

UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
COMMODITY FUTURES TRADING COMMISSION

JOINT MEETING ON HARMONIZATION OF REGULATION

Washington, D.C.

Wednesday, September 2, 2009

ANDERSON COURT REPORTING
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4 LUIS AGUILAR, Commissioner

5 KATHLEEN CASEY, Commissioner

6 TROY PAREDES, Commissioner

7 ELISSE WALTER, Commissioner

8 Commodity Futures Trading Commission:

9 GARY GENSLER, Chairman

10 BART CHILTON, Commissioner

11 MICHAEL DUNN, Commissioner

12 JILL SOMMERS, Commissioner

13 Panel One:

14 WILLIAM BRODSKY
Chicago Board Options Exchange

15 JOHNATHAN SHORT
16 ICE Futures

17 CRAIG DONOHUE
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18 ANTHONY LEITNER
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1 P R O C E E D I N G S

2 (9:34 a.m.)

3 MR. GENSLER: Good morning. I want to
4 call to order this joint meeting of the Commodity
5 Futures Trading Commission and the Securities and
6 Exchange Commission.

7 I'd also like to note the historic
8 nature of the meeting. It's the first joint
9 meeting in the history of our two agencies.

10 I also want to apologize for being a
11 little late. Scheduling this on the first day
12 back to school for my children was quite a trip,
13 and I live in Baltimore and missed my train this
14 morning. So I appreciate everybody for their
15 forbearance.

16 I'd like to thank Chair Schapiro --
17 Chairman Schapiro, and my fellow commissioners,
18 members of the SEC, and our distinguished
19 panelists for being here today.

20 In June, President Obama called on the
21 CFTC and SEC to make recommendations to Congress
22 for changes to statutes and regulations that would

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1 harmonize regulations in the futures and
2 securities world. Specifically, there are three
3 areas where this would benefit the American
4 public.

5 First, I believe there are significant
6 gaps in our current financial regulatory system.
7 I believe we must act urgently to reduce risk and
8 protect market integrity, promote market
9 transparency by adopting comprehensive regulatory
10 reform for the over-the-counter derivatives world.
11 I believe working together with the SEC and
12 Congress we can get this right and we can get it
13 on the right track. And consistency between our
14 two agencies from the beginning will help and will
15 avoid jurisdictional issues in the future.

16 Second, there are areas where the CFTC
17 and SEC regulation currently overlap. In some
18 cases this might benefit the American public. For
19 instance, in the enforcement area where we bring a
20 third of our cases with the SEC, and I think that
21 benefits the public. But in some cases it doesn't
22 benefit the public where there might be

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1 inefficiencies or even potential for regulatory
2 arbitrage or uncertainties for regulated parties.

3 Third, there are areas where the CFTC
4 and SEC regulate similar products, practices, or
5 markets, but do so differently. There are times
6 where these differences are appropriate, but at
7 other times they could stifle competition,
8 increase cost, or limit investor protection.

9 Upon joining the CFTC, I held a staff
10 town hall meeting and discussed the importance of
11 working with other regulators; directing everyone,
12 as I continue to do, to check turf at the door and
13 focus on solely striving for the best public
14 policy.

15 We're fortunate to have a great partner
16 in Chairman Mary Schapiro. Our mutual
17 understanding, dedicated staffs, and respective
18 commission support gives me great confidence that
19 we'll be able to get this job done as the
20 President has called us to do.

21 We look forward to hearing from a wide
22 variety of viewpoints on this very important

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1 issue. Written comments on the topic of this
2 hearing will be accepted by the public through
3 September 14th and included in the record. Please
4 visit cftc.gov or sec.gov for a link and
5 instructions on how to submit written comments for
6 the record.

7 I'll now turn to Chairman Schapiro for
8 opening remarks.

9 MS. SCHAPIRO: Thank you very much,
10 Gary. I'm really pleased to be here this morning
11 as well with my fellow commissioners from both the
12 SEC and the CFTC. And for me, personally, it's a
13 special honor to sit at this table once again. I
14 really want to thank Chairman Gensler and the CFTC
15 staff for all the work they've put into hosting
16 this first day of joint meetings, and we look
17 forward to continuing the dialogue tomorrow at the
18 SEC.

19 I also want to extend our appreciation
20 to all of our distinguished panelists who are with
21 us to share their insights, advice, and
22 recommendations. We are truly grateful that so

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1 many have agreed to participate in these meetings
2 and share their views with us.

3 Today's hearing will build upon the
4 progress that both agencies have made in
5 discussing harmonization matters, as well as
6 designing a framework to regulate OTC derivatives.

7 I believe it will move us further down
8 the road of harmonizing our regulations, which
9 should in turn help to increase transparency,
10 reduce regulatory arbitrage, and rebuild
11 confidence in our markets.

12 As Gary mentioned, the Obama
13 Administration's Financial Regulatory Plan laid
14 out proposals that seek to ensure comprehensive
15 regulation of our financial markets and that seek
16 to fill in gaps that came to light in the wake of
17 the financial crisis.

18 One important component of the
19 Administration's White Paper and the reason we are
20 here today is a recommendation that we harmonize
21 the existing regulatory regimes for futures and
22 securities products. Specifically, the

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1 Administration asked our agencies to complete a
2 report that identifies all existing differences in
3 statutes and regulations. Where such differences
4 exist, we must either explain why those
5 differences are necessary or recommend changes to
6 those statutes and regulations.

7 To advance this important harmonization
8 initiative, we at the SEC have been engaging in a
9 continuing dialogue with the CFTC, and staff from
10 both agencies have been developing a coordinated
11 approach to our task. They've undertaken a joint
12 effort to complete a comprehensive evaluation of
13 our regulatory systems to find ways to align the
14 oversight and regulation of similar types of
15 financial instruments. And we have made much
16 progress. We both recognize that enhanced
17 coordination and cooperation concerning issues of
18 common regulatory interest is necessary in order
19 to protect investors, foster market innovation and
20 fair competition, and to promote efficiency in
21 regulatory oversight. I am confident that we will
22 also be able to work towards the goals expressed

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1 in the Administration's White Paper as we seek to
2 build a common foundation for market regulation.

3 As noted in the White Paper, securities
4 regulation and futures regulation share common
5 ground with respect to the broad public policy
6 objectives of protecting investors, ensuring
7 market integrity, and promoting price
8 transparency.

9 The mission of the SEC is to protect
10 investors; maintain fair, orderly, and efficient
11 markets; and facilitate capital formation. The
12 mission of the CFTC is to protect market users and
13 the public from fraud, manipulation, and abusive
14 practices related to the sale of commodity and
15 financial futures and options, and to foster open,
16 competitive, and financially sound futures and
17 options markets.

18 While the securities and futures
19 regulatory regimes share broad public policy
20 objectives, differences do exist in the regulation
21 of markets for securities and futures. I believe
22 that some of these differences are necessary to

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1 achieve the underlying policy objectives.
2 However, I also believe that many benefits could
3 be achieved through greater coordination and
4 harmonization between the SEC and CFTC for
5 regulation and oversight of similar types of
6 financial instruments. Some of these benefits
7 include increasing transparency, reducing
8 regulatory arbitrage, promoting product
9 innovation, and rebuilding confidence in our
10 markets.

11 I do believe that the joint meetings we
12 are holding over the next two days will serve as a
13 strong foundation for that process. We will have
14 the opportunity today and tomorrow to hear from a
15 wide variety of panelists with varying
16 perspectives. We are honored to have with us
17 expert representatives from the investor
18 community, market participants, self-regulatory
19 organizations, academia, and the legal community.
20 With such a broad spectrum of constituencies
21 represented, we look forward to an engaging
22 conversation on this topic.

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1 So thank you all in advance for your
2 participation. The insight that you provide today
3 will be extremely valuable to the CFTC and the SEC
4 as we take further steps towards harmonizing our
5 regulations. Thank you.

6 MR. GENSLER: Thank you, Chair Schapiro.
7 It's good to be here with you. It's good to be
8 with all of the SEC commissioners. I think we
9 last saw each other during the presidential
10 transition.

11 And with that, I'm going to turn to
12 Commissioner Casey, I think, for your opening
13 statement.

14 MS. CASEY: Thank you very much,
15 Chairman Gensler and Chairman Schapiro. I'm also
16 pleased to be here with my colleagues at the SEC
17 and the CFTC at this important inaugural joint
18 hearing.

19 I would like to first commend the staffs
20 of the two agencies for putting together such a
21 high-caliber roster of panelists representing a
22 wide array of interests and perspectives. And I

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1 look forward to hearing their highly developed
2 views on the challenging and critical issues
3 relating to harmonization of securities and
4 futures regulation.

5 Calls for rationalizing, harmonizing, or
6 consolidating securities and futures regulation
7 have been made for years, as many of you here can
8 attest to. And yet the challenges -- political,
9 philosophical, statutory, jurisdictional -- have
10 crippled previous efforts. And even today still
11 pose formidable challenges, but they are not
12 insurmountable. Indeed, best efforts by both
13 Commissions in recent years sought to facilitate
14 greater cooperation in order to address
15 cross-jurisdictional issues. But even in the best
16 spirit of cooperation, we are necessarily limited
17 in what we can achieve.

18 We are here today, as already noted,
19 because the administration has called on both
20 agencies to complete a report to Congress
21 identifying all existing differences in statutes
22 and regulations. The report must either explain

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1 why any differences are necessary or recommend
2 statutory and regulatory changes. And working
3 well with each other doesn't necessarily mean that
4 we will always agree. But to the extent that we
5 do disagree, it should be based on reasoned
6 principles, not merely jurisdictional protection.

7 Of course, we stand ready to implement
8 any changes that Congress deems necessary. But in
9 the meantime, as both Chairman Schapiro and
10 Gensler have noted, the SEC, and I hope the CFTC
11 as well, is committed to continuing its close work
12 in order to benefit investors and the markets
13 through enhanced investor protection, market
14 integrity, regulatory clarity, and innovation.

15 So I'd like, again, to thank the staff
16 for their great efforts to assemble this two-day
17 series of hearings. Thank you, all the panelists
18 before us who are lending their wisdom and
19 expertise to this important and worthwhile
20 harmonization effort, and I look forward to your
21 presentations and the discussion that follows.
22 Thank you.

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1 MR. GENSLER: Thank you, Commissioner
2 Casey. Commissioner Dunn.

3 MR. DUNN: Thank you, Chairman Gensler
4 and Chairman Schapiro. I commend both of you for
5 holding these meetings. This is truly a historic
6 day for both Commissions.

7 And part of that historic part is we're
8 going to hear the same story from these entities.

9 Since I arrived at the Commission in
10 2004, I've called for public meetings between our
11 two agencies so that we could discuss together,
12 analyze, and tackle problems facing the country's
13 financial markets. Most importantly, in my
14 opinion, is a need to identify gaps in our
15 regulatory schemes that put consumers and our
16 economy at risk. Once identified, it's imperative
17 that we work jointly and quickly to address these
18 shortcomings.

19 While the markets and products we each
20 regulate are more different than similar, it is
21 each agency's mission and duty to ensure that
22 these markets function properly and are free from

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1 fraud and abuse. I believe everyone recognizes
2 the fact that for a small number of financial
3 instruments, the once clearly delineated lines
4 between what is a commodity and what is a security
5 has been blurred.

6 On June 17, 2009, President Obama called
7 our agencies to recommend changes to the law we
8 oversee to eliminate regulatory differences
9 between similar types of financial instruments. I
10 hope our meetings over the next two days allow us
11 to identify the instruments and differences
12 described by the president. But more importantly,
13 I hope that these meetings provide the groundwork
14 for a new era of cooperation between our agencies.

15 I would like to thank all of the
16 witnesses in advance for appearing before such a
17 large and inquisitive group of policymakers. And
18 I look forward to hearing your testimony, and
19 appreciate the service you're providing both of
20 our agencies. I greatly appreciate the efforts of
21 the staff at both the CFTC and SEC that have put
22 into making this meeting a success. As with prior

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1 meetings and hearings, my commitment to you is to
2 listen with an open mind to your thoughts on
3 everything we discuss. Thank you.

4 MR. GENSLER: Thank you, Commissioner
5 Dunn. Commissioner Walter.

6 MS. WALTER: Thank you, Chairman Gensler
7 and Chairman Schapiro.

8 I am very happy to be a part of this
9 joint meeting of the SEC and the CFTC to discuss
10 harmonization of regulation. The two agencies
11 have worked together for years, and on occasion
12 dueled. It certainly has become increasingly
13 obvious, particularly during the recent financial
14 crisis, that the current bifurcated approach to
15 securities and futures regulation is outdated and
16 in need of overhaul. And I believe that the
17 discussion over the next two days will be a
18 critical step in this effort.

