
12 haven't collected, it's 100 percent charge against
13 capital. They have an initial margin. There's a
14 grace period of four days, and I understand
15 looking at it going into the OTC space, that's
16 going to potentially be looked at. Is that an
17 appropriate grace period for CDS at this stage,
18 and it'd be down to one for initial end, and the
19 deficits, if you don't collect it within one day.
20 But what's paramount is that the initial margins
21 are set appropriately. That's our first line of
22 defense in any structure that we set up, even in

1 an individual seg, if it's structure, if the
2 margins aren't set appropriately, that puts risk
3 into the system, and proper risk management and
4 monitoring of the margin calls.
5 MR. RADHAKRISHNAN: So, you raise a good
6 point because, right now, a clearinghouse issues a
7 call from IM in the customer origin, you just pay,
8 right? The firm pays it. You have no choice, you
9 have to pay it.
10 MS. BURKE: Correct.
11 MR. RADHAKRISHNAN: But, in most cases,
12 it's a pass on, and what it is you get from the
13 customers, but, in some cases, you fund --
14 MS. BURKE: It's our own capital.
15 MR. RADHAKRISHNAN: You fund --
16 MS. BURKE: But we're meeting that.
17 MR. RADHAKRISHNAN: You're funding it,
18 right. Right.
19 MS. BURKE: We're meeting that margin
20 call on trade. We're meeting.
21 MR. RADHAKRISHNAN: Because you may not
22 have collected it from the client.

1 MS. BURKE: Correct.
2 MR. RADHAKRISHNAN: And the Joint Audit
3 Committee always gives you four days to collect
4 it, and otherwise, there's a capital charge. So,
5 if we go to a world where there is individual
6 segregation, it could mean one or two things. It
7 could mean that you have no more grace periods
8 anymore, right? You collect right away from your
9 customer and you pass it on, or you're actually
10 passing on your own money, and it's being called
11 customer money at the clearinghouse. Is that
12 possible?
13 MS. BURKE: That is exactly what is
14 happening.
15 MR. RADHAKRISHNAN: That's what happens
16 now?
17 MS. BURKE: Yes. I mean, that's exactly
18 what we have. We went through a whole flow of the
19 timing and flow of funds. Trade date. There's
20 direct debit authority against our bank accounts.
21 The FCMs have their own capital sitting in
22 segregated bank accounts. There's a prohibition.

1 You have a continual requirement to ensure that
2 you're fully segregated at all times. It's not a
3 look back, and there is not a cure period for
4 this. So, we have to ensure at any point in time
5 when we have a direct debit against our bank
6 account that we were able to cover that, that
7 we're not using one customer's funds to meet
8 another customer's obligations. And all the big
9 FCMs and even smaller FCMs, in order to ensure
10 that that is the case, they have to have some of
11 their firm capital in the segregated bank account,
12 and the next day, this is for the safeguards that
13 are in place, a computation has to be prepared by
14 12:00 p.m. the next day to prove that the amount
15 of your obligations out to all of your clients
16 that they were fully segregated, and if there's
17 any seg deficiencies, a reportable violation that
18 needs to be reported immediately.
19 MR. WASSERMAN: Maureen, I just want to
20 clarify one thing.
21 MS. BURKE: Yes.
22 MR. WASSERMAN: And then maybe keep you

1 on the spot for a few more minutes. What you've
2 been talking about for the past couple of minutes
3 has been the impact of individual segregation.
4 MS. BURKE: Correct.
5 MR. WASSERMAN: So, let's look at the
6 model I was talking about a little bit earlier and
7 the one we had discussed in our previous meeting.
8 MS. BURKE: Sure.
9 MR. WASSERMAN: Clearly, there are some
10 additional duties that would be involved in terms
11 of passing information up to the clearinghouse.
12 MS. BURKE: Yes.
13 MR. WASSERMAN: That kind of model, what
14 sort of additional administrative costs, and I
15 think we're going to be talking after the break
16 about impacts on guarantee funds and the like.
17 But just in terms of the types of costs you were
18 discussing now, the back office costs, if you
19 will, what sort of impact is that?
20 MS. BURKE: That's not nearly as
21 burdensome, as you would know, Bob, and I'm sure
22 anyone else can figure out. But, so, as you're

1 laying out the proposal, it's a reporting of your
2 underlying clients and their positions, and, from
3 there, you can compute their initial margin
4 requirement. So, from the operational burdensome
5 of multiple, open up massive amount of accounts
6 and tracing that all the way through, that that
7 does eliminate that burden. But it still creates
8 a cost, and this, I guess, will be a part of the
9 second session. The open question is: What is
10 that cost, and where would that cost be borne?
11 MR. PRAGER: Don't you have to calculate
12 that anyway?
13 MS. BURKE: Calculate the --
14 MR. PRAGER: To the endpoint, the
15 individual customer exposure anyway?
16 MS. BURKE: We do that. We do that
17 every day. So, that's why we're saying the
18 operational burden to send that over to the
19 clearinghouse gets diminished versus an individual
20 seg that gets diminished. But we can talk about
21 the costs now. I don't know if you're putting
22 that off until the second half, but there will be

1 costs to reduce that mutualization, and what is
2 that cost? That's a critical component that we
3 need to address. What's the cost, and the cost
4 would be borne by the industry.
5 MR. RADHAKRISHNAN: But there's a
6 difference between the firm telling the
7 clearinghouse look, I have 10 customers, here's
8 their individual margin requirement, right?
9 That's one part of it. But that doesn't mean that
10 the firm cannot pay the margin that the DCO calls.
11 MR. PRAGER: Oh, no, no.
12 MR. RADHAKRISHNAN: The firm's got to
13 find the margin call. But I'd like to know what
14 the model is. Is it just a reporting as to what
15 the requirement is, but not and this is how much
16 my customer paid me?
17 MR. WASSERMAN: No.
18 MR. RADHAKRISHNAN: Right.
19 MS. BURKE: And, Ananda, that's the
20 point.
21 MR. RADHAKRISHNAN: Right.
22 MS. BURKE: It's assuming the client

1 paid, made all those payments, and we go through
2 the delays. A big chunk of that will be the FCM's
3 money that's in that number. It's assuming
4 everything is fully paid for. There's time delays
5 on the collection of margin. So, it's at what
6 point in time?
7 MR. PRAGER: But don't you do that
8 anyway?
9 MS. BURKE: We do that anyway, but going
10 back to the last day, and then what the trustee
11 has to go after, and whose funds have been sent
12 off potentially to another clearinghouse or
13 exchange? Did the customer fully pay for those
14 positions at that point in time?
15 MR. RADHAKRISHNAN: Let me make a point.
16 It would be not a good outcome if, in my view,
17 there was this reporting, the firm sent the money
18 up, but it's not your money, it's the firm's
19 money. Something happens, and you walk away with
20 the firm's money. That's not a good outcome
21 because, to me, that's an unjust enrichment on
22 your part.

1 MR. PRAGER: But that can happen today,
2 can't it?
3 MR. RADHAKRISHNAN: I don't see how. An
4 unjust enrichment.
5 MS. TAYLOR: (Off mike.)
6 MR. RADHAKRISHNAN: The seg, yes.
7 MS. TAYLOR: (Off mike.)
8 MR. RADHAKRISHNAN: Right.
9 MS. TAYLOR: I think I agree with what
10 Ritchie's saying. If a firm puts money into seg
11 now and some customer defaults.
12 MR. RADHAKRISHNAN: Right. Right.
13 MS. TAYLOR: That money that the firm
14 has put into seg is part of what is pro rata or
15 distributed to all the clients.
16 MR. RADHAKRISHNAN: To all the clients.
17 So --
18 MS. TAYLOR: So, I mean, it's unjust
19 enrichment of everyone.
20 MR. RADHAKRISHNAN: Potentially --
21 MS. TAYLOR: As opposed to unjust
22 enrichment of --

1 MR. RADHAKRISHNAN: I just wanted to
2 tease that out. (Laughter)
3 MR. WASSERMAN: Just to be clear, the
4 firm is essentially making a loan to the client,
5 and, so, in the insolvency proceeding, either the
6 customer's claim would be reduced because the
7 customer might have a claim that is over and above
8 what was transferred or the customer would
9 potentially owe the trustee money. But the
10 customer doesn't get to keep that. That
11 accounting is ultimately done. Don't count that
12 money yet. (Laughter)
13 MS. TAYLOR: Could I ask a question here
14 because I'm thinking there might be another way to
15 solve the problem? Is the problem that you
16 gentlemen are facing that you want to be able to
17 make sure that you would get your customers' exact
18 assets back, or you're interested in preserving
19 value of the assets?
20 MR. PRAGER: Yes, at least in our case,
21 we acknowledge in my comments earlier that there's
22 this value, and there might be slippage. So, I'm

1 acknowledging there might be slippage in the value
2 so it's not trying to make it so onerous that it's
3 specific. I mean, others might have a different
4 view, but, I mean, there has to be some
5 concessions in looking for the balanced solution
6 here, and we'd run that risk today.
7 MR. THUM: Yes, it's Bill Thum at
8 Vanguard. I think the value is the point, and I
9 think having a more robust way of determining the
10 value and a more controlled way determining the
11 value is going to be the important consideration
12 going forward.
13 And I think in terms of the costs, while
14 we can look at the difference between the existing
15 futures model and this new world that we're
16 talking about in terms of cleared derivatives, we
17 could also look at it in terms of the cost the
18 existing bilateral approach now, where our clients
19 are not only where you have a strong, highly-rated
20 or highly-capitalized client trading with a dealer
21 and getting the benefit in terms of an initial
22 margin levels, but while, at the same time,

1 willing to spend the money in certain
2 circumstances to set up tri-party custody
3 accounts, having to do that with every single
4 dealer on the street with which it trades to
5 protect its client assets.
6 So, these are both assessments being
7 made by dealers at present in terms of what
8 initial margin levels should apply, and they're
9 also costs that clients may elect to pay,
10 sometimes are required to pay in terms of mutual
11 fund clients to protect client assets. So, those
12 costs are built into the existing bilateral model.
13 So, I think when we think about costs, we have to
14 think are we talking about the difference from the
15 futures model, are we talking about the difference
16 from the bilateral derivatives model?
17 MR. RADHAKRISHNAN: I just want to make
18 one point, that I don't think the statute said
19 whatever happens in the bilateral world is going
20 to happen in the cleared world. I think I want to
21 make that clear. I don't think that's what the
22 statute says. I think what the statute says, it

1 provides a clearing mandate because I've been
2 hearing the certain things about well, this is
3 what happens in the bilateral world, and,
4 therefore, we must make sure it happens in the
5 cleared world. I don't think that's the purpose
6 of the statute.
7 MR. KASWELL: It's a fair point, but if
8 I may, I mean, one of the goals, it seems to me,
9 of Dodd-Frank was to encourage move to a
10 centrally-cleared environment.
11 MR. RADHAKRISHNAN: Correct.
12 MR. KASWELL: And, so, if customers feel
13 they're getting a poorer deal in the
14 centrally-cleared environment than they are in the
15 bilateral, they're not going to want to go there,
16 and that seems to me defeats one of the key
17 animating provisions of Dodd-Frank. So, they're
18 different, I agree, but the goals are --
19 MR. RADHAKRISHNAN: I agree, but the
20 question is: What is a good or bad deal? Right,
21 so, I think that's what we're trying to figure
22 out.

1 MS. TAYLOR: The reason I asked about
2 the value issue versus the specific collateral is
3 I wonder if we might be able to solve the customer
4 protection concern that I'm hearing loud and clear
5 with an industry-provided insurance vehicle -- I'm
6 thinking of something that would operate similarly
7 to how a specific coverage operates in the broker
8 dealer industry, where the FCMs would be able to
9 obtain insurance for the return to the clients of
10 the value in their account, even if there's a
11 shortfall in the account at the time of an FCM
12 bankruptcy, and if that type of a vehicle solves
13 the concern that you have, I wouldn't be surprised
14 if that would be overall cheaper for the industry
15 to provide certainly than it would be to provide
16 the individual segregation, and then it might be
17 to provide legal but not operational segregation.
18 MR. EDMONDS: I mean, I think I agree
19 with that, Kim. I guess the question is: Who's
20 going to be covered in that? It's been proposed
21 duty of care for the clearinghouse is just going
22 to increase potentially.

1 Do you disagree with that, Bob? I may
2 have gotten confused on --
3 MR. WASSERMAN: No, I guess my only
4 quibble would be with the term "duty of care."
5 MR. EDMONDS: Okay. Rather the exposure
6 would be changed. That would, I assume, then flow
7 through in terms of how you would approach that
8 exposure. So, in other words, right now, you can
9 look at the entire collateral pool of an FCM's
10 customers and risk manage against that. Now, you
11 would be looking at customers individually, and I
12 presume you would risk manage against that, and I
13 might make assumptions, but those are just
14 assumptions that I'm making as to how you might
15 choose to address that different risk environment,
16 but it's not, in other words, a "duty of care" in
17 the sense that we're going to be going after you
18 for failing to do this or that; it's just you're
19 only going to be able to look at each customer's
20 positions and then in the event of a default, you
21 would then essentially not have as much of that
22 collateral to look at as you do know.

1 MR. WASSERMAN: Right, and I think we'll
2 talk about that in the second session because
3 that's really the balance between IM and guarantee
4 funds. So, we'll save that for later. But to
5 Maureen's point about they send us the report,
6 right? We have that. We sum up the 132 accounts
7 that you used in your example. It comes up to be
8 $100, hypothetically. We know we've collected
9 $100 in omni account. From a clearinghouse
10 perspective, is it your interpretation that that's
11 it, unless there is a default, that we're then
12 after the default, going back, as we would in a
13 post-mortem environment anyway in trying to
14 recreate.
15 Is that as far as it goes, or is it more
16 than that?
17 MR. EDMONDS: Well, it is more than that
18 in the sense that I would expect that you would
19 then be looking at that, and I would expect you'd
20 be risk managing differently. And, so, all those
21 132 customers, small ones you might well ignore,
22 saying oh, that guy's not going to cause a

1 problem, but just as I think many of you do today,
2 you look at the larger customers and look at the
3 exposures at the account level, particularly on
4 OTC. I think so, for somebody who is rather
5 relative to the FCM, I'm guessing you would be
6 looking over their shoulder. But, to be very
7 clear, it would be over their shoulder, it's their
8 responsibility, their work, it's just since it's
9 partially your exposure, I expect you might have
10 some concern that you would then, using your
11 judgment, determine okay, what do we need to do
12 about this, and that would vary by FCM, it would
13 vary by the size of customer, the size of the
14 exposure. You would be using your judgment in
15 supervising the firm's duty. And getting back to
16 the point we had earlier, who's going to be doing
17 all of the AML and such? Just like today, it's
18 the firm. Who's going to be doing the money going
19 back and forth? Just like today, it's the firm.
20 It's just like today where if you see one of your
21 firms doing things that make you wonder, there's a
22 particular customer, a particular large exposure,

1 there's a call made, hey, what's going with
2 so-and-so? I guess I'm anticipating there might
3 be a couple more of those calls.
4 MS. SCHNABEL: Okay, so, just to clarify
5 what Bob was saying, I think the cost of the more
6 calls or other action associated with risk
7 managing on individual customer level may not be
8 costs that are attributable directly to individual
9 segregation, and the effect of bankruptcy
10 protection on the individual customer level. So,
11 what I'm thinking is the cost of risk managing is
12 actually going to be under the risk management
13 core principle cost, whereas, for us, I think we
14 need to really focus on what the cost is of
15 individual segregation.
16 And, to that effect, I have a question
17 for Maureen, which I was just trying to clarify
18 the exchange between you and Ritchie because I'm
19 still a little bit confused as to where the
20 increase in cost would be with respect to the
21 individual customer protection model because it
22 had seemed to me, and maybe I mischaracterized the

1 exchange, so, let me know, that whatever you said
2 you had to do under the individual customer
3 protection model you already do. So, where is the
4 increase in cost, I guess?
5 MS. BURKE: We have to go back. You
6 spoke about two different models. The first
7 discussion was full individual seg. Are we
8 referring to that?
9 MS. SCHNABEL: We are not. We're
10 referring to --
11 MS. BURKE: The positional.
12 MS. SCHNABEL: We're referring to --
13 MS. BURKE: The reporting requirement.
14 MS. SCHNABEL: No, we're referring to
15 the legally segregated, operationally omnibus.
16 So, it seems to me from an operational perspective
17 if it's still omnibus, where is the extra cost?
18 MS. BURKE: The cost is going to come
19 from the clearinghouse, and I think we have to
20 stop here or go right into this now because that's
21 what we need. We need to know what the cost is
22 from the clearinghouse because that's the starting

1 point. What's the initial margin requirement?
2 What's the initial margin requirement going to be,
3 what's the guaranteed fund requirement going to be
4 if you eliminate that mutualization in the
5 waterfall?
6 MR. WASSERMAN: And, so, to be clear,
7 our entire second part of this is going to be
8 devoted to just those questions. Any other issues
9 though on the more operational end or --
10 MR. PRAGER: Just one comment on the
11 operational end, and, Maureen, I mean, your
12 numbers of the escalating accounts, from our
13 perspective, where we sit, we have to manage all
14 those accounts anyway. I mean, so, that's, again,
15 and we did say or at least I said earlier, we're
16 very sympathetic to any sort of operational burden
17 of maintaining them, but, to be clear, from our
18 side, we have to make those money transfers daily.
19 So, at BlackRock, we have thousands of accounts in
20 fixed income, nearly 3,000 overall; in north of --
21 5,000 accounts. We have to maintain those daily.
22 We make cash payments daily. We reconcile daily.

1 So, I mean, we understand that, we get all of
2 that, and, so, we understand that mushrooms in the
3 backend, but for an organization like yours, last
4 time I read the end report, you had some 50
5 million individual accounts in the retail level.
6 I mean, there is mechanisms to manage scale out
7 there. When we manage scale, that's what we do.
8 The wire transfers and things like that,
9 I totally appreciate that. We're very sympathetic
10 to that point of mushrooming in the very
11 individual, the physically segregated.
12 MS. BURKE: Well, I mean, we manage all
13 of the segregation coming into our firm and ensure
14 that the customers' funds are protected, that
15 they're segregated. We look at the obligations,
16 we issue out the margin calls every day, have a
17 robust system for looking at credit, reviewing the
18 credit from our clients. It is in the latter part
19 of that, the wire transfers. That's where the big
20 chunk of the cost came into play. A very large --
21 looking at securities that come in from an
22 individual client, $1 million U.S. Treasury Bill,

1 and they have $1 million margin requirement.
2 Taking that $1 million U.S. Treasury Bill and
3 having that sent to the Fed wire system. Today
4 it's in $50 million. So, we send in increments by
5 CUSIP $50 million increments, and we look at it in
6 total.
7 The largest part of the cost is the
8 second one. We have staff on hand. We reconcile
9 every account today. That's part of the
10 responsibility on your seg computation. You can't
11 just produce a seg, you have to prove that what
12 you're producing you reconcile to the external
13 statements. So, it's those multiple of the
14 accounts and the increase in the reconciliations,
15 and then the follow-up is an out of balance, and
16 we're going to have to get massive amount of
17 information from the clearinghouse. The
18 clearinghouse is going to duplicate everything we
19 will have to do, as well, because you want to make
20 sure it's fully segregated.
21 MR. PRAGER: That's if it's fully
22 segregated, not the sort of model --

1 MS. BURKE: Correct, on that seg.
2 MR. PRAGER: The legally segregated
3 operation --
4 MS. BURKE: On a legally segregated,
5 that's a different discussion.
6 MS. SCHNABEL: Okay, so, just to I guess
7 sum up, and I know that Bob will have some other
8 summing up points, on operational costs, it seems
9 to there's agreement that with respect to the
10 actual legally separated and operationally
11 segregated, that there might be an increase in
12 cost because of various wire transfers and other,
13 I guess, mechanical issues that would have to be
14 multiplied across accounts was in the legally
15 segregated, operationally still omnibus. It seems
16 as if most of the cost would be in changes in risk
17 management at the clearinghouse, and, therefore,
18 there would not be necessarily operational costs,
19 at least from the FCM level.
20 MR. ROSEN: Well, I'll say that we can
21 come back to this at a later time when we get to
22 them. But I think there are non-account

1 operational costs that either of those models
2 produce that I think we need to discuss at the
3 appropriate time.
4 MS. TAYLOR: And, also, depending on how
5 this is implemented and depending on if it's every
6 single account, if it's people who can opt out.
7 Very likely, there would be an increase in the
8 operational interaction and the cost of that
9 between the clearing members and the
10 clearinghouses because, right now, one of the
11 benefits you get from cleared environments is you
12 take 1 million payments, and you net them down to
13 one. And we do that every day. We net down all
14 the payments that the clearing member owes us
15 across all their customer to be one net payer
16 collect, and we do the same thing for their house
17 account.
18 So, they pay us twice a day, but they
19 only pass us two payments or we pay them two
20 payments. And, depending on how this need for the
21 legal segregation ends up working, at the very
22 least, we need to be able to do that at the

1 individual segregated account level because if one
2 of those customers doesn't pay us, if we don't get
3 paid because of one of those customers, we can't
4 have netted everything out, and I think there will
5 be individual payments on a per segregated account
6 basis that would be likely to occur between the
7 clearinghouse and the clearing members.
8 MR. WASSERMAN: Just to be clear, and
9 then I'm going to break, and then we can come back
10 to this.
11 MS. TAYLOR: They may hit the same
12 account, but they would be different payments.
13 MR. WASSERMAN: Yes. The intention here
14 is every day, other than the day of a default,
15 it's going to be the same net approach as it's
16 done today, it's just you'll be getting
17 information that would break that done.
18 Now, on the day of the default, things
19 will get very interesting indeed, and very costly
20 indeed, but that's inherent in a default. But
21 every other day, the only difference that you're
22 going to see is you're going to be getting

1 additional information. You're going to then want
2 to use that information, but from a money, asset,
3 and collateral movement, just the same as it
4 happens today.
5 MR. SWANN: Bob, it's Paul Swann again.
6 If I could just interact and ask a question about
7 what you've just said. If that's the case,
8 presuming the day after, insolvency occurs, there
9 are outstanding payments due from some of the
10 customers, just in the ordinary reevaluation of
11 open contracts from customers, and those payments,
12 therefore, are not going to be satisfied because
13 they're not going to be met as an omnibus payment
14 from the now insolvent FCM. What would the
15 expectation be in relation to the CCP's activities
16 in relation to those clients which are now
17 deficient and under-collateralized?
18 MR. WASSERMAN: Essentially, you have
19 the collateral that they have posted. At that
20 point --
21 MR. SWANN: And the collateral is
22 deficient. It's now actually --