19 Splitting the regulation of securities
20 markets and futures markets between the two
21 agencies has made it difficult for either agency
22 to have comprehensive oversight.

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1 Regulatory cooperation is absolutely
2 essential if we are to come as close as possible
3 to consolidated real-time information over markets
4 that have become increasingly interrelated in
5 recent years. That knowledge is necessary if our
6 respective agencies are going to be able to
7 prevent market manipulation, fraud, and other
8 abuses effectively. To put it simply: You cannot
9 regulate what you cannot see.

10 Also, as financial products have become
11 increasingly indistinguishable in economic
12 function and purpose, it is very difficult to
13 determine their correct regulatory treatment.
14 Agency disputes over products that straddle
15 regulatory boundaries serve neither the interests
16 of investors nor the efficiency and
17 competitiveness of our financial markets. The
18 time has definitely come for our two agencies to
19 not only work together, but to successfully
20 harmonize our regulatory regimes where differences
21 are not justified.

22 Now, as many of you may know, I once

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1 served as the general counsel of the CFTC, back
2 when SEC Chairman Schapiro was the CFTC's Chairman
3 Schapiro. My experience at the two agencies has
4 given me the good fortune to observe and, on more
5 than a few occasions, participate in these debates
6 and discussions from both sides of the regulatory
7 table. Whatever the differences that may need to
8 be ironed out and the gaps that may need to be
9 filled in in working on this harmonization effort,
10 I believe that each agency has a unique
11 perspective to bring to the table.

12 For example, I was always struck when I
13 was at the CFTC at the extent to which economists
14 played a central role, which is, I believe, of
15 great benefit to that agency. I cannot help but
16 believe that more cross-agency pollination,
17 particularly of thought, would be beneficial for
18 all of us.

19 Thank you to both of our staffs. And I
20 very much look forward to the discussion.

21 MR. GENSLER: Thank you, Commissioner
22 Walter. Commissioner Sommers.

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1 MS. SOMMERS: Thank you. Good morning.
2 Thank you all for being here.

3 I also want to say thank you to the
4 staff of both agencies for the enormous efforts
5 that they've put into pulling these two days of
6 hearings together in just a few short weeks. We
7 have a lot to get through today, so I'm going to
8 be brief.

9 The CFTC and the SEC have been asked to
10 identify conflicts in how the two agencies
11 regulate similar financial products, and to either
12 explain why those differences further important
13 policy goals or make recommendations for resolving
14 differences where they do not.

15 As many have observed, futures markets,
16 used primarily to manage risk and discover prices,
17 and equities markets, used primarily to raise
18 capital for public companies, serve fundamentally
19 different purposes. A futures contract on corn
20 and a share of IBM stock are not similar financial
21 products. Certain structural differences in how
22 these markets operate necessarily require

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1 operationally divergent regulatory schemes.

2 That being said, there is a growing list
3 of derivatives products that straddle
4 jurisdictional lines. I share the frustration of
5 those who complain that our inability to resolve
6 jurisdictional disputes or harmonize our
7 regulatory approach for these products creates
8 capital inefficiencies and delays in bringing
9 beneficial financial tools to the marketplace.
10 But I am hopeful that these joint meetings are a
11 good start, and today and tomorrow will lead to
12 some real progress. And I look forward to all of
13 the discussions.

14 Thank you.

15 MR. GENSLER: Thank you, Commissioner
16 Sommers. Commissioner Aguilar, good to see you
17 again.

18 MR. AGUILAR: Good to see you. Thank
19 you, Chairman Gensler and Chairman Schapiro.

20 Good morning. I, too, would like to
21 welcome the panelists and the members of the
22 public present, as well as those that are

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1 observing by webcast. I am delighted to be here
2 for these unprecedented meetings and I welcome
3 these upcoming discussions.

4 As some of you know, I have been
5 supportive of combining the SEC and the CFTC.
6 Among other reasons, it would permit more
7 comprehensive and coordinated oversight of
8 financial markets that are increasingly
9 interconnected, and would reduce the concerns and
10 uncertainty about jurisdiction.

11 Although the SEC has many unique
12 responsibilities, such as oversight of capital
13 market offerings and financial reporting, some
14 market and intermediary oversight by the CFTC and
15 SEC involve similar tasks.

16 Holding these joint meetings can
17 accomplish some of the same purposes as combining
18 the agencies. And I am certain that it will
19 result in important improvements to our markets.
20 For example, harmonized rules could enable more
21 consistent recordkeeping by regulated entities.
22 And investors who seek to engage in both

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1 securities and futures transactions may be able to
2 better manage their affairs and have their needs
3 met more efficiently.

4 It is true that harmonization would not
5 make sense in every case because of the different
6 needs of market participants. As a result, as
7 this process unfolds it would make sense to
8 consider harmonization consistent with some key
9 principles. In particular, harmonization should
10 be pursued, and pursued with vigor, where doing so
11 would advance the public interest by enhancing
12 investor protection by providing a fair and
13 competitive market structure that facilitates
14 informed decision making, and where harmonization
15 would further both agencies' efforts in vigorous
16 law enforcement. Investor protection is the
17 animating principle of the SEC and it will help
18 guide our work in this project.

19 And even where harmonization would not
20 be appropriate, these meetings will assist our
21 ongoing efforts to coordinate with one another.

22 My thanks to the staffs of both agencies

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1 for their work in organizing this important
2 two-day meeting. Thanks, again, to the panelists
3 for agreeing to share their views with us. And
4 thanks to our respective chairmen and my fellow
5 commissioners at the SEC and at the CFTC for
6 agreeing to hold these meetings.

7 MR. GENSLER: Thank you, Commissioner
8 Aguilar. Commissioner Chilton.

9 MR. CHILTON: Thanks, Mr. Chairman. You
10 two -- Chairman Schapiro share -- Chairman Gensler
11 -- a really driving leadership at these agencies.
12 And I commend you for doing it, like my colleagues
13 have.

14 I've got a written statement, but I'm
15 not going to read it, if that's okay. I've got,
16 really, just one point. And it -- for decades
17 some of these issues have been around.

18 And what happens is they get stuck down
19 at the staff level. And that doesn't mean that
20 the staff aren't working as hard as they should.
21 But if they don't have the ability to resolve the
22 issues, it really is us. It's the people that the

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1 presidents nominate and the Senate confirms that
2 have the responsibility to actually see a positive
3 success trajectory on these issues. And so I
4 think to hold our feet to the fire, we need to
5 continue these.

6 I commend Acting Chairman Lukken and
7 Chairman Cox for doing an MOU last year. One of
8 the things that several of us tried to get,
9 including Commissioner Dunn, was meetings that
10 would be setup regularly by the commissioners. I
11 think without that it'll go back down to the staff
12 level, and it may not reach any conclusion.

13 So, like many of my colleagues have
14 said, you know, we've got different legislative
15 mandates, but we've got similar missions to have
16 efficient and effective markets. And we're two
17 agencies, but I'm very optimistic that today --
18 and hopeful that we're going to start acting like
19 we're one government.

20 Thank you.

21 MR. GENSLER: Thank you, Commissioner
22 Chilton. Well said.

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1 Commissioner Paredes, please.

2 MR. PAREDES: Thank you. And thank you
3 to the staffs of both agencies for all of their
4 efforts in pulling this together. And, of course,
5 thank you to the panelists who are participating
6 in these joint meetings. I greatly appreciate the
7 chance to hear your views.

8 Harmonization is not an end in and of
9 itself. Indeed, it's not clear what harmonization
10 means exactly or at what point it's realized. For
11 example, there may be legitimate reasons for
12 certain differences to persist between the
13 regulatory approaches at the CFTC and SEC.

14 To me, the language of harmonization
15 speaks to a broader objective, namely, the goal of
16 identifying and undertaking regulatory steps to
17 ensure that we have innovative, efficient, and
18 competitive markets that serve investors and our
19 country's economic interests more broadly.

20 Over the next two days, we'll cover a
21 range of topics: Portfolio margining, the
22 approval of new products, enforcement, clearing,

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1 to name a few. Even in those particular instances
2 where harmonization is not prudent or achievable,
3 some regulatory change may still be called for. I
4 welcome ideas that could improve the SEC's
5 regulatory regime and approach, even if securities
6 regulation and futures regulation continue to
7 differ. For example, there undoubtedly are
8 regulatory changes that could promote competition
9 in capital formation while properly protecting
10 investors' interests.

11 Finally, the search for harmonization
12 need not be all or nothing. Whether or not the
13 law on the books is harmonized, there is still
14 room for the two agencies to cooperate and
15 coordinate in a more effective manner. We should
16 take advantage of those opportunities when they
17 present themselves.

18 MR. GENSLER: Thank you, Commissioner
19 Paredes. And now, in an act of harmonization, I
20 hand it over to Chairman Schapiro, who is going to
21 introduce the first panel.

22 MS. SCHAPIRO: Thank you, Chairman

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1 Gensler. And thank you to all of our colleagues
2 for your excellent opening statements.

3 It's my honor to introduce the first
4 panel. And I'll keep the introductions very brief
5 so we can actually get to the substance here.

6 To the far left, in terms of where
7 they're seated, Bill Brodsky, Chicago Board
8 Options Exchange; Johnathan Short, ICE Futures;
9 Craig Donohue, CME Group; Tony Leitner, AJ Leitner
10 & Associates; Annette Nazareth, Davis Polk &
11 Wardwell; and Eric Baggesen from the California
12 Public Employees Retirement System, known as
13 CalPERS.

14 Thank you, all. And I guess we'd ask
15 you to make opening statements in that order.

16 MR. BRODSKY: Thank you, Chairman
17 Schapiro, Chairman Gensler, and all the
18 commissioners for what you have done to get this
19 group together today.

20 My name is William Brodsky. I'm
21 chairman and CEO of the Chicago Board Options
22 Exchange. I'm also currently serving as chairman

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1 of the World Federation of Exchanges, which
2 includes 50 of the world's largest regulated
3 exchanges.

4 For the past 35 years, I've served in a
5 leadership role at major U.S. stock, futures, and
6 options exchanges, including 11 years as CEO of
7 the Chicago Mercantile Exchange and 12 years in my
8 current role at the CBOE.

9 CBOE strongly supports the
10 Administration's call for the CFTC and the SEC to
11 work towards harmonizing their statutes and
12 regulations. I commend both agencies for acting
13 promptly on this recommendation, and I'm honored
14 to share CBOE's perspective with you today.

15 As outlined in the reform proposal, the
16 differing missions of the SEC and the CFTC, and
17 the separate statutes under which they operate,
18 lead to inconsistencies in regulation of futures
19 and comparable securities products. These
20 inconsistencies have implications for investor
21 protection, for tax revenues, and for the
22 competitive position of the United States in the

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1 global marketplace.

2 The philosophies that guide and inform
3 the approach of the SEC and the CFTC are
4 fundamentally different.

5 CFTC's principles-based approach gives
6 exchanges considerable discretion in determining
7 how they operate. In contrast, the SEC's
8 rules-based approach requires exchanges to comply
9 with numerous and prescriptive regulations. This
10 disparity imposes severe competitive disadvantages
11 on securities exchanges and inhibits innovation in
12 the securities markets. The SEC's rules-based
13 approach leads to substantial and unnecessary
14 delays in introducing new products and making
15 operational changes. Consistent with the
16 administration's recommendation, we strongly
17 recommend that the CFTC shift closer to the
18 principles-based approach.

19 We have experienced interminable delays
20 in bringing new products to market as a result of
21 disputes over which agency has jurisdiction.
22 These delays, while acutely vexing to the CBOE,

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1 adversely affect our entire economy in the form of
2 lost tax revenues and lost ground to international
3 competitors. For example, the introduction of
4 what is now a very actively traded product, the
5 option on gold ETFs, was placed on hold for three
6 and a half years because the two agencies could
7 not agree on jurisdiction. In another instance,
8 an option on a credit default product was placed
9 on hold for seven months, while Eurex, Europe's
10 largest derivative exchange, was able to introduce
11 a similar product within weeks of announcing it.

12 There needs to be a quick and decisive
13 mechanism to end jurisdictional disputes. We
14 recommend that the Treasury Department, which is
15 well-versed in the relevant issues, be used as a
16 tiebreaker to resolve jurisdictional disputes, at
17 least until we have a more definitive mechanism in
18 place.