1 MR. WASSERMAN: I'm sorry --
2 MS. TAYLOR: (Off mike) to market.
3 MR. WASSERMAN: Right, and that point,
4 you would have the choice of you could liquidate
5 and then basically return the collateral, you
6 could, if you so choose, get the collateral
7 directly from the customer. If the deficiencies
8 were sufficiently small, you might be able to
9 transfer. Ultimately, in other words, you would
10 not be giving back all of their collateral if
11 their positions had lost. If they had a variation
12 pay, you would be deducting that variation pay
13 from their collateral in determining what each of
14 those customers is entitled to.
15 MR. SWANN: The point I'm raising, the
16 question was really to draw out --
17 MS. TAYLOR: Then they're under
18 margined.
19 MR. SWANN: Hearing the complexity that
20 particular environment adds to the immediate post
21 insolvency actions of a central counterparty.
22 MR. WASSERMAN: And, in fairness, today,

1 if you have an FCM who defaults because of a
2 customer, you're going to have essentially all
3 that collateral and all those customer positions,
4 and, again, you're going to have to make the
5 choice do you want to liquidate it? Do you want
6 to manage it? What do you want to do? It becomes
7 more ramified such that you're looking at each
8 customer individually, and that will, I have to
9 concede, increase complexity, but, today, if one
10 of your members defaults their customer account,
11 one option available to you is to just liquidate
12 that whole customer account and return what's
13 left. Ultimately, while there would be more
14 accounting, that same option would be available to
15 you under this proposal.
16 MS. TAYLOR: I don't disagree that
17 that's an option. I don't disagree that it would
18 be an option under the new proposal regime. The
19 problem that I have with not considering the
20 implications of calculating pay and collect
21 information and keeping track of on behalf of
22 which customers we got paid and on behalf of which

1 customers we didn't get paid is that I interpret
2 customer protection to encompass more than just
3 protecting the collateral assets that we have to
4 be holding. I interpret customer protection to
5 include protecting and safeguarding the customer's
6 positions and their access to the market, and both
7 of those things will also be threatened in the
8 case of a clearing member default, and the best
9 way to be in a position to ensure that the
10 customers' positions and their access to the
11 market is preserved is to be aware of which
12 customers had a problem and which customers didn't
13 so that the ones who didn't have a problem can
14 move to their secondary clearing member
15 immediately. So, if everything has been netted
16 down and the clearing member failed to the
17 clearinghouse in one omnibus pay and collect, that
18 is going to delay the time at which the good
19 customers can transfer to their second home, and I
20 think that is a big part of what the customers
21 want, is better portability in a bankruptcy.
22 MS. SCHNABEL: Dan? Sorry.

1 MR. WASSERMAN: And to be very clear, as
2 I'm writing the regulation, I think it would be a
3 requirement for the FCM to make pays on behalf of
4 those customers other than the defaulting
5 customer. I must tell you, as I am writing that,
6 I'm somewhat chuckling to myself because I fear
7 that this is a regulation -- I hope it would be
8 followed, but I don't expect it will because I
9 think the reality is in any kind of a default
10 situation, the likely outcome is there isn't going
11 to be any payment. And look what happened, and
12 people are going to look at what happened to Tex
13 Griffin and the litigation that's going on even
14 now and say well, gosh, I'm not going to do
15 anything, I'm not making any payments. I'll just
16 let the trustee take care of that. Again, that's
17 true today, it's true under this regulation. That
18 is a reality. I mean, we can try, and I will, but
19 I recognize that it's a try.
20 MR. ROSEN: But, Bob, you have to go
21 back to the point that Ananda was making in the
22 exchange with Maureen earlier, which is that, in

1 reality, what happens is that the FCMs put up
2 their own money, and they have to put up their own
3 money if they're going to avoid the position being
4 blown out for being under-margined. If Kim is
5 going to be able to figure out what accounts are
6 going to get transferred, and transferees want to
7 know that they're getting an account that is, in
8 fact, margined properly and not topped up with
9 funds that they're entitled to, it's going to
10 delay that process. And Kim is going to probably
11 have to get the information from Maureen.
12 MR. WASSERMAN: 764(b), privileges a
13 transfer that's approved, what Maureen has done is
14 loaned Ritchie some money, and that money is what
15 Kim's holding on to. Kim doesn't know and will
16 not be, cannot be held responsible for knowing
17 whether that money was of Ritchie, of his own, or
18 whether Maureen lent it to them.
19 MR. ROSEN: Right. Yes, but the person
20 who cares about it is not Maureen. The person who
21 cares about it is the person that might be taking
22 the account.

1 MR. WASSERMAN: And under 764(b),
2 there's no claw back, and, so, what will happen is
3 assume for the moment that Kim does find a willing
4 transferee. And let us assume, I mean, for
5 instance, one possibility is there was no default
6 at CME, there was a default at ICE, and, so, let's
7 say, in fact, Kim has all the money. She can
8 transfer, 764(b) protects the transferee from a
9 claw back. Now, at that point, Edith, who's
10 Maureen's trustee, is going to be reducing
11 Richard's claim, and, indeed, may even going to
12 Richard and saying excuse me, actually, you owe
13 me, and please pay it rather quickly. But,
14 essentially, Kim doesn't know any of this. It
15 would be operationally very difficult to make her
16 know any of it, and, therefore, she's looking at
17 it as I have an account that says Mr. Prager on
18 it, and it's fully margined, and I don't know
19 where he got the money, but I don't care.
20 MS. SCHNABEL: Dan, did you want to say
21 something?
22 MS. BURKE: Just one more point on that.

1 So, it's a matter of the timing of the margin
2 calls, and we have that doc, Bob, of issuance of
3 margin calls, and we see the end of the margin
4 calls, and it's not just the firm capital, there's
5 other clients' money that potentially could be
6 moved out, and then the trustee would have to go
7 back and claim back those monies. The trustee
8 would have to claim back the monies. So, we have
9 a continual seg requirement. You know that, so,
10 you don't use clients' margins to offset another
11 client in the debt for the deficits. It's a
12 continual seg, but it's a matter of the tracing,
13 and that's what happens in a bankruptcy, the full
14 tracing.
15 MR. WASSERMAN: Shall we keep it going
16 or shall we take a timeout?
17 MS. SCHNABEL: Can I just say one thing
18 before we take a timeout, and this will be very
19 fast. I think that the exchange between Kim and
20 Bob and Maureen illustrates something. I mean, I
21 think that if we go with the proposal that Bob had
22 been thinking about, which was to keep omnibus

1 segregation relatively the same operationally, at
2 least I haven't heard a reason for there to be an
3 increased cost other than at the clearinghouse.
4 Now, I think what Kim was saying is
5 there may be to effect individual customer
6 protection to the, I guess, best manner, we may
7 need to change omnibus segregation to all, I
8 guess, greater granular detail with respect to
9 pays and collects, and I think that in terms of
10 that discussion, I think we'd need to acknowledge
11 that there are benefits because what Kim was
12 saying was the flip side of the coin is that is
13 actually going to help protect customers better,
14 as well as costs, which would be of increased
15 operational costs.
16 So, that's it. We're on break.
17 MR. ROSEN: Just what I was trying to
18 crystallize was until Maureen explains to Kim who
19 didn't fund the money, you don't know who's
20 defaulted. If it is the defaulted account that
21 goes to a transferee, I'm sorry, but either the
22 transferee or Maureen has to lose. One or the

1 other one. There's no way that everybody is
2 protected in that scenario. And, so, I'm thinking
3 that the portability will be affected by the need
4 to figure out where the default actually occurred,
5 who didn't fund because, as far as Kim is
6 concerned, she's got an account that was funded by
7 the generosity of Maureen.
8 MR. WASSERMAN: And there is, I think,
9 two possibilities. I think one possibility is
10 when Kim looks at her accounts she sees okay, this
11 one lost $50,000, this one lost this. This one
12 lost $20 million, and the original margin was $1.
13 That's probably it. And, in any event, of course,
14 to that extent, she doesn't need to know who was
15 the defaulter because all she's transferring is
16 what that account is entitled to after the
17 deduction of losses on the positions that she
18 knows about. Now, it's possible that, in fact,
19 all of this happened as a result of day trading,
20 in which event, at that point, Kim is probably not
21 going to be doing a transfer because she's going
22 to have to wonder wait, how did all this loss

1 happen, and, yet, I haven't seen it in this? I
2 mean, ultimately, the information is there, and
3 ultimately, I am giving Kim the choices to act in
4 a way that will protect the clearinghouse.
5 Remember, transfer is optional.
6 MS. TAYLOR: But the transfer is the
7 whole point.
8 MR. ROSEN: The only point is that it
9 does slow down the process of transfer a little
10 bit. That's all.
11 MR. WASSERMAN: It is a very important
12 issue. There are restrooms down the escalators
13 and to your left. It is 2:46. Could we try and
14 come back around a couple of minutes of 3:00 so we
15 can discuss very importantly the next issue?
16 MR. SWANN: Bob, just for those on the
17 phone, do we stay on the phone or should we detach
18 and rejoin?
19 MR. WASSERMAN: Please do. We'll be
20 back in about 15 minutes.
21 (Recess)
22 MR. WASSERMAN: Ladies and gentlemen,

1 could we all take our seats? I know some folks
2 have planes, so, we really need to get back to
3 this. I intended to devote the second, now third
4 of the meeting, to what I've been calling the risk
5 cost. Before I do, is there any last details that
6 we need to cover in a minute or two on the other
7 issues?
8 Edith? I'm sorry.
9 MS. O'BRIEN: That's okay. Thank you,
10 all, for participating today. I think that a
11 number of individuals from this table don't have
12 the benefit of the extensive experience of the FCM
13 structure, and I've heard two hours of dialogue
14 about seg customer movements between the
15 clearinghouses and the exchanges, and as the
16 conversations continued, it appears that this is
17 extraordinarily myopic view of the current
18 safeguard structure that operates in America and
19 has effectively worked to the best of my knowledge
20 for years. This safeguard structure in this
21 financial framework is not just about customer seg
22 money moving from FCMs to exchanges, it is based

1 on layers of partners and components across
2 banking institutions who are approved to be
3 exchange settlement banks, exchanges approved
4 participating FCMs. FCMs do credit reviews of
5 clients. It's layered. Everybody has a role,
6 some of the roles cross over. There's segregation
7 rules, there's segregation calculation. There's
8 now capital rules. There's now capital
9 calculations. There's rule of 15(c)(3) about what
10 can be done of the firm while FCMs are holding
11 them.
12 So, as we continue the conversation this
13 afternoon, I want everyone to consider the fact
14 that there's a greater framework at hand here, one
15 that has actually worked extremely well.
16 One of the comments that I've heard over
17 the last couple of weeks is how do we prevent a
18 Lehman from happening here? We did. Lehman
19 happened in the U.K.; it did not happen in
20 America.
21 So, I think that Bob does want to
22 explore the risk components this afternoon, and I