19 The two agencies also handle margin
20 levels, which is also called performance bonds,
21 for similar products very differently. These
22 differences result primarily in lower margin

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1 levels and more lenient treatment of margins for
2 futures and futures options, and, therefore, a
3 cost advantage over comparable securities options.
4 Margin levels should reflect the relative risks of
5 the products and not the jurisdictional silo in
6 which they happen to reside. We recommend,
7 therefore, that all equity derivative margins be
8 subject to the same standards and process of
9 oversight.

10 There are several areas where securities
11 laws are more vigorous than the futures laws in
12 promoting customer protection and market
13 integrity, including stronger prohibitions against
14 insider trading and heightened suitability
15 requirements. There is no policy reason for this
16 disparity. In order to better safeguard
17 investors, we recommend that futures regulations
18 be strengthened along the lines of the securities
19 laws.

20 In conclusion, we applaud the spirit in
21 which this forum is being conducted. CBOE
22 operates a separate stock exchange and option

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1 exchange and a futures exchange under the
2 jurisdiction of both your agencies. We comprehend
3 and appreciate the enormous complexity of the task
4 ahead. On behalf of CBOE, I stand ready to work
5 with both of your agencies and staffs in a most
6 constructive way.

7 Thank you again for this opportunity to
8 testify at this important hearing. I'd be happy
9 to answer any questions you may have.

10 MR. GENSLER: Thank you. I'm just going
11 to mention, all of your written statements will be
12 entered into the record. And Doug Leslie over
13 here is the man with the little clock there that
14 will help everybody try to summarize up and know
15 when the window is.

16 MR. SHORT: Good morning, Chairman
17 Gensler, Chairman Schapiro, CFTC and SEC
18 commissioners. I'm Johnathan Short, senior vice
19 president and general counsel of
20 IntercontinentalExchange, or ICE.

21 We appreciate the opportunity to appear
22 before you today to discuss rule harmonization

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1 between the CFTC and the SEC. As a global
2 operator of both regulated futures exchanges,
3 electronic over-the-counter markets, and
4 clearinghouses, ICE firmly believes in the proper
5 regulation of markets to ensure that market users
6 as well as the broader public have confidence in
7 our markets, and that instruments with similar
8 economic attributes are regulated consistently.

9 In summary, we have three
10 recommendations: That the SEC and CFTC should
11 adopt common core principles that govern
12 regulation, that the SEC and CFTC should take a
13 unified approach to dealing with foreign markets,
14 and that the SEC and CFTC should avoid duplicative
15 or conflicting regulation wherever possible.

16 Given the complexity and continuing
17 evolution of global financial markets, ICE
18 believes that a broad set of core principles
19 governing markets would allow the SEC and CFTC to
20 work toward the common goal of protecting market
21 integrity and reducing systemic risk in markets.
22 Core principles allow financial regulation to be

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1 flexible and prudential. Flexibility is important
2 as it allows regulators to respond to evolving
3 market dynamics and anticipate future problems and
4 -- rather than living by prescriptive regulations
5 that may have been designed to address yesterday's
6 markets and yesterday's problems. To be flexible,
7 regulators must also be prudential, and with an
8 intimate knowledge and understanding of their
9 markets and market participants. Core principles
10 guiding the SEC, the CFTC, and market participants
11 will help achieve these goals.

12 Furthermore, there should be an active
13 and ongoing dialogue between the SEC and CFTC
14 regarding acceptable practices for implementation
15 of these core principles.

16 Second, the CFTC and SEC should take a
17 unified approach to foreign markets. Like many of
18 today's businesses, today's financial markets are
19 global in nature. Providing access to our markets
20 abroad and providing access to foreign markets
21 domestically has greatly benefited end users of
22 markets, offering competition, financial

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1 innovation, and more liquid and robust markets.
2 Against this backdrop, it is important to note
3 that foreign regulators may approach regulation in
4 a different manner than U.S. regulators. And
5 while broad regulatory equivalency should be a
6 requirement for access to United States investors,
7 identical regulation is neither likely to be
8 achievable nor necessarily desirable if true
9 cooperation is to be facilitated. When examining
10 different regulatory regimes for the purposes of
11 recognition, we believe that U.S. financial
12 regulators should focus on whether the regulatory
13 system is comparable, but should not mandate
14 identical regulation. Attempting to impose
15 identical regulation on other countries will only
16 lead to less regulatory cooperation and the
17 potential for retaliation by foreign regulators.
18 Again, a common set of core principles offers the
19 best structure for a unified approach to global
20 regulation.

21 Finally, we would ask that the CFTC and
22 SEC attempt to avoid duplicative regulation and

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1 overlap wherever possible.

2 Thank you, and I'll be happy to answer
3 any questions.

4 MR. DONOHUE: Chairman Gensler, Chairman
5 Schapiro, and commissioners, thank you very much
6 for inviting CME Group to be here with you today.
7 We greatly appreciate the opportunity to share our
8 point of view and provide input to you in your
9 effort to seek harmonization of the regulatory
10 frameworks for securities and futures markets.

11 Commissioner Dunn, we hope not to
12 disappoint you in your expectation of historical
13 consistency.

14 I have a few points I'd like to make,
15 and then look forward to taking your questions.

16 But we agree with those of you who have
17 expressed the point of view that harmonization
18 should be defined by its goal. We certainly
19 support harmonization in areas that will fill
20 regulatory gaps, particularly those that are the
21 result of congressional exemptions. And we
22 certainly support the effort to harmonize in areas

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1 that will cause the two agencies to work better
2 together and to function better together in the
3 protection of investors and in facilitating
4 innovation and competition. In particular, those
5 areas that relate to hybrid products as well as
6 the new framework for rules governing the trading
7 and clearing of OTC derivatives instruments.

8 CME Group does not favor and support
9 harmonization efforts that make regulation
10 identical, given the substantial differences in
11 the nature and scope of securities and futures
12 markets. We believe these markets are actually
13 highly dissimilar in material respects in terms of
14 their function, products, customers, and the
15 customer protection requirements that are
16 necessary to facilitate utilization of these
17 markets, as well as the basis upon which we
18 fundamentally compete and innovate in the global
19 marketplace.

20 While the harmonization goal as we
21 define it could be valuable, it is equally
22 important, in our view, that we be cognizant of

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1 the prevailing regulatory standards in foreign
2 markets in which we compete. Any outcome here
3 should, in our view, ensure our ability as U.S.
4 securities and futures and options exchanges and
5 U.S.-based financial intermediaries to compete in
6 the global marketplace.

7 Thank you, and I look forward to taking
8 your questions.

9 MR. LEITNER: Chairman Schapiro,
10 Chairman Gensler, I'm very honored to be here
11 before you today. This is an historic meeting.

12 My name is Tony Leitner. I am
13 unsuccessfully retired, in that -- having worked
14 in this area for 30 years, first at a major
15 investment bank and now for a stock exchange, I
16 think I've been at the heart of many of the issues
17 that you are discussing and addressing in these
18 very historic hearings.

19 I'd like to forget my remarks and just
20 touch on a couple of key points. First of all, I
21 want to give the intermediary perspective, and
22 also a bit of what I would call the plumbing

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1 perspective.

2 The intermediaries, broker-dealers and
3 FCMS, and also clearinghouses, play a critical
4 role in our financial markets. And the point I
5 want to make, very simply, is this, and it relates
6 to so-called portfolio margining. By portfolio
7 margining I really mean the ability for a market
8 and financial intermediary to provide to a
9 customer a comprehensive ability to bring their
10 assets together in one place and to make sure that
11 they are -- if leverage is going to be given at
12 all, that it's done in an efficient and safe way,
13 and a monitored way. Over time, we have not in
14 this country had the ability to create a
15 comprehensive portfolio margining regime for
16 intermediaries. For broker-dealers or banks, for
17 that matter. So-called cross margining, the
18 ability to include futures and securities products
19 together, is one piece of that. It's not the only
20 piece because -- but we've approached this so far
21 incrementally. Right now, we have a portfolio
22 margining regime in this -- federal securities

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1 markets; it does not include futures. I say fix
2 that.

3 It does not solve the comprehensive
4 problem because we've still got to be able to get
5 more product within an account that's being
6 provided by an intermediary for a customer.

7 And by the way, we're talking about
8 wholesale business here. When we talk about
9 protection of investors, we're really talking
10 about those folks who really use credit as part of
11 what they do, hedge funds and so forth. That
12 business went to London. And when Lehman Brothers
13 blew up, there were a lot of very unhappy
14 investors who had used Lehman Brothers for their
15 goals and haven't got their money back yet. It is
16 a shame that the United States did not have a
17 regime that could provide a service in a -- so
18 it's, for me, it's a systemic issue, and it's a
19 customer protection issue.

20 I think that the debate about whether we
21 have a one pot or two pot model, I'm a one pot
22 guy. I think that at the intermediary level, it's

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1 important to put everything in one place. I think
2 at the clearing level, it's also good to be able
3 to have agreements among clearinghouses so that
4 you can reduce risk to clearing firms that have
5 offsetting positions in these environments.

6 Finally, hope you'll redesign the table.
7 Because I think that you're going to need more of
8 these kinds of joint meetings in the future. I
9 agree with Commissioner Chilton, it's always a
10 matter of getting the right people in the room to
11 have this conversation.

12 Thank you.

13 MS. NAZARETH: Thank you. I'm Annette
14 Nazareth. I'm a partner in the law firm of Davis
15 Polk & Wardwell. And I was previously at the
16 Securities and Exchange Commission as a
17 commissioner and running the division of what is
18 now known as the Division of Trading and Markets.

19 As you probably know, this isn't the
20 first time that the agencies have been instructed,
21 in the absence of clear congressional guidance, to
22 reconcile the differences in your regulatory

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1 approaches. In the year 2000, the agencies were
2 required under the CFMA to jointly craft rules
3 that would apply to single stock futures,
4 including comparable margin requirements and
5 regulatory filing requirements. But remember that
6 during that period, the CFMA propelled the CFTC
7 towards a more principles-based approach. And at
8 the same time, the SEC, in the wake of Enron and
9 WorldCom, was compelled in a Sarbanes-Oxley
10 environment to extend its more prescriptive,
11 rules-based approach to regulation. So factors
12 outside of your control have contributed to the
13 differences in your approaches.

14 So though born in the same jurisdiction,
15 the regulatory regimes of securities and futures
16 have distinctly disparate statutory parents. And
17 frankly, until Congress or the administration is
18 willing to make some very difficult policy
19 choices, the SEC and the CFTC, I fear, will
20 continue to struggle to find common ground under
21 some very different statutory mandates and
22 regulatory philosophies.

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1 My own view is in an ideal world
2 Congress should have reconciled these issues and
3 probably have merged the agencies and let you
4 reconcile some of these differences from within.
5 But that is not where we are today and so I
6 applaud you in doing the best you can in trying to
7 reconcile these differences.

8 I comment on a number of issues in my
9 prepared statement. The four issues I cover for
10 harmonization are investor protection standards,
11 insider trading prohibitions, customer protection
12 in margining, and fungible products and common
13 clearing. I'll just make a few remarks about each
14 of those issues.

15 With respect to investor protection
16 standards, I note again the interesting dilemma
17 that we now face in this area. Just as the
18 administration is recommending in its legislation
19 that the SEC raise the standards, the customer
20 protection standards for broker-dealers, from a
21 suitability standard to a fiduciary standard,
22 you're now being asked to reconcile with the

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1 standards of FCMs, which are really quite
2 different; that really just require disclosure and
3 do not provide for investor protection standards
4 in anywhere near the same way. So again, you find
5 exogenous forces moving you in opposite directions
6 while you're being told to reconcile these things.

7 Likewise, I think the insider trading
8 prohibitions are very important. And given the
9 plethora of financial futures products that are
10 linked to securities, I think it's very important
11 that insider trading prohibitions apply in all the
12 appropriate instances.

13 With respect to customer protection in
14 margining, I certainly couldn't improve on what
15 Tony Leitner said in that area. But I also cover
16 that issue in my remarks.

17 The area that I think is important to
18 focus on today, and I don't have too much time to
19 talk about it, is the issue of fungible products
20 and common clearing. Again, this is a very
21 important area as we are moving towards the
22 possible exchange trading and mandatory clearing

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1 of over-the-counter derivatives. We have a highly
2 competitive securities and options market where we
3 have a common clearing mechanism where it has
4 resulted in multiple competing markets.

5 What we see in the futures markets,
6 really, in my view, is quite different. These key
7 features of fungibility and common clearing, or at
8 least linked and coordinated clearing, are not
9 found in the futures markets. Futures trade in a
10 single listing environment. The exchange on which
11 the particular contract trades controls the
12 clearing of that contract. And even if contracts
13 with identical terms are traded in different
14 exchanges, they are not fungible. So each
15 exchange operates in a silo with no way for a
16 member to offset margin obligations by taking into
17 account positions in correlated financial futures
18 traded on different markets.

19 I do commend to you the Department of
20 Justice comments to the Treasury Department from
21 2008 that address this issue. And I do think it's
22 something that the CFTC should focus on as we move

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1 towards even greater exchange trading and
2 clearance settlement of over-the-counter options.

3 Thank you. And swaps.

4 MR. BAGGESEN: Good morning. My name is
5 Eric Baggesen. I'm here from CalPERS. Thank you
6 to Chairman Schapiro and Chairman Gensler and all
7 the commissioners for letting us participate in
8 this meeting.

9 First, CalPERS is obviously a large
10 public investor. We represent 1.6 million plan
11 participants. Our asset size is somewhere in
12 excess of \$180 billion, depending on what the
13 market's doing today. And we actually contribute
14 in the form of benefit payments over \$10 billion a
15 year to the California economy.

16 The recent market events and our
17 society's response to these events have
18 demonstrated the fact that we have shifted the
19 risk to society of, in many instances, bad
20 decisions. That shifting of risk requires us, in
21 order to avoid the moral hazard attached to that,
22 it requires us to have much stronger regulatory

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1 coordination and response. We see no way to
2 mitigate the potential uncontrolled leveraging and
3 risk taking that can spring from this transfer to
4 the general public of the events that have
5 happened.

6 So if you look at an instance, for
7 example, such as AIG, the government has stepped
8 in with more money to support AIG than was paid to
9 clear up the entire savings and loan mess that
10 happened back in the '80s. And these instances
11 have all sprung from the same kinds of attributes:

12 Excess of leverage, questions on
13 creditworthiness, and duration mismatch between
14 the types of instruments that are there. So we
15 see your institutions as being the regulatory
16 entities that are going to have to walk in to this
17 breach to protect us as taxpayers and just members
18 of our society from the kinds of unmitigated
19 risk-taking that can be demonstrated.

20 The risk-taking has stemmed from the
21 over-the-counter derivatives market. In this
22 area, the lack of transparency has made it almost

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1 impossible for us as market participants to really
2 understand the risks of the entities that we do
3 business with. So we see this task of regulatory
4 harmonization as one to help us understand that.

5 So our very first objective for you as
6 regulators seeking to help our society move to a
7 better place is really transparency. If you can
8 create transparency, we think you'll be a success.
9 We are in favor of universal registration of
10 market participants. We think that all market
11 participants need to be able to be identified to
12 your regulatory entities. We also have a great
13 affinity for organized markets, if for no other
14 reason than simply to trade reporting mechanics
15 that are attached to those markets and the
16 transparency that engenders from them.

17 We also like clearinghouse settlement.
18 The clearinghouses have done an extremely good job
19 of assessing creditworthiness, if for no other
20 reason than their extreme risk-adverse nature.
21 They look at all exposure that is happening in the
22 marketplace and understand exactly the obligations

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1 that they have to meet. And they demand that
2 there is sufficient collateralization to meet
3 those obligations. They understand that moment by
4 moment. They have been extremely effective in
5 that area.

6 Certainly, when we look at some of the
7 failures of the credit rating agencies in
8 assessing the risk attached to many of the
9 participants in the marketplace, we really see a
10 divergence between how the credit rating agencies
11 and the clearinghouses have been able to deal with
12 it.

13 Our second objective for your regulatory
14 harmonization would be effectiveness. If you are
15 going to be effective, again, we believe
16 transparency is the very first measure of that.
17 We also believe that the ability to bring together
18 your enforcement actions and registration
19 activities certainly can help with effectiveness.

20 As a market participant, we transact in
21 the underlying securities markets. We also
22 transact in the futures markets. We see those

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1 economic exposures being one in the same, and yet
2 we are approached by your organizations in the
3 marketplace from two very different regulatory
4 environments. So we believe that you need to be
5 able to look past the instruments that you
6 regulate and understand the economic exposure and
7 the actual purpose of the exposures that are taken
8 by market participants. By doing that you'll
9 better understand what we do in positioning our
10 portfolios, which will help you in that whole
11 regulatory and enforcement regime.

12 And then the last objective that we
13 would have for your organizations is one of
14 efficiency. Obviously, a single point of
15 registration for entities would be extremely
16 useful.

17 There are so many opportunities in front
18 of you to take advantage of the strengths and the
19 differences between your organizations to bring
20 greater efficiency to this marketplace. We would
21 really like to be able to approach the market and
22 deal with one form of registration that seeks to

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1 provide that information across the entire arena
2 that you cover without having to have redundant
3 forms of activity.

4 And beyond that, we applaud the task
5 that you have taken on. We think that anything
6 less than a complete partnership between your
7 organizations will not bring us to the place that
8 we need to be.

9 Thank you.

10 MR. GENSLER: Thank all of our
11 panelists. We're going to each take now five
12 minutes of questioning. So I'm going to try to be
13 very efficient with my own.

14 I read all of your testimonies; they
15 were excellent. I can't tell you whether any of
16 them are in my daughter's book bag to school
17 today. It was a very late night. She was up at 1
18 o'clock anxiously fluttering about her first day.

19 But there were a number of issues that
20 crossed all of the testimonies that I saw, and I'm
21 going to focus on one collection, but hope that
22 others will get to issues of product approval and

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1 some of the inefficiencies of product approval;
2 some of the sales practices and insider trading;
3 many of the key issues of enforcement and so
4 forth. But I saw it, I think, in five of the six
5 panelists. I don't know if the Cal.

6 MR. DONOHUE: PERS testimony had this
7 about margining and cross-margining and portfolio
8 margining and related issues of fungibility. Did
9 I read correctly that all -- at least five, from
10 Annette down to Bill -- that all of you are for
11 some form of cross-margining and portfolio
12 margining if we could work it out and maybe work
13 with Congress? Is that a -- that's a yes from --

14 MR. LEITNER: That's a yes from me.

15 MR. GENSLER: That's a yes from Mr.
16 Leitner. Craig?

17 MR. DONOHUE: It depends on how you do
18 it.

19 MR. GENSLER: Okay. The devil is in the
20 detail.

21 MR. DONOHUE: It always is.

22 MR. SHORT: My answer would be the same

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1 as Craig's. I think you've got to ensure, you
2 know, proper risk management at any clearinghouse.
3 And it could be worked out, but we'd need to see
4 the details.

5 MR. GENSLER: Okay, so rigorous risk
6 management at the clearinghouse.

7 MR. BRODSKY: I look at it as a national
8 competitive imperative from the point of view of
9 the U.S. financial markets, that we are so far
10 behind the rest of the world in that area.

11 MR. GENSLER: And is the key issue -- is
12 this fungibility issue for the CMA? I mean,
13 that's like at the core of your business. And Ms.
14 Nazareth would say to have fungibility in the CMA
15 would probably say not to have it?

16 MR. DONOHUE: No, not as it relates to
17 cross- margining. Hopefully, we'll have an
18 opportunity to talk about the realities of
19 fungibility in futures versus security markets.
20 But on this particular topic that you're asking
21 about, I think it would be very difficult to
22 achieve a cross- margining mechanism that will

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1 work if we don't first deal with the underlying
2 customer protection and bankruptcy and capital
3 computation issues. I think if those can be
4 solved I think that this becomes much easier. But
5 I think we'd be probably foolish to think that we
6 could get easily to a cross-margining regime that
7 will work well because fundamentally the issues
8 are customer protection issues given the
9 differences between securities and futures
10 markets.

11 MR. GENSLER: So, is it your point of
12 view that this relates to making sure that we have
13 the same segregation rules and how it relates to
14 those customer protection and the related SIPC?

15 MR. DONOHUE: Well, what we've proposed,
16 Chairman Gensler, is that we allow these positions
17 to be retained in separate accounts so that we can
18 gain the existing benefits of the separate --

19 MR. GENSLER: You might want to pull the
20 mike closer.

21 MR. DONOHUE: Yeah. What we've proposed
22 is that these be retained in separate accounts so

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1 that we cannot have to deal with the complexities
2 of the different customer protection regimes, both
3 of which have their merits and work well for the
4 securities versus the futures markets, but that we
5 effectively allow the cross-margin credits that
6 would exist to be allocated to the different
7 accounts on the basis of the differences and the
8 contracts and the risk management methodologies
9 that are used. We think it's a very effective,
10 you know, two pot approach that can work.

11 MR. GENSLER: At risk of my time running
12 out, did either Annette or Tony -- I'm sorry, I
13 know all of you. I mean, Tony, I remember 30
14 years ago you were teaching me things. You still
15 are teaching.

16 MR. LEITNER: I'm still trying. Trying.
17 Look, I mean, the fact of the matter is that
18 broker-dealers are in the credit extension
19 business; that's what they do. And firms that
20 deal with this at the wholesale level want
21 everything to be in one place so that they can see
22 it all. It's inefficient to have two pots because

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1 if you have a client with offsetting positions --
2 S&P, securities, and short futures -- what you're
3 going to have to do is -- what's going to happen
4 is that the client on a particular day is going to
5 have no exposure, and yet have exposure to the
6 futures exchange. The broker-dealer is going to
7 have to lend the money to make that payment
8 because -- and create a debit.

9 If you do it in a single account, it is
10 important, still, to protect futures customers at
11 the clearing level. We have to make sure that
12 there is integrity there. But as long as there is
13 certainty of result to the customer and to
14 customers of the broker-dealer in the event of the
15 insolvency of the broker-dealer so that everybody
16 knows what's going to happen.

17 And by the way, Craig is absolutely
18 right. We need to look at that and be sure that
19 the answer to that is yes, we know what's going to
20 happen. Then we're okay. One pot is better.

21 MR. GENSLER: Let me just ask as my time
22 is going to be up.

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1 How much of this relates, in a sense,
2 the difference between the panelists, also to the
3 difference in the cultures that the CFTC -- we've
4 been -- we take the words risk-based portfolio
5 margining to mean one thing. Congress actually
6 wrote that into statute a year ago, that we were
7 to work together to jointly write rules on
8 risk-based portfolio margining, but it may be that
9 culturally inside the SEC the same words mean
10 something different to the SEC. Or is that not
11 wrapped up in this issue?

12 Annette? And then I'm going to hand
13 over to Chair Schapiro.

14 MS. NAZARETH: I think it's probably
15 easier to reach consensus on how you perform the
16 portfolio margining, although, admittedly, the
17 exchanges use different methods and have invested
18 in different systems. I think that's a different
19 issue from one pot/two pot, which I see as frankly
20 more of a friction on the system to have two pots
21 and its more Byzantine approach to the issue. I
22 don't see any reason why once you decide on a

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1 methodology for doing portfolio margining why it
2 couldn't be done in a single place. It leads to
3 much greater efficiency. You get the benefit of
4 the offsets and I think two pot would be extremely
5 difficult to implement, which is why it's taken so
6 long.

7 MR. GENSLER: I'm supposed to hand over
8 to Commissioner Dunn. Actually, Chairman Schapiro
9 gets to be cleanup hitter here on this.

10 MR. DUNN: As you can see, we're all
11 having our own little turf battle up here. We're
12 not used to being squeezed into this tight place.

13 I had indicated to Mr. Donohue and Mr.
14 Brodsky that I was going to ask them to amplify a
15 bit on the one pot/two pot question which you
16 opened up, but let's continue in this vein because
17 I think this is extremely important. So, if you
18 two would like to go ahead and amplify a little
19 bit and then continue on.

20 MR. DONOHUE: I'd be happy to do that.
21 I think, again, back to the fundamental point of
22 this being a customer protection issue, you know,

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1 wholesale professional financial institutions that
2 are futures customers don't want an insurance
3 protection regime. What they want is the
4 continuation of their exposures in the market and
5 the portability of their positions and the
6 protection of their positions in a bankruptcy
7 situation or an insolvency situation involving
8 their financial intermediary. So this is a
9 fundamental issue.