1 want everyone to consider what the wider framework
2 that does effectively work at this time, always
3 looking at ways to enhance this to protect
4 customer funds. There's no question about that.
5 But an enhancement is different than the entire
6 change to an infrastructure.
7 MR. WASSERMAN: I would just make one
8 note in response. Certainly, Lehman was an
9 example of how well things worked in the future
10 seg world, and I am very gratified, one might even
11 say personally gratified at how that happened such
12 that futures customers, I think, things worked
13 well with barely a hiccup. But understand that
14 Lehman was an issue outside of the customer
15 account. This was not due to a fellow customer,
16 this was due to a problem essentially on the prop
17 level and at the parent level. What we're dealing
18 with here is what happens if there is a problem at
19 the customer level, and while that has been
20 happily very rare in the future space, and very
21 happily so, and that's in large part due to the
22 excellent work that's done by a lot of people over

1 here both at the clearinghouse and at the firms,
2 we're bringing in a new environment here on the
3 OTC, where it would be, I feel, a little bit
4 premature to assume just how well things are going
5 to work. Obviously, we hope that we are
6 developing a system where things will work as
7 well, but there's some different risks that we're
8 going to be confronting, and, so, there's some
9 different issues out there.
10 With that, I think it's important to
11 talk about what the costs are on the risk level
12 because this absolutely changes the risk
13 environment. Today, clearinghouse can look at the
14 entire omnibus account at an FCM, and that's
15 essentially in addition to, obviously, the
16 resources of the FCM, their capital that they are
17 supposed to use to meet the obligations; their
18 default fund contribution, their memberships,
19 their proprietary account, all of that.
20 Essentially, the next level under the present
21 system is the collateral of the fellow customers,
22 and I sort of envision that as somewhat of a

1 shield. It is only under the present futures
2 approach after that shield is consumed that one
3 then goes to the clearinghouses, capital
4 contribution, and the rest of the default fund.
5 Take away that shield, and you're changing the
6 cost calculations. Clearinghouses, I think, can
7 address that a number of ways, and one has to
8 expect that they will address it in some way.
9 They could increase collateral for everyone. They
10 could, indeed, to a certain extent, will be
11 required to because of the financial resources
12 rules. The default resources are going to have to
13 be essentially the same in the sense that they
14 would have to account for that shield, and, so,
15 I'd like folks to talk a little bit about how
16 those costs might be calculated, and since mention
17 has been made of doing this voluntarily, how would
18 those costs be different under a voluntary system
19 versus a mandatory system?
20 MR. PRAGER: Bob, if I could go back to
21 the conversation before the question I'd asked
22 Dan. So, in life, you're careful what you wish

1 for. So, as we ask for a segregation and we look
2 at it, we have to consider the added costs, and we
3 have been looking at that, as well. And then if
4 you look at the DDD models that are out there,
5 where, admittedly, they're not FCM models, but to
6 the OTC models where they have done the
7 calculation, and I guess with Dan and Chris, you
8 guys have done it. It's slightly different in
9 terms of proportion of initial margin versus size
10 of the fund. You've done the calculation. So, we
11 know it works, we know that it's a clearing price,
12 so to speak, from today's functioning market where
13 most of the volumes rise.
14 I think the other thing you have to look
15 at is what other consequences or incentives are
16 created by, perhaps, this movement of larger
17 initial margin? I think, Kim, when we got
18 together before, you were very good about sort of
19 articulating the good of the system versus the
20 good of the individual, and we're tilting that
21 balance and suggesting that. So, how do we
22 compensate for that? And the logical one is you

1 think about how much does your initial margin have
2 to go up to compensate some of that, as well as
3 what is the assessment of the backend? But as you
4 think about if you had a system where, again, we
5 look to where there is an existing system, that
6 the market functions well, it's deep in liquid
7 among the dealers. It also creates an incentive
8 to keep very tidy books because, as you build
9 notionals and every time you're paying initial
10 margin, you now have an incentive to net down and
11 to build other tools, such as compression tools
12 and things like that are also good for the system
13 because you're taking notionals down. So, you
14 need to think of not just the cost of that per
15 transaction trade, but what are the other
16 incentives you're creating to keep a
17 well-functioning market and keep risks down?
18 So, I know at least from our perspective
19 at BlackRock, our swaps desk is incredibly
20 disciplined about taking notionals down,
21 constantly netting them down and working with the
22 dealing partners because of the mitigation and the

1 operational risk and the return of initial margin.
2 So, I think you can't just ask the question in
3 isolation of what is the cost, but what are the
4 other benefits actually you're creating by,
5 perhaps, making some positive incentives in the
6 system to bring down risk and notionals?
7 MR. EDMONDS: Maybe I'll take a stab at
8 least establishing a baseline of numbers we can
9 talk about, and since you've been asking that for
10 most of the day, Bob, on that front. And we'll
11 make a couple of assumptions, and this won't be
12 asset-specific, it won't be
13 clearinghouse-specific. These are just general
14 equations to think about.
15 Let's just start with the first
16 assumption, the product or characteristics of the
17 product has a normal distribution. If it doesn't
18 have a normal distribution, it likely means it's
19 going to be a higher price, but let's at least
20 start with that baseline.
21 Lots of clearinghouses talk about
22 confidence intervals, the 99 percent level, and

1 this is typically the model used when we think
2 about the mutualization or the shield that Bob is
3 making reference to when he walks through his
4 waterfall. So, at the 99 percent confidence
5 level, that equates to like 2.33 standard
6 deviations as a mathematical equation. And let's
7 assume that we're going to shift the balance to
8 Ritchie's point about his conversation with Kim
9 more from this mutualized pool down to more the
10 initial margin and less in the mutualization pool.
11 So, let's take it from a 99 percent confidence
12 level to a 99.99 percent confidence level, again,
13 assuming a normal distribution of this.
14 That equates to a 3.8 standard
15 deviations. So, if we take the difference between
16 those two, if we divide 3.8 by 2.33, to effect the
17 cost or at least give us a benchmark of what the
18 cost might look like in shifting that balance
19 between the mutualization pool, you end up, again,
20 simple expression of the normal distribution, of
21 163 percent increase.
22 To get you to the same number, Bob, that

1 you wanted, you got to have the same number of
2 funds as a place to start, and then we can start
3 tearing up are there -- I don't know that this is
4 the right forum with 43 minutes left in the day or
5 whatever that you have, but then we can start
6 talking about the different asset classes and
7 things of that nature, and how that may be
8 impacted differently. But if you were to shift,
9 you still have some tail risk. We still have a
10 need for guarantee funds. We still have the
11 guarantee fund contributions. There's going to be
12 some return on capital from clearing members who
13 are putting that up, but and maybe that's not the
14 right balance, but it's at least a place to start.
15 MR. WASSERMAN: Couple of observations.
16 First is, assuming this rule were to be passed,
17 I'm assuming you folks will react to it in the
18 most cost-effective manner that you guys can think
19 of. Now --
20 MS. TAYLOR: That would be in our best
21 interests.
22 MR. WASSERMAN: Yes. That may be by

1 shifting from one balance of collateral and
2 guarantee fund to another, which is what you're
3 mentioning here, and, so, under that approach, you
4 would be increasing the margin levels by 63
5 percent, you would presumably be reducing --
6 MS. TAYLOR: One hundred sixty-three.
7 SPEAKER: One hundred sixty-three.
8 MS. TAYLOR: One hundred sixty-three.
9 SPEAKER: One hundred sixty-three.
10 SPEAKER: Is that --
11 MR. WASSERMAN: You said 3.8 sigma
12 versus 2.3 sigma?
13 MR. EDMONDS: Yes, divided by.
14 MR. WASSERMAN: Yes, you'd be
15 multiplying it by 163, which is an increase of 63.
16 MR. EDMONDS: Over zero or over --
17 MR. WASSERMAN: Well, right now, you
18 charge 2.3.
19 MR. EDMONDS: Charge one.
20 MR. WASSERMAN: You'd be going up
21 another 1.5 to 3.8.
22 MR. RADHAKRISHNAN: It's not doubling.

1 MR. WASSERMAN: Yes, it's not doubling.
2 MR. EDMONDS: It's not doubling.
3 MR. WASSERMAN: Okay. You would
4 presumably then be able to reduce the guarantee
5 fund because, essentially, there would be that
6 much less loss, but regardless, that might be the
7 better way for you to do it. There are other
8 ways. You might choose to instead increase your
9 guarantee fund to deal with this potential loss.
10 And, in other words, rather than increasing it
11 from 2.3, just simply say when I do my calculation
12 of my guarantee fund, right now, I can use the
13 entire customer collateral, now, it would only be
14 on a customer-by-customer basis.
15 So, in other words, for each loss, there
16 would be a customer involved. That customer would
17 have some collateral both in those positions and
18 in other positions. You would be doing that in
19 the guarantee fund for one or two or three
20 members, however you do your guarantee fund
21 calculation, assuming you follow our proposal,
22 let's say the first SIDCOs, it would be, say, the

1 top three. So, you would find the top three, but
2 then socialize that calculation across all of your
3 clearing members. That might come up with a
4 different number and it might be a lesser number.
5 You might do some combination of the two. I guess
6 what I'm saying is, the difficult thing here, and
7 I will confess, I'm not sure what the right answer
8 is, I'm not sure even how to find the right
9 answer, is I'm assuming that you're going to be
10 looking at all the possibilities and picking out
11 the best parts of each and picking out the most
12 cost effective parts in each, and I'm just not
13 sure sitting here, and maybe you are, that the
14 best way to do this is to go the 99.99.
15 MR. EDMONDS: And we have to start
16 somewhere. And the conversation we've had today
17 is where do you start to walk down that exercise
18 to determine what the menu of opportunities would
19 be? And at the end of the day, I would ask you
20 this question: The assumption is we're not going
21 to have less money as clearinghouses available to
22 us to cure defaults. That it's got to be at least

1 what we have today in some form or fashion in
2 different buckets, organized in a different
3 fashion. True?
4 MR. WASSERMAN: I think mostly yes. I
5 think the calculation changes. In other words,
6 the methodology you would use would be similar
7 today, taking into account the different risk
8 environment. And, so, part of it depends upon how
9 much business you're going to do, part of it
10 depends upon the risk environment based on how
11 much of the collateral you can use.
12 MS. BURKE: But, Bob, if you are trying
13 to reduce systemic risk, which that's the whole
14 intent here, and, Ritchie, going back to your
15 point, knowing there's a cost, right? We all know
16 there's going to be a cost. So, the initial
17 margin, that's our first line of defense. That's
18 our first line of defense in the financial
19 safeguards that are established, and to know that
20 you're assessing your clients, we don't set the
21 initial margin. We're -- there's too faulty. The
22 clearinghouse looks at the risks, looks at the

1 positions, looks to the volatility, and makes
2 decisions on the initial margin. The clearing
3 firms then step in and say okay, I have my client
4 base. I now need to go and review my client base
5 and say do I need to impose more than what the
6 clearinghouse imposes for initial margin based
7 upon the risk profile of our clients and after we
8 go through our credit and risk review. But to say
9 that it shouldn't go into the initial margin, I'm
10 not understanding because if a client is bringing
11 more risk into the system, a particular client is
12 brining more risk into the system, shouldn't we be
13 charging them for that risk and making sure they
14 have the capital and the resources and the
15 wherewithal to actually meet that margin
16 obligation?
17 MR. WASSERMAN: Heavens yes. No,
18 please, right now, if there's a client, you're
19 charging 99.99 percent confidence interval for the
20 collateral, please continue doing that. The
21 question is what I thought I understood Chris to
22 be saying is, well, the way we would address this