10 We're all in agreement that
11 cross-margining arrangements could be beneficial
12 and useful, but we have to respect the fact that
13 the futures customer base isn't interested in an
14 insurance scheme. We've had a multiplicity of
15 market events over the last 35 years where the
16 futures market has functioned extremely well in
17 terms of central counterparty clearing, largely
18 because they have the ability to continue their
19 exposures without disruption; they have the
20 portability of their positions; and they have the
21 segregation and protection of their funds,
22 property, and positions in bankruptcy.

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1 So, without resolving that, the only
2 realistic way in which you can achieve a
3 cross-margining program that will make sense,
4 unfortunately, is a two pot approach. It is a two
5 pot today. It's no different. So you can argue
6 for those efficiencies, but what you lose in
7 gaining the efficiencies of a single pot is the
8 whole mechanism that makes the futures market
9 work.

10 MR. LEITNER: Good. Can I just quickly
11 comment?

12 MR. DONOHUE: I just have one last
13 comment to make and it relates to Bill's comment
14 about sort of global competition. Frankly, I
15 don't think that cross-margining is really the
16 issue for us in terms of our competitiveness on a
17 global basis. It's the margining methodology. We
18 use risk- based margining in futures markets, as
19 you well know and understand, and we still have
20 strategy-based margining largely in equity options
21 and cash index options markets, notwithstanding
22 the fact that the vast majority of foreign options

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1 exchanges that trade cash index options as well as
2 equity options employ portfolio-based risk
3 margining methodologies. That's not a
4 harmonization; that's an issue of getting
5 contemporary with the methodology that is
6 prevailing in the marketplace on a global basis.
7 That's a far more important global competition
8 issue than cross-margining in a one pot/two pot.

9 MR. DUNN: (inaudible) then I'll come
10 back.

11 MR. BRODSKY: I guess I would say I have
12 a very different view. That is that, first of
13 all, I think that the goal of this hearing and the
14 work that you're doing should be decided from a
15 strategic point of view. What is the best thing
16 for the financial services sector of this country
17 to have? What's in the best interest of
18 customers? And where do we fit in terms of the
19 international competition?

20 My view is that, yes, it is complicated
21 to reconcile the difference between SIPC
22 legislation and traditional futures. But that

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1 doesn't mean it can't be achieved. These things
2 -- I think if we say this is what we think is the
3 goal, the question is then how do you solve the
4 goal rather than saying these are problems,
5 therefore, let's find a less efficient approach.

6 I also would add that if you look
7 outside the country the standard is a one pot
8 approach; it's not a two pot approach. In fact, I
9 would question whether there is any place outside
10 the U.S. where there is even a two pot approach.

11 The second thing is customers don't have
12 to have all their positions in one pot if they
13 choose not to. If they prefer to keep their
14 futures position in a futures account at a FCM,
15 that's their business. If they want to keep it in
16 a new one pot approach, that's their choice.

17 Secondly, I totally support the concept
18 of creating portfolio margining as a standard in
19 the industry. And, again, it's up to the firm and
20 up to the customer whether they will grant
21 portfolio margining for any particular customer.
22 So, I think that there are a lot of flexibility,

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1 but this is a situation where we should be looking
2 outside our borders and understand what exactly is
3 the standard internationally. In fact, I've
4 talked to people who've said to me every bit of
5 these products and positions we can move -- and
6 when I say move, the economics of a customer
7 account that we can move outside the U.S., we move
8 outside the U.S. Do we want to encourage our
9 customers from our brokerage firms to have
10 positions in London or economic relationships in
11 London when they should be here? And the answer
12 is no, but we have forced it away from ourselves.

13 And lastly, I would say that there's a
14 big difference between the portfolio margin
15 discussion and what I would view as the
16 cross-margin discussion. I think we have to look
17 very carefully from a systemic point of view of
18 having like or comparable positions that offset
19 each other in various clearinghouses be able to
20 maximize the offsets that exist. And I'm talking
21 about positions between a Russell future, for
22 example, and a Russell option at the CBOE and at

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1 the Merc. These things ought to be
2 cross-margined; some are and some are not. And I
3 think that when we talk about these concepts
4 you've got to look at the difference between a
5 portfolio margining which is a customer account
6 and cross- margining between one product in one
7 clearinghouse and a similar product at another
8 clearinghouse.

9 MR. GENSLER: If it's brief.

10 MR. LEITNER: My mike isn't working, but
11 if I could --

12 My suggestion in my paper is that the
13 next incremental step is for the CFTC to say it's
14 okay for futures customers to waive segregation
15 and allow the positions to be carried in a futures
16 account. That will require some legislation to
17 clarify the role of SIPC in this process to assure
18 we have certainty at the intermediary level.

19 I've also suggested, which was an idea
20 that only recently occurred to me, that we just --
21 the SEC allow the expansion of folks who can use
22 the current -- there is a cross-margining and

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1 portfolio margining regime today for professional
2 option market makers. The capital rule deals with
3 it. It works. The operations guys love it. It
4 works even with a single pot at the clearing level
5 among the clearinghouses. So, the SEC could
6 expand that.

7 In any case, these are incremental
8 steps. It just takes us to the next level and
9 that allows us to really look at what needs to be
10 done as you bring in all these other products,
11 which is going to happen at the next level of
12 derivative regulation.

13 MR. GENSLER: Thank you, Commissioner
14 Dunn. Commissioner Casey?

15 MS. CASEY: Thank you, Chairman Gensler.
16 I'd like to kind of step back a little bit and
17 touch on something that I think Mr. Short
18 mentioned and others, which is this notion of a
19 sort of common core set of principles to guide us.
20 And perhaps it also gets to the specifics of what
21 we've just been discussing here with respect to
22 the one pot/two pot approach. But I was just

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1 hoping that each one of you could identify in your
2 view what the key common core principles are that
3 should guide us in terms of how we look to
4 basically regulatory principles. And I want to
5 see whether or not there's a commonality in that
6 first instance because I think that ultimately
7 then gets to the question more specifically.

8 In key areas we talked about
9 suitability. We've talked about margining. We've
10 talked about registration questions. I'd also
11 like each one of you to identify in some of these
12 key areas where you think that either the SEC or
13 the CFTC approach is consistent with those
14 principles.

15 MR. BRODSKY: If you're looking to me,
16 Commissioner Casey, I would say to you that the
17 CFTC went through an enormous transformation as a
18 result of the CFMA to go from what I would call
19 the micromanaged approach that had existed
20 previously to the core principles. And I don't
21 have the CFMA in front of me, but I think that as
22 it relates to securities markets and securities

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1 markets structure, we would have to sit down --
2 I'm not prepared to give you that list right now
3 -- sit down and design something that is a radical
4 departure from the way the SEC has operated since
5 the '75 Act amendments, which required exchanges
6 to file every single thing they do every time they
7 want to do it, to a point where we have core
8 principles on fundamental issues of transparency,
9 competitive issues, et cetera.

10 And as I recall, the White Paper
11 actually tried to strike a little bit of a balance
12 where they said the SEC should have much more of a
13 core principles approach and the CFTC should get a
14 little bit further away from the current
15 standards. So, the SEC has to go maybe two-thirds
16 of the way in one direction and the CFTC about
17 one-third in the other direction.

18 So I don't have that list for you now
19 and I think that would be something that we would
20 have to sit down with the SEC and other SROs. I
21 would say this, though -- that in the case of the
22 option markets, which are subject to enormous

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1 competition among themselves, we have to, I think,
2 draw our distinctions between, say, new products
3 and existing market practices because I think
4 there is a bit of a difference in terms of how
5 exchanges make changes to their rules and changes
6 to trading systems that may be different than the
7 new product area. I think the new product area
8 really relates to more is it a security or is it a
9 future and the speed in which things are processed
10 which I think are very different than what I would
11 call trading mechanisms that exist today.

12 So those are two areas that I think
13 might apply. But I think that's another level of
14 discussion I think we would have to come back to
15 on.

16 MR. SHORT: I would echo some of what
17 Bill just said. I think a core principles
18 approach is the way to go and I think the CFMA has
19 been very successful in that regard in terms of
20 fostering competition and product innovation. I
21 think in looking at the core principles that
22 should be applied, I think the IOSCO core

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1 principles are a good starting point because
2 ultimately we're not just talking about a set of
3 core principles that make sense here, but across
4 jurisdictions. Because if you're really going to
5 get at the foreign competition issue, I think a
6 high level of regulatory equivalency is certainly
7 appropriate.

8 MR. DONOHUE: I would agree with my
9 colleagues that I think if you could find some
10 common principles towards adopting a
11 principles-based approach versus a prescriptive
12 rules-based approach at least for exchanges -- if
13 not also intermediaries -- would be highly
14 valuable. I think that if you could agree on a
15 common margining methodology and hopefully
16 risk-based portfolio margining -- which, again, if
17 you were to look at the methodologies that are
18 employed on a global basis with very successful
19 and highly well-regulated exchanges would be
20 portfolio-based risk margining versus
21 strategy-based -- that could be very useful.

22 As you're contemplating the rules and

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1 policies and frameworks that you will seek to
2 jointly apply to over-the-counter derivatives
3 markets in terms of central counterparty clearing
4 services, a common set of standards and procedures
5 that can be used by both registered securities
6 clearing agencies subject to the SEC's
7 jurisdiction as well as for derivatives clearing
8 organizations subject to the CFTC's jurisdiction I
9 think would be very useful and hopefully without
10 joint regulation by both agencies of those
11 entities.

12 And then lastly, another area that I
13 think could be useful is for the SEC to move
14 toward embracing a more globally competitive model
15 like we have in the futures markets. As you know,
16 for the last 12 years, I think, the CFTC has
17 recognized comparable foreign regulation
18 frameworks in order to allow foreign exchanges to
19 compete and list products that are traded on
20 domestic exchanges. While I agree that the
21 securities markets are highly competitive in the
22 U.S., they are a national market system. They're

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1 a domestic market. In the case of futures
2 markets, we have commodities that trade very
3 actively that are our same products in Dalian,
4 China. We have treasury contracts that are traded
5 in Germany; Eurodollar interest rate contracts
6 that are traded in London; and we have energy and
7 metals contracts that trade very competitively
8 with us in the London market as well.

9 So, that would be another area where I
10 think we could see an increase in competition in
11 the securities markets. You can find a lot of
12 examples of those products trading on foreign
13 exchanges in the futures markets. You can't find
14 an example where a NYSE- or NASDAQ-listed security
15 or call option or put option is traded on a
16 foreign exchange.

17 MR. GENSLER: I'm going to ask is there
18 anything that you're adding that's different?
19 Just to try to focus on that.

20 MR. LEITNER: Yeah. Actually, there is.
21 Two things.

22 Number one, I think the key area to keep

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1 in mind is, in both harmonization and principles
2 issues, is what are the standards going to be?
3 And by that I mean, for example, in risk
4 management should there be a common approach to
5 how you manage risk both at the intermediary and
6 clearing level?

7 I think the answer to that is it would
8 be good to do. It's a systemic issue.

9 The other is it's fine to have
10 principles, but to the extent that in the
11 marketplace each of your regulators are performing
12 what is essentially a referee function on
13 competitive issues there is, I think, a question
14 of whether this is an area where you take
15 different versus common approaches to the referee
16 function. Exchanges compete against each other
17 and sometimes, you know, they will use the other
18 guy as an example of what is bad for the market.
19 And that may be accurate. But those kinds of
20 disputes put the agency in a referee position.

21 What principle do you apply in being a
22 referee? And are they the same in both markets?

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1 I think those are -- that's an interesting --
2 that's actually a harmonization issue. I think
3 that was different.

4 MS. NAZARETH: I have to say briefly
5 certainly principles such as fostering fair and
6 efficient markets would be key. Fostering
7 competitive markets -- and as I said, I think
8 there are some real differences in how that goal
9 has been applied by the two agencies, certainly
10 from a market structure standpoint. I think the
11 securities markets have fostered much more
12 effectively the goal of multiple competing
13 markets.

14 Certainly, mitigating systemic risk has
15 to be at the top of the list and investor
16 protection issues. Avoiding regulatory arbitrage
17 is going to be very important in all instances.
18 And I just wanted to clarify that on the portfolio
19 margining front I think it's pretty clear that the
20 SEC has also embraced portfolio margining. It is
21 not just using strategy margining anymore. There
22 are clearly differences in how that is being

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1 applied at the two agencies, and I think those
2 differences could be bridged. But I don't think
3 that we're looking at a situation where it hasn't
4 been endorsed or applied by the SEC.

5 MR. BAGGESEN: Very short comment.
6 We're talking about an awful lot of structure
7 that's down in the weeds. As a portfolio manager
8 and as an investor in the marketplace, we need you
9 to move this discussion upstream. We need all of
10 the derivative instruments brought under your
11 purview.

12 The whole issue of, for example, whether
13 you're margining in the securities market or the
14 futures market, we as an investor have figured out
15 how to manage those cash flows and how to deal
16 with those competing areas. Certainly, the
17 efficiency of moving to a single system would be
18 wonderful. You cannot do that if you cannot look
19 at the entire portfolio of exposure. Without that
20 ability and without complete transparency this is
21 a pipedream. So you really need to move this
22 upstream and make sure that you're somehow

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1 bringing the entirety of my portfolio exposure
2 under your view before you can even move on to
3 some of these discussions.

4 So that would be my short comment.

5 MR. GENSLER: Thank you, Commissioner
6 Casey for getting all the witnesses. It's very
7 good.

8 And we'll try to keep it upstream and
9 out of the weeds, in one pot and two pot and so
10 forth.

11 Commissioner Sommers.

12 MS. SOMMERS: Thank you, Chairman
13 Gensler. It's hard to decide where to start
14 because there are so many different issues that
15 have already been talked about. So I'm going to
16 start with just one clarification I really am
17 unfamiliar with and it was something that Mr.
18 Brodsky was talking about with the international
19 standards on portfolio margining.

20 When you talk about what the global
21 standards are, you talked about they use a
22 risk-based approach and they all use a one pot

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1 approach. And I think I heard that right. Is
2 that --

3 MR. BRODSKY: I think that's a fair
4 statement.

5 MS. SOMMERS: Okay. And so what do they
6 -- how do they approach insolvency regimes? What
7 kind of insolvency rules? Is it more like an
8 insurance protection?

9 MR. BRODSKY: No, I think that's where
10 we get back to the devil is in the details.

11 We have a system in the United States
12 that has existed for many years for historical
13 reasons. SIPC is a function of the securities
14 industry and how it decided to handle insolvencies
15 of broker-dealers. I'm not familiar with the
16 specifics in different countries. What I'm saying
17 is, as Mr. Leitner said, if I'm a customer --
18 whether I'm in France, or Germany, or England --
19 and I want to put a stock position, an option
20 position, and a futures position on the same
21 account, that's the standard. It doesn't exist
22 the way it does here because of historical

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1 reasons.

2 So I can't give you the bankruptcy
3 rules. I think the problem is that we are the
4 outlier because of the bifurcated system that has
5 existed here since 1975, at least.

6 And I think what we have to do is say
7 that we have customers -- as Mr. Leitner talked
8 about -- who want to have their positions all in
9 one account. And I think it's for us to figure
10 out how to rationalize what we have. But again,
11 it only in my view doesn't require that we throw
12 out everything that we have. If someone says,
13 look, I prefer the current system and don't want
14 to have a portfolio -- my account in one place --
15 no one should deny that of that person. That's
16 not the issue unless somehow you bring the whole
17 thing together.

18 And, again, I think you need people who
19 can sit down and say what is the goal that we're
20 trying to do? If we're going to keep FCMs and
21 futures accounts as separate and securities
22 accounts and broker-dealers as separate, that's

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1 fine. But if a customer comes in and says I have
2 a \$10 million portfolio and I want to keep it in
3 one account at one firm and I don't care about the
4 other issues that exist because I'm making the
5 decision of how I want my money managed -- the
6 same way I do it in London, the same way I do it
7 in Frankfurt, and the same way I do it in Paris --
8 then I'm saying that you should be able to allow
9 that to happen.

10 MS. SOMMERS: Another issue that I find
11 really interesting -- and whomever would like to
12 comment on some more details -- is the issue that
13 Ms. Nazareth brought up about common clearing.
14 And I'm wondering, from the clearinghouse
15 perspective what complexities and how you actually
16 implement being able to clear a number of products
17 that you either don't trade or are not executed as
18 part -- talk about how exactly we could implement
19 that kind of structure.

20 MR. DONOHUE: Well, I'd be happy to
21 address that. And I'm thankful for the
22 opportunity to do it.

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1 I mean, I think this is another case of,
2 you know, the Greeks talking Chinese to the people
3 who are speaking Portuguese because we don't
4 understand each other in terms of the way these
5 markets function. In the securities markets and
6 in the options markets you do have, as I mentioned
7 earlier, a national market system and you happen
8 to have a single clearinghouse for cash equity
9 securities and for equity options and index
10 options. And unlike that market structure in the
11 futures markets, we have a multiplicity of
12 clearinghouses -- not just one -- and that
13 presents a number of complexities for considering,
14 you know, fungibility of positions in futures
15 markets.

16 We have significant differences as well
17 in terms of the basis upon which we compete. As
18 you probably recognize in cash equities and in
19 equity options as well as index options, there's a
20 fairly low level of kind of innovation and product
21 development in those particular products. We
22 often compete on the basis of distinctions in

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1 products rather than the sameness of the products.
2 I think a great example of that is the competition
3 that exists between ICE and CME Group in the
4 energy markets. But when you start to contemplate
5 fungibility in futures markets you have to deal --
6 to your question, Commissioner Sommers -- with the
7 increase to systemic risk potential of, you know,
8 how do you create sort of interoperability among
9 clearinghouses. How do you recognize the credit
10 differences or credit profile differences of a
11 variety of different clearinghouses? How do you
12 deal with the operational risks that are attendant
13 to transferring positions and transferring
14 customer property and funds?

15 In the world that we operate in, given
16 that 90 percent of exchanges that we compete with
17 are clearing their products on or through
18 vertically integrated clearing structures versus
19 horizontal utility clearing organizations, we have
20 to deal with sovereign risk issues and we have to
21 deal with the competitive landscape issues of
22 we're not operating just -- it's not the Merc

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1 competing with the Board of Trade and NYMEX in
2 Kansas City anymore. We're competing on a global
3 basis and those are very real issues and
4 distinctions, both in terms of innovation, in
5 terms of competition, in terms of systemic risk
6 potential that can't just be waived away because
7 it works different in the securities markets.

8 MR. LEITNER: If I could I'd just like
9 to make one quick comment. And that's to
10 distinguish fungibility which is, okay, I put on a
11 contract here and there's another exchange trading
12 a similar contract and it's cheaper for me to take
13 that position off so I'm now economically neutral,
14 but I have positions in two different places. And
15 presumably, the market-to-market payments are
16 going back and forth and I don't even see that.

17 Then there's the issue of what happens
18 if the intermediary goes belly-up, Lehman Brothers
19 goes under, and that situation exists? The
20 systemic risk issue is how do you unwind and net
21 those positions in those two different
22 clearinghouses to cause the least impact to the

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1 system? Okay. So it seems to me we've got to
2 separate what I'd call the systemic risk issues
3 and the issues that Craig Donohue raises are
4 absolutely correct. That is, whenever two
5 different clearing organizations work out some way
6 of kind of common clearing offsetting those
7 positions, they're taking each other's risk.

8 So, in my paper that I've circulated to
9 all of you there is a detailed discussion of the
10 two different ways that clearinghouses have today
11 sought to be able to modify the risks between
12 them. They're very different. If we had a white
13 board we could get into that. But that's the kind
14 of issue that's going to be a little bit more
15 difficult to resolve, but it does need to be
16 resolved. And it is, I think, necessary to bring,
17 you know, kind of technology and operations and
18 risk managers into the discussion first and then
19 the lawyers and the regulators second. I think
20 that risk management is the key issue.

21 MR. GENSLER: Thank you, Commissioner
22 Sommers. We'll try to bring a white board next

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1 time for you.

2 Commissioner Walters?

3 MS. WALTER: Well, I see that our time
4 -- we're already getting into time trouble so I
5 will restrict myself to one question which I think
6 is unfortunately not likely to get us out of the
7 weeds.

8 I'd like to talk a little bit about
9 bureaucratic turf battles and whether -- since
10 we're in a situation where we have dual agencies
11 and there are going to be products that seem to
12 straddle the line -- in fact, there are going to
13 be products that do straddle the line -- what
14 suggestions you have as to how best we can cope
15 with those where there are legitimate
16 jurisdictional questions?

17 MR. BRODSKY: Yes, Commissioner Walter.
18 I tried to make a couple of suggestions, both in
19 my oral testimony and in my written in a little
20 more detail. And that is that there is a proposal
21 in the White Paper that would provide a council
22 that I believe would have some authority to deal

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1 with that. Right now we have no legal way to do
2 that other than the agencies ultimately making --
3 coming to some resolution or to end up in the
4 federal courts, which is a multiyear process.

5 I believe that there needs to be
6 something that's hard coated that says if the
7 agencies are going to remain separate and there
8 are differences, that there's a way to resolve it
9 other than through the federal courts. And one
10 way in the short term would be to designate
11 someone -- some part of Treasury to do that, but I
12 think ultimately there ought to be a hard-coated
13 mechanism, be it the council that's proposed or
14 some other mechanism. Because, remember, the
15 report that was put forward was merely a
16 recommendation to Congress; it wasn't something
17 that's going to just happen.

18 But what my experience has been is that
19 there are times -- and certainly the goal of the
20 ETF issue is probably the most glaring -- where in
21 the recent past we made a submission to the SEC to
22 trade an option on a security that was trading

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1 actively on the New York Stock Exchange and NASDAQ
2 and this thing languished for three and a half
3 years.

4 And there was no place we could go to
5 get resolution. And sometimes just because, in
6 our case, the SEC is distracted by many other
7 unrelated issues and this never gets to the top of
8 the pile or because notwithstanding memoranda of
9 understanding, the agencies are just not getting
10 along at that moment in time and therefore,
11 nothing gets resolved. The moment that that
12 product started trading, we were trading hundreds
13 of thousands of contracts a day which meant there
14 was a pent up demand; that we denied American
15 investors; and hence, the U.S. Treasury of
16 revenues that they would have gotten had the
17 product been approved two and a half or three
18 years earlier.

19 So I think that this is something that
20 could come out of this group or out of the
21 Congress. But what I can say is as long as the
22 agencies are separate and as long as we define

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1 securities and futures in a way that doesn't have
2 clarity, there needs to be a resolution process.

3 MR. GENSLER: You're yielding back time.
4 Wow.

5 MS. WALTER: Always being gracious. I'd
6 like to yield it to a CFTC colleague.

7 MR. GENSLER: Then I believe it's
8 Commissioner Chilton.

9 MR. CHILTON: Thanks. You got me, Bill,
10 because I had something else.

11 Shame on us if we can't resolve some of
12 these things. I feel silly because you've been in
13 this industry for decades and played a leadership
14 role. And we've discussed this before and maybe
15 from your perspective we just need adult
16 supervision. But I really hope, and I'm very
17 optimistic with the leadership that we have, that
18 we can resolve these issues without having to have
19 mom or dad step in and help us in the form of the
20 Treasury Department.

21 Talking about all these things -- you
22 know, the staff -- everybody's talked about what a

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1 great job the staff does -- this is, you know, our
2 binder and it differentiates a lot of what we're
3 talking about today between the securities and the
4 CFTC law. And it sort of reminds me of the title
5 of that Clint Eastwood movie, you know, The Good,
6 the Bad and the Ugly. I won't talk about the bad
7 and the ugly, but some of the good that I like in
8 our law -- in the statute is the principles-based
9 approach with specific regard to product approval.
10 It used to take us, you know, six to nine months
11 sometimes to approve products that you all as
12 business people would think would be a good idea.
13 In the meantime, maybe somebody else on a foreign
14 soil would come up with that product and begin
15 offer it. So we were at a competitive
16 disadvantage and I think that's one of the good
17 things.

18 Likewise, I like the SEC's manipulation
19 standard that it just has to be reckless. We've
20 got to actually prove intent. We've got to find
21 an e-mail or a tape of somebody to prove
22 manipulation. So I wouldn't mind having that at

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1 the CFTC.

2 The one thing I'm not sure about though
3 is insider trading. Ms. Nazareth talked about
4 insider trading, and to quote from her testimony
5 she said, "The CEA generally contains no such ban.
6 While this disparity may have made sense when most
7 futures were related to agricultural products,
8 today the overwhelming majority of futures are
9 financial futures. Good public policy," she says,
10 "would dictate the extension of insider trading
11 prohibitions to the futures markets to ensure the
12 integrity of each of the financial markets and to
13 prevent regulatory arbitrage."

14 I'm not so sure I agree with that
15 particular change. I'd like to ask Mr. Brodsky,
16 and Mr. Short, and Mr. Donohue if you'd respond to
17 that specific question.