1 or the way we're going to cost this is we're going
2 to assume we're going to apply to every client
3 collateral at the 99, that we're going to require
4 essentially margin at a 99.99 percent. That way,
5 we'll have much less in the way of risk over and
6 above client collateral. Is that --
7 MR. EDMONDS: Well, what I attempted to
8 articulate, and apologies, Bob, if I
9 mis-communicated this with you, but I said if we
10 start with the idea that the 99 percent confidence
11 interval is typically what's associated with where
12 the waterfall you went through and accurately
13 described as this shield of customer funds to
14 begin with. Your charge to us was what does it
15 look like if you take that out and begin to shift
16 the balance other places? In order to shift the
17 balance to the others, one idea, to walk through
18 the map that we did, was to go straight to the
19 99.99, and that's just at the clearinghouse level.
20 That doesn't bring into the fact what Maureen
21 said, it is perfectly capable for any of the
22 clearing members or the clearinghouses or their

1 customers to charge more than the clearinghouse
2 minimums. Don't think that you're going to change
3 that. I don't think that's on the table in the
4 conversation. So, it's just about establishing a
5 baseline in the conversation that if you wanted to
6 shift that balance, these are the numbers you're
7 going to end up with.
8 MS. TAYLOR: And our numbers, magnitude
9 wise, would be very similar to what Chris is
10 saying if what the decision was let's make it all
11 up based on margin. Just I mean --
12 MR. WASSERMAN: Let me ask one
13 additional question. One of the other things that
14 has been on the table occasionally is do this on a
15 voluntary basis. So, some of these folks have
16 said you know what, yes, that would be us. We'd
17 want to do that. What would happen to your
18 guarantee fund calculation? I'm assuming for the
19 moment that you're going to permit them to do
20 that. I think that's at least a possibility.
21 MR. EDMONDS: We typically don't well
22 telling customers they can't do something.

1 MR. WASSERMAN: Right.

2 MR. EDMONDS: Long-term basis.

3 MR. WASSERMAN: So, let's say you do
4 that. Because here's where I'm coming from on
5 that score. I know this shield of fellow customer
6 collateral is important to the guarantee fund
7 calculation, and I was coming at it actually from
8 the opposite point. Let's say you don't do it
9 through increased margin, you do it through
10 increased guarantee fund. Now, let me tell you
11 what I was seeing, and I could be entirely wrong.
12 So, if we let those folks here who would want to
13 pay for that, they're many of the largest folks,
14 and, so, if they start walking off, it seems to me
15 that panels of that shield are walking off with
16 them. And the amount of that shield, that fellow
17 customer collateral shield that's available to
18 reduce what hits the waterfall is walking off with
19 them. And it seems to me the very folks who are
20 going to want to walk off, they're folks with very
21 small accounts that might not be worth it. Folks
22 with very large accounts, very large exposures,

1 big pension funds, they're the ones who are going
2 to want to do this, and that seems to me to be
3 taking out a large part of your shield which
4 means, from where I'm sitting, most of the cost of
5 the guarantee fund that you'd be incurring if you
6 took the shield out entirely, you'd still be
7 incurring if you did it on a voluntary basis.
8 MS. TAYLOR: That might be true because
9 the way that I've looked at this situation is that
10 the customers how are most likely to value this
11 benefit are going to be customers who are very
12 large, and potentially, customers who are
13 primarily fiduciary in their role as opposed to
14 customers who are risk takers in their role, even
15 if they might be large. So, depending on the risk
16 profile, every number that we give you is just a
17 hypothetical number that we have modeled based on
18 certain assumptions that we've made that could be
19 very different in real life because it all depends
20 on the risk profile of the worst case loss that we
21 would suffer. So, we have to look at the
22 potential size and make up and distribution of the

1 customer activity and determine whether or not
2 that drives the worst case loss that the
3 clearinghouse would face. If it doesn't, then
4 there wouldn't be a need to change the waterfall
5 at all, but I think the assumption is that by
6 nature of splitting out the certain exposures from
7 a pool, by definition, you're creating increased
8 risk because you're removing part of the asset.
9 Right now, if a clearing member owed us
10 money, we have already netted that we're not going
11 to pay them any winnings if they have a residual
12 loss. And, in this model that you're describing,
13 I think we would be obligated to pay the
14 individual customers who are making money would
15 get their payments, and the individual customers
16 who are not making money, that we potentially
17 would not be paid for those. So, it's a change in
18 the pooling nature of the risk profile that the
19 clearinghouse faces, and, so, every piece of that,
20 everything you un-pool increases the risk that
21 you're going to lose your netting benefit.
22 A clearinghouse is designed to be a bulk

1 service, and it is designed to do two things, the
2 two things Ritchie mentioned and we've talk about
3 before, customer protection, a very important
4 part, a very important element of what a
5 clearinghouse does, but systemic risk protection
6 is the other very important element of what a
7 clearinghouse does. And the way that a
8 clearinghouse does that is, to a large extent,
9 affected by this ability to pool. So, as we lose
10 the ability to pool, there will be either a
11 corresponding increase in the margins that are
12 paid by the people who are not pooled, or there
13 will be a corresponding increase in the guarantee
14 fund contributions that are put in place by the
15 clearing members who contribute to the guarantee
16 or there will be some other element, concentration
17 margin, some other elements will come into play,
18 but there will be not insignificant increase in
19 the amount of resources that the clearinghouse
20 will need.
21 If you did it completely with margin,
22 we've estimated numbers that are not dissimilar to

1 the numbers that Chris talked about, between 50
2 and 100 percent, depending on what kind of
3 assumptions you want to make about the
4 distribution of what the positions look like. And
5 if you did it completely with guarantee fund,
6 under some situations, we thought about how many
7 customers. It's more likely that any given
8 customer will default than it is that any given
9 clearing member will default, and if what we're
10 assuming is that if a clearing member defaults,
11 we're at risk of not getting paid from any of the
12 customers, we'd probably want to cover a larger
13 number of customer defaults than we would cover
14 clearing member defaults and setting our
15 waterfall. And, so, if we looked at covering for
16 the largest five customer exposures whereas now we
17 would cover for the largest two clearing member
18 exposures, that would lead to a guarantee fund
19 increase that would be quite substantial.
20 Potentially, your clearing fund requirement could
21 tend toward meeting to double.
22 And you mentioned that there definitely

1 is a tradeoff, but the tradeoff that I'm the most
2 concerned about here is if there's a new cost
3 imposed by the regulatory regime, the market will
4 either pay it, find a way to pay it, or the market
5 will dissipate. And if we make the cost of
6 providing the clearing service too high on the
7 clearing members, several of the clearing members
8 have told us that in a regime where the clearing
9 fund was going to be double the size of what it is
10 now anticipated to be for the over-the-counter
11 business, they'd have to think twice about doing
12 this business, and that increases the
13 concentration among the remaining players, which
14 has two effects: It decreases the choices for the
15 customers to find service providers, it decreases
16 the customer's ability to diversify their own
17 exposure across a larger number of clearing
18 members, and even if everything stayed flat and
19 nothing changed in the exposure, it increases the
20 amount by which everyone else has to contribute
21 because there are fewer people to contribute to
22 the losses suffered by one defaulter. So, the

1 concentration and the further concentration of
2 providers is something that I take as a very
3 significant concern.
4 I also take as a very significant
5 concern the fact that if the costs are too high
6 for the clients, the clients will choose not to do
7 the business in this way, will choose to do a
8 different type of business, will choose to do
9 business somewhere else. So, that's why I like
10 the idea of the choice, the option, better than
11 enforcing that cost on everyone because then each
12 client can make an individual business decision on
13 whether or not the protection that they're gaining
14 is worth the cost to them and you don't impose
15 that additional cost then on every client in the
16 system.
17 MR. WASSERMAN: But here's my question
18 on that point: Let's assume Richard and Bill are
19 customers of your reference member. The top
20 member who's driving your default fund, who's one
21 of the two or three who's driving your default
22 fund calculation, if we give them the option, how

1 does that change -- let's assume for the moment we
2 say fine, this is going to be entirely optional.
3 My hypothesis, and tell me if you disagree and
4 please tell me why, is that if these guys are
5 customers, the reference member, and they are
6 given the option to walk away, that your costs are
7 still going to go up significantly, and, indeed,
8 if they and others like them are a large part of
9 the customer collateral at that reference member,
10 then you're going to incur most of the costs,
11 letting them walk away anyway. And they don't
12 know, by the way, the reference member doesn't
13 know hey, I'm the one because if they're at number
14 four, it doesn't matter.
15 MS. TAYLOR: If a customer did nothing
16 but walk away, and by walking away, you mean
17 choose the optional seg, the individual seg?
18 MR. WASSERMAN: (Off mike) collateral
19 (off mike).
20 MS. TAYLOR: So, if the biggest customer
21 posing the biggest risk to the clearinghouse in
22 driving the worst case loss decided to opt for

1 individual seg, our risk profile changes by the
2 same amount that it would if it was required that
3 he did or that he opted that he did, I agree with
4 that. But the customer who's going to opt to do
5 that instead of have it be a mandate would be, I
6 think, also looking at other ways of managing the
7 business in addition to just opting into the
8 individual seg. He can affect his own business by
9 splitting it up among more clearing members. He
10 can affect his own business by some of his clients
11 choose and some of his clients don't choose. Eh
12 can affect his own business by choosing to opt
13 into a kind of a mini pool of segregation where he
14 would put all of his clients for which he's a
15 fiduciary into their own mini pool instead of
16 putting them into their own individual pools, and,
17 therefore, that reduces the increase in the cost,
18 as well. So, there are actions that the customer
19 can take. But I think we should provide an
20 environment where the customer is encouraged to
21 also take steps that help to get a cost effective
22 outcome.

1 MS. SCHNABEL: Okay, Dan?
2 MR. MAGUIRE: Okay, so, maybe just to
3 take a little bit of a step back here. I can get
4 some real context of this. We have 40, 50 percent
5 of the global cleared interest rate derivatives
6 market now. Admittedly, the majority of that is
7 dealer to dealer, but we're dealing with the same
8 product here.
9 I think if I was to characterize what
10 I'm hearing, there's probably four real questions
11 here, and we sort of blend between the four. One
12 is: What is the exposure? And there's different
13 ways of calculating that, so, how is calculated?
14 We have a method today for a dealer to dealer, a
15 community, how would we do it including clients?
16 You mentioned the top two, top three today on the
17 clearing member side, but, of course, we need to
18 consider this double default scenario that we're
19 talking about. Is it the top 3, 4, 500 customers
20 within that, whatever that flavor may be.
21 Then, I think you get into the question
22 of: Who pays or how you cut it. Those are the

1 really two questions. How do you cut that? Is it
2 all I mean? Is it all default fund? And who's'
3 going to pay in that?
4 So, to try to give you some context
5 today around our existing portfolio, we did some
6 sample numbers across the 15 largest clearing
7 members, which constitutes pretty much the
8 majority of the cleared OTC swap business today,
9 interest rate swap.
10 On average, and we are, as we talked
11 about, very conservative in our margin approach
12 because our approach is very much defaulter pays
13 first, which I think every DCO would say the same,
14 but it's defaulter pays first, so, we have a high
15 margin charge, which was vindicated through the
16 2008 experience.
17 On average, to go from 100 to a 99
18 confidence interval, and I know statisticians will
19 argue that may 100 is not really 100, but to go
20 from 100 to 99 percent, that sees a reduction in
21 the initial margin on average across those 50
22 members by 39 percent. In monetary terms, that's

1 about $250 million dollars per firm.
2 The maximum when we did that is a 55
3 percent reduction, and this is really to Chris'
4 point, these are not normal in terms of their
5 distribution. These are non-linear. There is a
6 high degree of linearity in the swap products, but
7 these are not normally distributed in terms of
8 their losses. So, you go a maximum of 55 percent
9 on 1 particular clearing member, and that was a
10 $550 million reduction in their margin level. And
11 then the minimum we saw was 18 percent, and that
12 was $120 million. So, you need to multiply all
13 those numbers by 15 to get a sort of size. If we
14 went from 100 to 99, what would that do, just on
15 the existing today before we even mention any
16 scenario involving clients.
17 Today, in the swap clear service, we
18 have a grand total of in the region of $15 billion
19 of initial margin shared across each of those
20 clearing members, depending on the risk. And it's
21 very clearly the amount of risk you put in in
22 terms of your directional diversified position,

1 the higher your initial margin is. But to balance
2 that, we have in the region of $14 billion, $15
3 billion initial margin, we have $1 billion in
4 terms of guarantee fund. So, that gives you a
5 very big flavor of how that is cut today.
6 If we then move into how you calculate
7 that exposure, quite simply, my number there is a
8 14 and 1. My number is 15. That's the way I see
9 it. I could make that seven and eight or I could
10 make that nine and six, whichever way you cut
11 that. But the reality is the first I need to do
12 is work on my exposures and what the scenarios?
13 And I think the two keywords in this are prudent
14 and plausible. Every time we talk about stress
15 testing an initial margin, we have to have things
16 that, from an initial margin standpoint, are
17 plausible in a relevant, economic cycle and a
18 relevant, historic time period. That's one piece.
19 On the stress testing, we can create
20 some crazy, whacky scenarios out there in terms of
21 market event and extreme moves, but we also have
22 to think about what is a plausible scenario of the

1 client going delinquent as well as the clearing
2 member at the same time, as well. So, stress
3 testing plus the initial margins is really what
4 your risk exposure is.
5 I don't think there's an answer right
6 now. We can all speculate, and it's interesting
7 to hear the DCO's views on this about is about is
8 it the two plus their top five clients and how you
9 cut that. I think there needs to be more analysis
10 done around this. But I think we need to be
11 careful that we don't polarize this as just an IM
12 or a stress test debate. The risk exposure is the
13 same, and that's regardless of a gross omnibus
14 account, of a gross segregated account with omni
15 collateral or a gross segregated account with
16 segregated collateral. The market risk is the
17 same. It's absolutely the same. It does not
18 matter which way you cut it.
19 I might have a different view to Kim and
20 a different view to Chris of how I calculate my
21 market risk because it's a subjective science or
22 art or whatever you want to call it, but it's

1 market risk exposure. That's what we're really
2 talking about here.
3 So, we don't, as a clearinghouse, have
4 an answer exactly how we would do this because,
5 right now, it's quite nebulous. We're talking
6 about client clearing. But the fact of the matter
7 is there are no clients really clearing. So, to
8 speculate on a very few client's clearing OTC
9 derivatives so I can be specific, it's very hard
10 for us to say this is the right number and this is
11 the right configuration. You have to model that.
12 The extreme scenario I think Kim
13 referred to is we could just take every single
14 client within a top two, top three, and that would
15 be a pretty extreme event and probably be on
16 plausibility. But that's one way of doing it.
17 Then you can go the other end of it, but I think
18 also to your point, Maureen, the first line of
19 defense is the initial margin. So, back to our
20 point, the defaulter pays. We put that at the
21 front of all of it, and we use a pretty high
22 confidence interval. If you cut it down and down,

1 you're just basically going to spread it. For me,
2 it doesn't matter which way you do it. You're
3 going to always have to rebalance.
4 MS. BURKE: And how many days do you
5 have (off mike)?
6 MR. MAGUIRE: That's based on a
7 seven-day holding period over a five-year observed
8 history.
9 And maybe just to the final point, which
10 is touching on some of the introductory remarks
11 that Ritchie made on this, this is a full
12 portfolio approach. So, this is a very
13 diversified methodology. It has 14 currencies.
14 This goes out to 50 years. These are OTC
15 derivatives as traded over the last 10, 11 years.
16 This means that the dealers in this example are
17 incentivized to do risk impression and trade
18 compression. So, that means we've
19 institutionalized tariffs. So, we keep reducing
20 the notional. You get more and more trades all
21 the time, but on notional, the point is relatively
22 constant. It will, over time, one would expect

1 start to go down, because the risk that you're
2 putting in there versus the amount of trades are
3 two very different things. And risk compression,
4 as well. So, one is trade and notional
5 compression, which, personally, I don't see as a
6 real measure of risk.
7 The other is the actual risk
8 compression, as well. That's really a fact of how
9 you run your buck and what your business is. If
10 you have a very consolidated risk position, a
11 30-year dollar swap, if I can't close that in my
12 assumptions of 7 days or 5 days or 5 years
13 history, whatever it is, I'm going to apply and
14 multiply to that, and I can justify that by saying
15 if I looked at your position today against the
16 market today and the (inaudible) at the market, I
17 can't close that side out in 7 days. Therefore, I
18 have to put a multiplier on that, a concentration
19 risk or a liquidity risk or whatever you want to
20 call it. That's what we do actively now at the
21 dealer level. That's what we also do at a client
22 level, as well. This has to pass through all the

1 way because, going back to my final point, which
2 was the clearinghouse is looking to credit risk at
3 a clearing member we're looking at market risk as
4 a whole throughout the client community. So, I
5 have to look at the market risk on the clients
6 regardless of credit. It's absolutely the role of
7 the FCM to take the credit risk and view the
8 credit add on, et cetera. I only face that when
9 the clearing member is gone, but all things being
10 equal, the clearing member won't go.
11 MS. BURKE: So, that concentration that
12 you have drills down to the client and to the
13 clearing firm or is --
14 MR. MAGUIRE: Absolutely. In any
15 account structure we have, it would always go down
16 to the client account level.
17 MS. TAYLOR: But let me ask you a
18 question, Dan, just to make sure I understand.
19 You talked in terms of going from 100, if that's
20 your coverage level now, down to 99.
21 MR. MAGUIRE: Yes.
22 MS. TAYLOR: And the change being

1 between 40 and percent. So, when Chris and I were
2 talking about the difference being -- going from
3 99 to basically 100, and our numbers were between
4 50 and 63 percent --
5 MR. MAGUIRE: It consists --
6 MS. TAYLOR: It's the same --
7 MR. MAGUIRE: It's actually the same --
8 MS. TAYLOR: Yes, right.
9 MR. MAGUIRE: Because if went 99 to 100
10 --
11 MS. TAYLOR: It's the same.
12 MR. MAGUIRE: You'd have a lower
13 numerator, it's the same number, relatively
14 speaking. Yes, yes. So, I guess the key for us
15 is under any of these models, the LCH on a swap
16 cleared, gross omni, gross seg, on collateral
17 gross seg, seg collateral, the initial margin
18 number will be the same because the market risk
19 exposure is the same. It's actually about how you
20 calculate the stress number, and then it's about
21 who he's going to pay. If you fund the initial
22 margin, the default fund de facto will be smaller.

1 The guarantee funds, so, it will be smaller.
2 MR. KASWELL: Thank you. This is very
3 interesting to listen to because I think this is
4 the sort of discussion that I think we were
5 looking forward to where people actually roll up
6 their sleeves and say what is it actually going to
7 cost? We're sensitive to cost because,
8 ultimately, it's customers, and we end up enjoying
9 a lot of that cost. (Laughter)
10 But I think in anticipating this kind of
11 calculation, it's important to say what are the
12 real costs, and I think what you started to get
13 into, what is the baseline cost of the system
14 versus the marginal cost of saying in order for me
15 to have the individualized seg, what is that
16 actual difference? Because we all know there's
17 going to be a cost to building this thing one way
18 or the other. So, the real question is: How much
19 more does it cost to have the segregated? I do
20 fear that your proposed compromise will actually
21 give us the worst of both, that we'll end up with
22 some of the additional costs without a lot of the

1 legal protections.

2 But the other thing I think in

3 considering these costs, it's not just the cost

4 that the various firms will face, the central

5 clearing parties will face, but also the external

6 costs that the users will face, again, because if

7 we don't think we're getting the kind of

8 protection that we feel comfortable with, we have

9 to go out and buy a CDS, and I think it is the

10 CFTC's responsibility, with all due respect, not

11 just to look at the individual, but look at the

12 system-wide cost to make sure that you're not

13 saying well, it's going to be cheaper here. It's

14 actually going to be more expensive over there.

15 And then, finally, the cost at the

16 individual FCMs, I mean, I understand there is

17 additional cost involved and there's more

18 communication between the central clearing party

19 and the FCM, but, of course, the FCM still has to

20 keep score about where it is with its own

21 individual customers and where it's collateral.

22 That is also a baseline cost that is not going to

1 go away.

2 MR. WASSERMAN: And, in fairness, that

3 is something that always happens, and that's never

4 going to change. I think though, again, my big

5 question is: Okay, if you change from a 99th

6 percentile to a 99.99, at that point, that might

7 help you facilitate this. Indeed, it might

8 address most, if not all of us. It has some other

9 benefits along with it, among other things, the

10 default fund would be corresponding, I think,

11 going down.

12 MS. TAYLOR: I think the assumption that

13 was in my numbers was that if the margin went up

14 by the 50 percent, that mean there was no change

15 in the default fund, and what would really likely

16 happen is that it would be a blend, but I was

17 giving you the number.