18 MR. BRODSKY: I think this is a very
19 complex area. I certainly, from my days at the
20 CME, would understand the difference between
21 insider trading in oil or gold where there isn't
22 an issue or per se, versus securities-related

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1 products.

2 My concern on insider trading is that as
3 it relates to comparable products -- which in my
4 case would be securities indexes, broad based,
5 narrow based, or whatever -- that you shouldn't
6 have one very strict standard in one area and zero
7 standard in the other. And I recognize that the
8 issue of insider trading could be very different
9 in a broad based index option versus a narrow
10 based index option. But my focus on insider
11 trading would be comparable products. I think
12 that you can carve out and look at pure commodity
13 products differently. On the other hand, the
14 Treasury market could be viewed as different. I
15 mean, there have been incidents in the Treasury
16 market where people had insider information coming
17 out of the Treasury.

18 So, I think you have to, again, take an
19 intellectually honest approach and say let's clear
20 the table and let's talk about it
21 product-by-product and what makes sense.

22 MR. GENSLER: Thank you.

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1 MR. SHORT: I think that's right. You
2 know, Mr. Brodsky alluded to the difference
3 between commodities markets and equities markets.
4 I mean, when you look at commodity futures, I
5 mean, obviously I don't think an inside
6 information or insider trading regime would be
7 appropriate. I mean, they're primarily risk
8 management markets. People are seeking to hedge
9 price risk and are trading on inside information
10 that they, you know, that they have. But you can
11 see where if you had "like products," one of which
12 was a derivative and one of which was an equity
13 product that you could get to an anomalous result
14 if you didn't have some sort of standard to govern
15 that conduct.

16 MR. DONOHUE: Well, I certainly
17 appreciate the distinction between the equity
18 markets and the commodity and other financial
19 derivatives markets where essentially people are
20 using all the time information that they have as
21 commercial participants in the market as they're
22 entering the futures market and they're bringing

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1 that information to the futures market. And so I
2 don't think you can superimpose the insider
3 trading regime of securities markets on futures
4 markets in any way, shape, or form and have it
5 work.

6 With respect to the distinction on
7 equity securities, I actually don't even
8 understand what the issue or the problem is and
9 I'm trying to understand why you would want to do
10 that. Would a mutual fund or insurance company
11 that has a very large portfolio of S&P portfolios
12 have to disclose to the market what its long term
13 intentions are with respect to its actual
14 ownership base investing in those stocks before it
15 could effectuate hedging or risk management or
16 portfolio management strategies in the equity
17 derivatives market? I would hope not. So I'm not
18 sure, maybe somebody can explain why we need to do
19 that. But it doesn't make any sense to me.

20 MR. GENSLER: Commissioner Chilton,
21 thank you. Commissioner Aguilar?

22 MR. AGUILAR: Thank you. In the

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1 interest of time I'm also going to limit my
2 question.

3 As everyone was speaking in the
4 beginning I heard mostly bullish statements about
5 the potential for harmonization, except -- if I
6 misheard, I apologize, but I thought that Mr.
7 Donohue was a little less bullish about
8 harmonization because of the difference in
9 markets. And if I heard that right, could you at
10 least talk -- not in the weeds -- if we can at a
11 macro level -- about what those fundamental
12 differences are in the markets and whether or not
13 there are abilities to bridge them. Otherwise,
14 there's probably a day and a half -- I can save a
15 lot of people's time.

16 So, if you could address those issues.
17 That's what I thought I heard. And your remarks
18 that you wrote, that will be available to everyone
19 who is interested, do talk about the dangers that
20 you see for more harm than good. And I'd like to
21 give you a chance to flush that out and then maybe
22 have people to either get onboard with you or tell

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1 me why perhaps there is light at the end of the
2 tunnel for harmonization.

3 MR. DONOHUE: Well, thank you for the
4 opportunity to do that. I mean, you know, again,
5 we do support harmonization efforts. There are
6 areas where I think it can be useful. We've
7 touched on a number of them today, but I think
8 it's important to respect the fact that, you know,
9 capital formation and risk transfer markets are
10 functionally fundamentally different in terms of
11 their purpose and scope.

12 People use them for different reasons to
13 achieve different objectives. And so that's a
14 critical distinction between the two.

15 Ownership-based investing in the
16 securities markets is very different than what
17 occurs in the futures markets. The products are
18 different; the market structures are different;
19 the customers are different. We have some
20 overlap, but we tend to have a very wholesale
21 financial market orientation in exchange traded
22 derivatives and over- the-counter derivatives

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1 markets. We tend to have a much larger retail
2 component to the securities markets, as well as
3 the securities options markets. There are many,
4 many, many differences that are endemic to these
5 markets and we've designed regulatory frameworks
6 that respect those differences. Even in other
7 regulatory frameworks, and ours is certainly more
8 bifurcated than many, there's still a need to make
9 functional distinctions between these markets and
10 products for the very reasons of they are
11 different and they function differently.

12 So that's a challenge that any regulator
13 has, no matter what the structure of it is. There
14 are a lot of different models. Those have been
15 studied by all of you, others in government, the
16 private sector. But those distinctions always
17 have to be made. There will always have to be
18 people deciding whether a gold ETF is more of a
19 security or has elements of futurity and perhaps
20 is more of a futures contract. And what's the
21 right way to regulate it? And it may not be the
22 same approach even within a regulator that's a

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1 consolidated regulator.

2 So, those are many of the differences.
3 We respect the fact that there is some value to be
4 gained from harmonization. We're not opposed to
5 that. We're just simply opposed to making things
6 identical just because it would be neat. If it's
7 neat and it doesn't serve the purposes of the
8 market or the customers who use these markets,
9 then it is ineffective.

10 MR. SHORT: I would just echo some of
11 what Craig just said. I think Washington lately
12 has caught a case of loopholeitis. I mean, there
13 is such a push to make sure that everything is
14 completely consistent and buttoned down that you
15 really do need to start at the high theoretical
16 level of what is the difference between the two
17 markets.

18 And, you know, I keep coming back to the
19 futures market being about the future. Right?
20 It's a risk management market where people are
21 speculating about what the future may be. And,
22 you know, that's pretty different from a cash

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1 equities market. And I think it's always
2 important to keep those two differences in mind
3 when you're talking about rationalization because,
4 you know, you could end up hurting both markets if
5 you tried to, you know, make a square peg fit in a
6 round hole.

7 MR. BRODSKY: I have a little different
8 take on that, and that is we are where we are
9 because of the history.

10 And if, again, you go outside the
11 country where there are very vibrant cash markets,
12 futures markets, options markets, they tend to be
13 regulated under the same overall umbrella. That
14 doesn't make it perfect, but I think it helps
15 avoid a lot of the debates that we have. And it
16 probably would be highly instructive for the two
17 Commissions to talk to their counterparts at other
18 countries where they do, in fact, regulate these
19 products through an overarching system, albeit
20 they may look at the risk transfer of products
21 differently than they do the cash ones.

22 But I would certainly point out, even

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1 though I'm here on behalf of CBOE, that the option
2 markets in the United States certainly have more
3 characteristics of risk transfer than they do
4 capital formation, if you want to slice it that
5 way. And, in fact, the option markets from a
6 volume point of view are as large as the futures
7 markets. So I think -- I don't want to find
8 ourselves putting the fact that the futures
9 markets and risk transfer markets and the
10 securities markets are capital formation markets
11 when, in fact, the option markets are trading 15
12 million contracts a day and have as many
13 institutional customers as they have retail
14 customers. I think that that may be why I feel
15 that we're kind of caught in between these two
16 worlds.

17 The other thing I wanted to add, and I
18 think it's critical to the issue of Commissioner
19 Chilton on the insider trading issue, is one of
20 the things that we've all touched on -- and I
21 agree with Craig's earlier comments on the OTC
22 markets -- is that there's a whole world of OTC

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1 derivatives that exist today. And it's not just
2 credit defaults or other kinds of interest rate
3 swaps, but in equity derivatives where there's no
4 regulation. There's no transparency, there's no
5 reporting, and obviously no effect -- ability to
6 do insider trading. And I think if you're looking
7 at the whole picture you must look at and figure
8 out how to get this under the tent in some fashion
9 or you have -- forgetting about whether it's done
10 in the U.S. or abroad, which a lot of our options
11 trade outside the U.S., meaning OTC equity
12 options, that completely elude the regulation.

13 And I think you have to figure out what
14 you're going to do about that because there was an
15 opportunity in 2000 and Congress decided to
16 exclude -- not only exempt, but exclude -- and now
17 you have a question of what do you bring under.
18 And I think it's something that has to be looked
19 at from a point of view of the effect on the
20 existing markets and what exists -- where they
21 lean on our markets to hedge, but, in fact, the
22 regulators have no idea what's going on.

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1 MR. GENSLER: I thank you. And if I
2 could have the opportunity to say I know that
3 Chairman Schapiro and I are both committed to
4 bringing the full over-the-counter derivatives
5 marketplace working with Congress under
6 regulation, as many of the witnesses have said.
7 So I just wanted to make sure we get that once
8 again on the record because that is critical.

9 Commissioner Paredes?

10 MR. PAREDES: Thanks. One of the topics
11 we touched on a little bit, and I think Chairman
12 Gensler mentioned it in passing in his remarks, is
13 the question of new products. Bill Brodsky spoke
14 to that a little bit in response to a prior
15 question and I think a number of you addressed it
16 in your written remarks.

17 I just want to go back to that topic and
18 really just throw out an open-ended question,
19 which is to share the thoughts and, in particular,
20 the concern where the inefficiencies are, where
21 the roadblocks are, and what the consequences are.
22 Certainly, there are consequences for those of you

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1 who run businesses that depend on the ability to
2 offer new products and all the rest, but there are
3 impacts for the marketplace, investors' impacts
4 that may be for the better, but impacts, of
5 course, that may be for the worse.

6 So, if we could perhaps hear in the
7 interest of time from Mr. Short and Mr. Donohue
8 and then others from this end of the table. Ms.
9 Nazareth, I think, has a unique perspective
10 perhaps and, of course, from the perspective of an
11 investor -- that would be great.

12 MR. SHORT: I certainly think that the
13 CFMA -- the changes that were brought into effect
14 by the CFMA and the principles-based approach to
15 the introduction of new products --
16 self-certification by exchanges -- is a step in
17 the right direction. It does allow exchanges to
18 be competitive. We have a very healthy
19 competition with the CME's energy markets. And I
20 think having some of the delays that Mr. Brodsky
21 described earlier in the middle of that would be
22 very problematic.

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1 I understand what you mean. There's
2 obviously a tension there between allowing
3 exchanges to compete on an open playing field and
4 speed products to market and having the proper
5 customer protections in place. One of the
6 recommendations we made in adopting core
7 principles was to have a higher level of
8 prudential regulation where the regulator is
9 sitting down with the exchange and the market
10 participants on a real-time basis and better
11 understanding the dynamics of how the businesses
12 operate and what the products do to get that
13 additional level of comfort to address some of the
14 issues that you're concerned about.

15 MR. DONOHUE: Well, Bill is actually a
16 really good friend of mine so I'm going to show
17 him some empathy on this one, even though I
18 disagree with his solution. But I agree that it's
19 a problem.

20 And so in this area of hybrid products
21 that are both securities and have elements of
22 futurity, we think the sensible approach is

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1 actually to do -- back to my earlier comments --
2 what the CFTC has done for 12 years. And so we
3 have an unusual situation where the CFTC actually
4 will recognize functionally comparable regulation
5 by foreign regulators who want to distribute their
6 products here to U.S. investors. And a great case
7 in point is, you know, FSA- regulated exchanges,
8 like ICE Europe, where it's different. They don't
9 have position limits in the way that we have
10 position limits. I'm not picking on you, but it's
11 different.

12 And we live with many of those
13 differences. It's not the same, but it's
14 functionally equivalent.

15 And I think a great step forward would
16 be for the CFTC and the SEC to think similarly
17 with respect to these hybrid products that are
18 both securities or have elements of futurity and
19 allow an exchange -- bills exchange, securities
20 exchange, an options exchange, and a futures
21 exchange -- to pick the scheme that it wants to
22 use to bring the product to market. End the

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1 disputes; there will be differences. They'll have
2 to pick that. There's probably some risk of
3 regulatory arbitrage, but we live in that world
4 already, at least in the derivatives part of the
5 market. We can tolerate those differences, but we
6 can still innovate and come to market.