18 MR. WASSERMAN: Yes.

19 MS. TAYLOR: I don't know what the blend

20 would be. So, I was giving you the if I did it

21 all this way, this would be the effect. If I did

22 it all this way, this would be the effect. Very

1 likely, it would be a blend.
2 MR. KASWELL: Can I just make one more
3 point? On the choice, I mean, choice always has a
4 great appeal as an initial matter. You should be
5 able to opt in or opt out. One, that we think
6 that there is a risk that the overall cost for
7 everybody would go up because building choice into
8 the system means more expense. There's the point
9 that you were making, Bob, about what happens if
10 all the big players opt out, and we think there's
11 also the question of risk to the system if some
12 people are in and some people are out, where does
13 that leave you as far as protecting yourself if
14 one of the big players goes down.
15 Thank you.
16 MR. ROSEN: Just a --
17 MR. SWANN: Bob, can I make one
18 observation before you move on? There's an
19 implication in this discussion, the status quo
20 relation to the mutualized portion of the backing
21 of a clearinghouse remains stable in circumstances
22 where the profile at the underlying risk is

1 changed, and I think it's for assumption to assume
2 that in the current environment the direct members
3 as clearinghouses are willing to socialize the
4 tail risk beyond what's captured by initial
5 margining because they know who they're sharing
6 that risk.
7 In an environment where they no longer
8 know who they're sharing that with because they
9 don't know necessarily who the customers are as
10 all of the other participants, it's not, I think,
11 a given assumption that they would equally be
12 willing to continue to provide the backing that
13 supports that tail risk. From a systemic point of
14 view, that's an important point as what's it going
15 to cost and what's the right distribution?
16 MS. TAYLOR: That is a very good point,
17 Bob, because what happens in this kind of a model
18 is that the tail risk of the -- there's the
19 clients who made a poor credit decision about
20 their FCM, and the FCMs who made a poor credit
21 decision about their clients. You could argue
22 that either way, and, right now, the pair of those

1 two things bears the cost of the problems caused
2 by those two things much more so than everyone
3 else who didn't make bad credit decisions bears
4 those costs. And, so, you shift the mix.
5 MR. WASSERMAN: I mean, right now, my
6 understanding is if you get past the shield of the
7 clients, that's still socialized, and it's
8 socialized regardless of why it is that happened.
9 MS. TAYLOR: I don't disagree with that,
10 but what I'm saying is it's like a first line of
11 defense is the people who chose the FCM who
12 couldn't cover the risk of its client business and
13 the FCM who chose clients who wouldn't pay their
14 market to market. So, the people who made the
15 failed credit decision share risk prior to other
16 parties who were not part of that failed credit
17 decision.
18 MR. WASSERMAN: Well, fair enough.
19 MS. TAYLOR: It's like it's another
20 example of the defaulter pays model, and we can
21 switch that model, but we've all been talking
22 about the costs of it, and Paul pointed that

1 there's also kind of a moral hazard cost that none
2 of us have really talked about, that that's one
3 way that shows itself.
4 And I think another way the moral hazard
5 risk shows itself is that customers now have a
6 very strong incentive to make a good credit
7 decision, and if customers are completely isolated
8 from the credit risk of their FCM, not being able
9 to make good on its obligations, then they lose a
10 large amount of the incentive that they have to
11 make a wise credit decision, and, actually, I
12 believe that that's one of the elements of the
13 whole risk management framework in this industry
14 that has served this industry very well over time.
15 Everyone had an alignment of interests in making
16 sure that there was good risk management going on
17 at every step of the way.
18 MR. WASSERMAN: Granting that point, if
19 CME's $100 million comes before the customers,
20 what does that do to your incentives for risk
21 management as the clearinghouse, and if the
22 members of the risk committees default funds come

1 before the customers, what does that do to the
2 risk committees' incentives to look at what you're
3 doing and ask you to do more of it?
4 MS. TAYLOR: If people decide that they
5 want to stay in an environment where that's the
6 mutualization scheme, there would be an incentive.
7 There already is a strong incentive for those
8 elements of risk management to be there. So, I'm
9 not sure that that incentive could be
10 strengthened. I mean, there's a very strong
11 incentive for those protections to be in place.
12 MS. O'BRIEN: I think what Kim is
13 referring to is the infrastructure that exists
14 currently, allows the exchanges, some transparency
15 to individual composition clearly cohesive
16 transparency to the omnibus position, the FCM, and
17 FCMs have an obligation within their capital
18 structure and their seg structure as they're doing
19 credit and real-time risk review of clients, that
20 smaller default component which occur every day,
21 they occur every day, they stay managed within the
22 client FCM structure, and they never get to the

1 exchange. That's part of the structure as it
2 exists today, and it's part of the protection to
3 our client that exists today. Banks are also
4 involved in this. The first place to get paid
5 every day is the exchange.
6 I agree with Kim. I have some level of
7 concern, as well, that if the exchange is going to
8 take on a greater role as a result of the
9 elimination of mutualization, that there could be
10 a fairly smart client out there that might in a
11 certain market decide that it would be
12 advantageous just not to make their position
13 whole, knowing that the clearing firm or the
14 exchange would have to segregate that component in
15 a market. I think, potentially, we could have
16 some manipulation here. We could walk through --
17 MR. PRAGER: I think the only thing I'd
18 add to follow your point, Bob, about would
19 behaviors change on risk management behaviors, and
20 I do think we have to look at the totality of the
21 behaviors that will change in this account class.
22 So, back to my earlier comments and Dan's

1 comments, and when we have looked at across all
2 our funds, it's not a homogenous group of
3 investment activity.
4 We talk about cost. I mean, it may be
5 the wrong word. From our span, it's what's the
6 drag on performance to the funds? And that drag
7 on performance actually would range from none,
8 based on how we run some of our funds today which
9 already presume a very high level of initial
10 margin and presume it's a leveraged account where
11 it has a lot of turnover to extreme drag on some
12 of our very long- term liability hedging type
13 activities where that initial margin is going to
14 have a material drag. So, you also have to think
15 of it across all the different types of activities
16 that we manage as a group of fiduciaries. So,
17 it's not going to be all the same, that drag, and
18 I do think that based on how you all come out on
19 the tilt and whether it's front-loaded or to the
20 fund, it will very much change the behavior of the
21 way that money is managed. Not necessarily for
22 the worst. I think to the extent it's

1 front-loaded, you get some of those systemically
2 beneficial behaviors of tidier books.
3 And I take your point that it's largely
4 market risk. Let me tell you, running 5,000
5 accounts, there's a lot of operational risk that
6 you take out, as well. So, and that is a real
7 cost reduction by netting down those notionals.
8 So, I do encourage everyone to think about not
9 just we talk about the narrow framework that now
10 exists. We're talking about the system, and I do
11 think that from this account class in the cleared
12 derivatives, you will change the behaviors, as
13 well. Some of it for the better by the shift in
14 that balance.
15 MR. HUSTON: Well, let's be clear on
16 costs. I mean, ultimately, the cost is going to
17 filtered down to the end consumer. And what I'm
18 concerned about when I hear increased costs and
19 increased initial marginal requirements, to the
20 extent in the agricultural industry, we're
21 required to utilize exchange cleared swaps versus
22 uncleared swaps. Or to a certain degree, exchange

1 future or a combination of the two.
2 Remember back in 2007, 2008, the prices
3 of corn and wheat got so high that there were
4 commercial institutions that pulled back out of
5 the market and would not allow farmers to forward
6 market and hedge because the volatility was great,
7 and, thus, the initial margins were so high. And,
8 so, unlike a drag in performance as it relates to
9 cost, I mean, here's a situation where bona fide
10 hedgers don't get the opportunity to hedge
11 financial risk with their particular operation
12 because of these increased costs that we're
13 talking about here today.
14 MR. ROSEN: And I want to look at this
15 issue, a pre 20 sigma event and post 20 sigma
16 event. Pre 20 sigma event, the cost that you're
17 acknowledging, that, Ritchie, you're willing to
18 pay as a fiduciary because you see the advantages.
19 The problem is what you can't avoid is that if you
20 adopt the voluntary model as you're interpreting
21 it, which is we will require clearinghouses to
22 give a choice to customers, you're imposing that

1 cost on the people who aren't looking for the
2 realignment in segregation exposure to the sort of
3 fellow customer risk. So that someone who's not
4 looking, but is clearing in the same clearinghouse
5 is going to end up having to pay for something
6 that you regard as a benefit, but something that
7 they don't regard as justified by the benefit.
8 And there's some other costs here that I
9 think it's just worth mentioning, and if the
10 commission is thinking of this as imposing a
11 requirement that a clearinghouse require cost, I
12 think there are other considerations and policies
13 that -- first of all, it's not as clear to me as
14 it seems to be to some people, that the statute
15 provides the authority for the commission to do
16 that. We don't have to go into that, obviously.
17 We don't have to go into that at this time. I
18 think that would probably not be productive, but
19 you might think about accommodating it as a choice
20 where a clearing organization could decide to
21 offer this model or not to offer this model and
22 let people gravitate to clearing organizations

1 that have the preferred model and not create this
2 cross contamination that occurs if you're all half
3 in or half out.
4 There are other casualties to this
5 arrangement though. As I mentioned before,
6 Dodd-Frank was oriented toward the reduction of
7 systemic risk. It also preserved the codes policy
8 of ratable allocation of shortfalls across
9 customers. That remains in place. It also
10 clearly had provisions that are designed to
11 promote portfolio margining, and portfolio
12 margining may be one of the earliest casualties of
13 this because you're not going to be able to offer
14 portfolio margining except in the account that is
15 either in one camp or another, and if you have
16 futures that your port into this camp because it's
17 in the account of a customer that wants this form
18 of segregation, then you're going to have an
19 issue, and I think you're going to have an issue
20 under the code because you may define whatever
21 account classes you want, but, at the end of the
22 day, you will have a situation where two futures

1 customers, one of whose position is in one of
2 these accounts and one whose positions are not in
3 this account, and if there's a loss and the
4 futures customer whose position is in a combined
5 account with these protected swaps, the results in
6 the insolvency will inherently not be ratable
7 because that party is going to get a much better
8 rate in the insolvency than the pure futures
9 customer in the same futures contract and is
10 carried with the same FCM. I think that's
11 something that needs to be considered as possible.
12 One other issue that you'll have to deal
13 with is that on cross-border business, if these
14 accounts are disclosed, whether they're legal or
15 operational, if they've got to be disclosed, then
16 you have a situation where either you're put in
17 the position of the U.S. FCM in a position as to
18 whether or not since they're going to know the
19 client because they're going to have to disclose
20 this information, they're going to be subjected to
21 registration requirements in every jurisdiction
22 where these clients are sourced, or,

1 alternatively, whether foreign brokers who
2 currently carry their accounts on an omnibus basis
3 with the U.S. FCM and don't have to register are
4 going to have to have a direct relationship where
5 this information is provided to keep it from their
6 competitors, and then, therefore, require them to
7 be registered with the FTC as an FCM. So, there
8 are other collateral consequences post 20 sigma
9 event. You have to remember that if there such an
10 event and people are looking where these losses
11 are falling, we're creating a situation where
12 those losses, if they get transmitted through the
13 guarantee structure, and don't forget that there
14 are multipliers on the guarantee fund that
15 increase the risk and the accountability for loss
16 of the clearing members, if that creates a ripple
17 that runs through, let's face it, the clearing
18 members of these clearinghouses are the vectors
19 through which systemic risk is transmitted in a
20 major financial crisis, and one of the things that
21 the public will be seeing is that what happened
22 was a lot of major users of the futures market,

1 the clear swap markets who benefited from that
2 infrastructure were able to walk away with their
3 marbles, and other people, if clearing members
4 failed because of the losses that they're going to
5 have to absorb, people who are utterly unaffected,
6 didn't benefit, didn't participate in these
7 markets are potentially going to be at risk, and I
8 think people will look at the policy judgments
9 that we're making very differently through that
10 lens at that time, and I think that's something
11 that needs to be borne in mind.
12 MR. WASSERMAN: Just responding to a
13 couple of those points, we may have differences as
14 to what we can do in terms of ratability, but
15 taking as a given the proposal on the table would,
16 in fact, distribute money ratably, it's just how
17 much would be coming back from the clearinghouse.
18 What would be non-ratable is if we endeavored to
19 do this on a voluntary basis, with some customers
20 being protected and some customers not.
21 MR. ROSEN: It's only ratable in the
22 portfolio margining. If you have a basis for

1 concluding the two people that are trading the
2 same swap positions and the same clearinghouse
3 through the same clearing member, end up with
4 different distributions because of which account
5 structure that you can define those as being sort
6 of different account classes so I don't have to
7 treat them ratably with each other, and I think
8 that's not clear.
9 MR. WASSERMAN: But what I'm saying is
10 under the voluntary approach where some customers
11 may choose this and others not, you are correct.
12 That's --
13 MR. ROSEN: Under the mandatory
14 approach, where all customers are treated the same
15 way, it would still be ratable. The issue is that
16 because the clearinghouse would be looking at the
17 customers individually, you would not have the
18 fellow customer losses.
19 MR. WASSERMAN: I think in the portfolio
20 margining account, even in a mandatory context,
21 there are issues with ratable distribution, and we
22 can walk through that at a different --

1 MR. ROSEN: Offline, yes.
2 MR. SZYCHER: I mean, I would take a
3 slightly different view. And I'm not certainly
4 not qualified to speak about anything regarding
5 the code, but I guess I may take a different view
6 regarding I guess the consequence of certain
7 clients walking away and sort of who's left in the
8 pool insofar as to the extent that there's some
9 perceived detriment to the folks who remain in the
10 pool, that, to me, is necessarily only the case
11 if, and in fact only if risk were not priced
12 correctly to begin with. That is that whoever
13 left was subsidizing whoever was there to begin
14 with. And speaking of whoever was going to be
15 subsidizing, if anyone is going to be subsidizing
16 anyone else, it's highly probable that, at least
17 in our minds, a pension fund, probably the lowest
18 risk of any institutional client, is probably
19 going to be doing the subsidizing, and, in doing
20 so, it's not readily apparent that there our
21 clients are benefiting from the subsidization of
22 credit risk across other less credit-worthy

1 entities.

2 MR. ROSEN: Great point.

3 MR. WASSERMAN: I'll let you have the

4 last word.

5 MS. TAYLOR: You'll be sorry.

6 (Laughter) I just wanted to come

7 back to something that I raised

8 earlier that I would like us to

9 think about, given everything that

10 we've discussed here today. I've

11 been racking my brain since I've

12 talked with you first, Ritchie, to

13 figure out a way where we could

14 increase the protection that the

15 customers have without kind of

16 tipping the balance of the systemic

17 protection, and the best idea that

18 I can come up with after talking

19 internally and talking within the

20 industry is actually to use some

21 kind of an insurance vehicle as a

22 vehicle for protecting the

1 customers against the prorated
2 losses, but not adversely affecting
3 the way the kind of bulk risk
4 management, systemic risk
5 protection mechanisms of a
6 clearinghouse work. And, so, I
7 just wanted to throw that back out
8 on the table.
9 MR. WASSERMAN: Okay, I'll make myself a
10 liar. The problem with that is, of course, that's
11 not there, and we've got rule-makings that we've
12 got to do now, and, so, it's difficult to base
13 something on that possibility.
14 MR. RADHAKRISHNAN: Sorry. You guys may
15 have discussed this, but it seems to me that if
16 somebody wants extra protection, they should pay
17 for it.
18 SPEAKER: That's the assumption.
19 MS. TAYLOR: And insurance is an
20 excellent way of targeting that cost right to the
21 --
22 MR. RADHAKRISHNAN: That's right. So,

1 the issue is how do you make the people who make
2 something extra pay for it? Because, right now,
3 in the futures world, everybody is treated the
4 same way. What you folks are arguing for, and I'm
5 not making a judgment on it, is you want something
6 different from what we have right now because the
7 cleared swaps, right now, the statute replicates
8 the futures model. You want something different,
9 and the question is: Are you willing to pay for
10 it, right? The way in which you can pay for it
11 is, and the funds are not going to like this, you
12 could be a clearing member yourself, right? You
13 can be a clearing, and then you're not exposed to
14 other customer -- I know I see unhappy faces.
15 (Laughter) But you're not exposed,
16 right? You're not exposed to other
17 customer risk. Now, of course,
18 what you then have to do is to
19 satisfy the clearinghouses that you
20 can be a clearing member. So,
21 that's one way of doing it. But
22 the other way is if you want extra

1 protection is to pay for it. Now,
2 Kim is talking about insurance, and
3 I'm wondering if there's some other
4 way because we're talking about the
5 opt-in approach. Is there some
6 other way in which people who want
7 extra protection --
8 SPEAKER: Their model --
9 MR. MALOY: Isn't clearing insurance,
10 you pay a premium, the higher the premium, the
11 better the protection.
12 MR. RADHAKRISHNAN: So, you are saying
13 you pay a higher premium. So, the question is:
14 What form does it take?
15 MR. MALOY: Initial margin.
16 MR. RADHAKRISHNAN: More initial margin.
17 Okay, so --
18 MR. MALOY: Or, in our case, the same
19 initial margin.
20 MR. RADHAKRISHNAN: I know we're
21 supposed to end, but is it possible that let's say
22 you have a firm with 10 accounts. The firm will

1 margin each of those accounts, right, and come up
2 with a number. Let's call that X. Is the margin
3 requirements that the DCO imposes on the customer
4 omnibus also X, or could it be something less than
5 X?
6 MS. TAYLOR: In our particular case for
7 the over-the-counter swaps, it would be the sum
8 total of the requirements across the accounts.
9 MR. RADHAKRISHNAN: Across, okay.
10 SPEAKER: Gross.
11 MR. RADHAKRISHNAN: So, then my idea
12 doesn't work because I thinking what if you got
13 more than what you had actually asked for? Is it
14 over possible that the firm will have more money,
15 more margin from its customers than you could
16 offer on the clearing firm?
17 MR. MALOY: Yes.
18 SPEAKER: It happens every day.
19 MR. MALOY: There's a model whereby you
20 can have -- there's two things here. One is the
21 amount of margin, and the other is about the
22 waterfall.

1 MR. RADHAKRISHNAN: Right.
2 MR. MALOY: Talk about the margin. If
3 you do a -- I'm going to pick on Richard's firm
4 and say let's say BlackRock have five funds. I
5 know they've got more than that, but let's say
6 they have five funds and they said look, we're
7 happy to commingle all of our five funds together,
8 and we're happy to say that if the FCM is in
9 default, we're looking to port, we're going to go
10 to a backup, a substitute, and those five have to
11 go together. If they're prepared to do that, then
12 we can say well, look at that exposure as a net
13 risk exposure, and, therefore, charge net margin.
14 That's the clearinghouse would charge that.
15 The FCM may choose to charge on a gross
16 basis, and that's where you have a gross margin
17 and from the clients to the FCM, but from the FCM
18 to the CCP, that would be a nets margin.
19 MR. RADHAKRISHNAN: So, think about it,
20 if a DCO got more money, more than IM, then it
21 would charge - would that make your life easy?
22 MS. TAYLOR: I think that's one of the

1 things that we figured would be an outcome of
2 having separate segregation.
3 MR. RADHAKRISHNAN: Yes. Okay.
4 MS. TAYLOR: Is that we would have more
5 --
6 MR. RADHAKRISHNAN: We would have,
7 right.
8 MS. TAYLOR: More money than we
9 otherwise would have.
10 MR. WASSERMAN: Though, in fairness --
11 MS. TAYLOR: More margin than otherwise
12 would have.
13 MR. WASSERMAN: Now, in fairness,
14 customer level margin, Kim, I think you guys
15 generally charge 130 percent of clearing member
16 margin or is that --
17 MS. TAYLOR: That would only be for the
18 initial initiating trade activity.
19 MR. WASSERMAN: Right.
20 MS. TAYLOR: Not on the ongoing basis.
21 MS. O'BRIEN: But currently today under
22 the infrastructure, if a clearinghouse makes a

1 credit assessment of a client who potentially has
2 significant intraday volatility and they're not
3 making intraday call they may do something
4 effectively super margining. They may charge a
5 client 140 percent of the actual margin charge by
6 the exchange.
7 What occurs with that extra 40 percent,
8 Bob, you're correct. It does reside within the
9 FCM, it does reside with the seg pool, which is
10 one of the infrastructure components today.
11 Perhaps, there's a dialogue about something called
12 a buffer. The difference between initial margin
13 that is required by the exchange. It is not a
14 funding that would lock up for a quarter like the
15 guarantee fund does. I will tell you, I have
16 considerable concerns about putting a significant
17 rate on FCMs to double the size of a guarantee
18 fund when you're talking about day-to-day movement
19 of clients. It's actually not consistent.
20 SPEAKER: Right.
21 MR. WASSERMAN: Let me mention two
22 things. First, from where I'm sitting, there is

1 nothing inconsistent with this proposal for a
2 clearinghouse to say as part of this risk
3 management or the FCM or either to say you know
4 what, one of your clients really gets us
5 concerned, and for that client, because of the
6 market risk, we want 150 percent of the normal
7 margin because that client worries. That's one
8 thing that could be done.
9 Second, the clearinghouse might say, and
10 this you won't like as much, you, as the FCM, are
11 guaranteeing each of your clients. We want you to
12 post X dollars in collateral to collateralize that
13 guarantee, and that would run across clients.
14 That also would be consistent, and then they could
15 essentially use that. And it's when you said
16 "buffer" that made me think of that. That could
17 then be applied to any client, and there'd be
18 nothing inconsistent with them taking that for any
19 client because it's not a customer's money, it's
20 the firm's money.
21 Again, it seems to me there's really a
22 wide pallet of ways in which the clearinghouses

1 could address this kind of a risk environment, and
2 it's not (inaudible) to say I'm expecting they
3 will creatively find the best way to do it.
4 MS. BURKE: Bob, on the point of the
5 buffer that you kind alluded to at the end, and
6 going back to Edith's point that it's not in the
7 guarantee, I think the firms would have to take a
8 look at that and evaluate it, and then come back,
9 but not have it as a guarantee, but have it as
10 part of your seg buffer that we have today.
11 MR. WASSERMAN: And, to be clear, to the
12 extent possible, I want that to be something
13 that's worked out between the firms and the
14 clearinghouses rather than by us saying you've got
15 to do it that way. The regulatory goal is to
16 protect these guys. The implementation of that
17 should, from where I'm sitting, as much as
18 possible, be up to you folks. With that --
19 MS. SCHNABEL: I think we're done. Our
20 mailbox is open if anyone wants to submit written
21 comments.
22 Okay, thanks.

1 MR. RADHAKRISHNAN: Thank you very much.
2 MR. SWANN: Thank you.
3 (Whereupon, at 4:13 pm, the
4 PROCEEDINGS were adjourned.)
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1 CERTIFICATE OF NOTARY PUBLIC

2 DISTRICT OF COLUMBIA

3 I, Carleton J. Anderson, III, notary

4 public in and for the District of Columbia, do

5 hereby certify that the forgoing PROCEEDING was

6 duly recorded and thereafter reduced to print under

7 my direction; that the witnesses were sworn to tell

8 the truth under penalty of perjury; that said

9 transcript is a true record of the testimony given

10 by witnesses; that I am neither counsel for,

11 related to, nor employed by any of the parties to

12 the action in which this proceeding was called;

13 and, furthermore, that I am not a relative or

14 employee of any attorney or counsel employed by the

15 parties hereto, nor financially or otherwise

16 interested in the outcome of this action.

17

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20 Notary Public, in and for the District of Columbia

21 My Commission Expires: October 31, 2011

22