7 So I think that would be a smart way for
8 you to think about how to expedite the process of
9 allowing people to bring products to market more
10 quickly. Maybe you'll have a different margin
11 regime if he chooses to do it as a SEC- registered
12 securities exchange; maybe he'll have some
13 advantage if he does it as a futures exchange.
14 He'll have to make those choices. But you should
15 let him make those choices, but you should let him
16 make those choices and then just have one
17 regulator, not two. And then you don't need a
18 tiebreaker.

19 MS. NAZARETH: Well, I can appreciate
20 the issues that Bill Brodsky has had. And again,
21 I think they are rooted in the jurisdictional
22 disputes, unfortunately, with the industry bearing

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1 the brunt of the, you know, lack of clarity. I
2 mean, it may well be that for some of these hybrid
3 products just as with single stock futures, they
4 should be able to trade in both options and
5 futures markets because it always seemed to me
6 that one of the challenges -- again, because of
7 the differences in market structure -- was why do
8 people passionately care about any of these
9 things? They care about it because there's a lot
10 of money involved. And if the product was on the
11 futures side, frankly it tended to not be
12 competitively traded. It would ultimately migrate
13 to a single market in the futures markets. All
14 the markets -- in the options markets, all the
15 markets had to compete in that space.

16 And so it seems to me, likewise, let a
17 thousand flowers bloom. If some of these products
18 bear, you know, attributes of both securities and
19 futures, let them trade as both, but let both
20 types of markets trade them. And again, see what
21 works out to be best for investors and where you
22 can get the most efficient pricing.

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1 MR. LEITNER: Just to remind you if I
2 could that on securities exchanges there will be
3 an issuer of the product. On futures exchanges
4 the contract is initiated by the exchange and then
5 it goes directly to clearing. So, that is a
6 difference that, I guess, has to be respected.

7 MR. BRODSKY: Actually, I don't think
8 that's completely correct, Tony. It would be an
9 issuer if there is actually a corporate issuer. I
10 mean, the case -- for example, one of our greatest
11 recent innovations was trading volatility and VIX
12 options and VIX futures. We traded the futures
13 through the CFTC and the option through the SEC.
14 And the issuer is technically the option clearing
15 corps, but it's really not the same. And the
16 creation of the option clearing corps as the
17 issuer is really a legal fiction that the SEC
18 forced upon the options industry in the early
19 days.

20 MR. LEITNER: I was thinking more of
21 ETFs than --

22 MR. BRODSKY: Yeah, but the issuer of

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1 the ETF is also State Street Bank or Barclays. I
2 mean, I think the concept of issuer in the case of
3 these new products is really taking, again, a
4 square peg and putting it into a round hole.

5 I mean, this is just the way the markets
6 have evolved. And I don't look at issuer in the
7 same sense, certainly not from an insider trading
8 sense.

9 MR. GENSLER: I think if I might thank
10 Commissioner Paredes and turn to Chairman Schapiro
11 for her round of questions as the cleanup hitter.

12 MS. SCHAPIRO: Thank you. And I am well
13 aware that we're quite over our time limit, so let
14 me just ask one question although there are about
15 a thousand I would like to ask you all.

16 To what extent do you think the nature
17 of the different participants in the futures
18 markets and the equity markets -- we think of the
19 securities markets as having a lot of retail
20 participation, certainly more than I think you see
21 in the futures markets -- to what extent should
22 the different nature of participants legitimately

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1 drive differences in our approach in any number of
2 areas, including approval of new products, for
3 example, or approval of exchanges rules, or
4 transparency? It's something we think about a lot
5 at the SEC because we do have this constant focus
6 on the individual investor, as well as, obviously,
7 on institutional investors, who at the end of the
8 day generally represent individual investors. To
9 what extent is that a legitimate reason for us to
10 look to different approaches here?

11 MR. LEITNER: Sorry. All of my issues
12 were wholesale market issues. I think that the
13 SEC has already made those distinctions. In
14 areas, and portfolio margining being a prime
15 example, the SROs have "harmonized rules" and they
16 have a class of eligible participant who can use a
17 portfolio margining account. We make these
18 distinctions.

19 In the area of -- Ms. Nazareth suggested
20 that we should have suitability standards, but
21 even there the SROs in the securities land have
22 said, well, you know, there should be a different

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1 standard to institutions than to individuals.

2 I think that's legitimate. So I think
3 across the board what you're hearing is that from
4 the securities regulators in the institutional
5 context we'd really be rather regulated more like
6 the CFTC does it. And the CFTC guys say when it
7 comes to harmonization, because we have a
8 wholesale market, please do not throw us into
9 securities land where we will be subject to a
10 standard of approval process and so forth that
11 will just, you know, undermine us. So -- and
12 those are legitimate concerns.

13 MS. SCHAPIRO: But specifically on the
14 context of new products and the process for
15 approving new products, is there any reason to
16 differentiate?

17 MR. BRODSKY: I don't think there's a
18 need to differentiate because the customer base --
19 there's a tremendous overlap. I think that other
20 than the fact that the securities markets
21 certainly have a broad retail component -- much
22 larger by percentage than I would expect exist on

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1 the futures side -- the other users are
2 institutional investors, whether they're
3 commercials, whether they're hedge funds, whether
4 they're pension funds, a la CalPERS or mutual
5 funds are the same, but in relation to new
6 products I think that if you hold people to a
7 suitability standard, at a minimum, I think
8 there's a level of protection there.

9 These products are, I don't think,
10 designed specifically for one class of customer or
11 another. I think it's really the customer or his
12 advisor recommends them. So I don't think that
13 there's a major distinction. And I think what
14 happens is the SEC tends to apply the retail
15 standard to everything they do and I think that's
16 why people say we'd rather be under the CFTC.

17 MS. SCHAPIRO: I guess what I'm trying
18 to get at is the idea that if you have a more
19 retail base and a product is going to appeal to
20 more of a retail base -- I'm really not talking
21 about sales practices -- ought the process of
22 approving that product be different? Is there a

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1 different inquiry on the part of the regulators?
2 Is there a different attention the regulators need
3 to pay? Or should you have a more summary process
4 that applies across the board that might be very
5 easy to apply in the institutional context with
6 those big people that can take care of themselves?

7 So what I really want to get at is
8 should our process be any different in the
9 approval of products if they're geared towards an
10 institutional or a retail base?

11 MR. DONOHUE: Okay. I'm going to try to
12 help Bill again. I don't think so. I don't think
13 it should be any different. Unless you believe
14 that the CFTC or the SEC is in a better position
15 to judge the product design or whether the product
16 will serve some kind of legitimate investing or
17 other, you know, trading purpose, I don't think
18 there's any value to be gained from higher levels
19 of scrutiny for products that might be traded by a
20 retail investor so long as you feel that the
21 self-regulatory agency or the exchange has
22 appropriately described the product and the terms

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1 and conditions upon which the product can be
2 traded and cleared.

3 Maybe I'm not fully understanding the
4 question, but I think, Chairman Schapiro, that
5 there's no need for that.

6 MR. BRODSKY: I thank Craig for his
7 assistance.

8 MR. DONOHUE: Pay me later.

9 MS. SCHAPIRO: Harmony everywhere. I
10 think with that, that concludes this panel. Let
11 me thank you all again.

12 Enormously helpful to us. And we'll
13 look forward to working with you on these issues
14 as we go forward.

15 And I think we're due to take a small
16 break. I'd be happy to keep going.

17 MR. GENSLER: The two chairs are happy
18 to keep going. Our fellow commissioners -- are
19 you all right? Keep going?

20 We're going to ask if the next panel of
21 witnesses -- we want to thank these six panelists,
22 but if you help us move along and we allow Tony --

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1 Tony, please -- help us move along. And I can do
2 that to the old professor. That's all right.

3 So we're now going to move to our second
4 panel. And if I might just introduce -- I don't
5 know -- well, I'll introduce from right to left,
6 just to change a little bit around.

7 Mark Cooper, from Consumer Federation of
8 America. Good to see you again, Mark.

9 We have Professor Lawrence Harris from
10 the University of Southern California.

11 Larry Leibowitz from NYSE Euronext.
12 Mark Young, representing the Futures Industry
13 Association. I guess we've swapped you around.
14 I'm sorry that we did that there.

15 Paul -- I mean, Peter, can you help me
16 just pronounce your last name so I don't --

17 MR. REITZ: Peter Reitz.

18 MR. GENSLER: Peter Reitz from Eurex.

19 And then Wayne Luthrisnghausen from the Options
20 Clearing Corporation.

21 And with that, maybe we'll at this time
22 go from right to left. And this little red light

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1 will flash at the end if you can help summarize.

2 MR. COOPER: Thank you, Chairman
3 Gensler, Chairman Schapiro, Commissioners. The
4 Consumer Federation of America greatly appreciates
5 the opportunity to testify on the important topic
6 of eliminating conflicts in statutes and
7 regulations in the effort to repair the financial
8 system of the United States. CFA has a half dozen
9 people who work on various aspects of the
10 financial meltdown, including investor protection,
11 consumer protection, housing, financial insurance,
12 and commodity markets. I analyze commodity issues
13 and economic theory for CFA so I will lay out some
14 broad principles for this inquiry to follow, and I
15 definitely will not get into the weeds.

16 In a report entitled "Reformer Financial
17 Markets" issued about six months ago, we concluded
18 that Alan Greenspan's admission that there was a
19 flaw in the theory that financial markets need
20 little, if any, regulation is a gross
21 understatement of the problem. We identified six
22 fundamental imperfections in financial markets

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1 that led to a pervasive market failure: Systemic
2 risk, perverse incentives, imperfect information,
3 agency conflicts of interest, and unfairness.

4 Financial market reform requires the SEC
5 and the CFTC to address all six if they are to
6 provide a harmonized approach to securities,
7 commodities, and derivatives regulation that both
8 protects investors and promotes market integrity
9 in capital formation.

10 The purpose of the financial sector is
11 to support the real economy. The effort to
12 harmonize regulation of financial markets between
13 different statutes and different agencies should
14 proceed with one overriding objective in mind: To
15 prevent these market imperfections from once again
16 undermining the important function of the
17 financial system. Any harmonization and approach
18 must be a harmonization upward to provide the
19 highest level of investor protection. Harmony
20 should never be achieved at the expense of the
21 effectiveness of prudential regulation. Financial
22 innovation, which nearly destroyed our economy,

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1 must take a backseat to safety and soundness.

2 Financial sector reform across all
3 agencies needs to follow a simple philosophy of
4 regulation. Accountability, and therefore
5 effective oversight, must derive from principles
6 of prudential regulation expressed in clear rules
7 that are strictly enforced in a transparent
8 manner. There need be no conflict between
9 principle and rules. Rules should be the
10 embodiment of principles. Principles without
11 rules are likely to be ineffective. Rules without
12 principles are likely to be misguided.

13 Only after policymakers identify the
14 principles that need to be applied and the rules
15 that should be implemented can they even ask where
16 harmonization is necessary. The inquiry should
17 not start by asking financial market participants
18 how they want to be regulated; it must start by
19 asking how market participants should be
20 regulated.

21 Only after we know what regulation is
22 necessary can we know which conflicts stand in the

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1 way of effective regulation and should be removed.

2 But we very much agree with the
3 sentiment in the last panel, not every difference
4 is a conflict. Similar things should be treated
5 similarly; different things can be treated
6 differently. Entities providing financial
7 services should be regulated by what they do, not
8 who they are. The extent of regulations should be
9 commensurate with the size, importance, and
10 complexity of institutions and products. The fact
11 that a single entity might be selling different
12 financial products in different markets that are
13 regulated differently by different agencies is
14 perfectly reasonable. It is not a flaw in
15 regulation; rather, it reflects a choice about the
16 necessary level of regulation for the specific
17 product or the specific market and the choice made
18 by the entity in regard to its own business
19 structure and lines of business within which it
20 chooses to engage. If an entity that sells
21 different products does not like the fact that it
22 finds itself subject to different regulation it

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1 should exit one of those lines of business, not
2 complain about conflicts in regulation. There
3 will be plenty of single purpose traders who will
4 take its place.

5 The bottom line is straightforward.
6 Harmonization must not be an excuse for inadequate
7 regulation. Applying these principles, the SEC
8 and the CFTC should identify which prior statutory
9 language, regulations, and agency practices
10 resulted in gaps in regulation that opened the
11 door to market failure. They should identify the
12 steps necessary to close those gaps and where
13 there are conflicts between agencies they should
14 adopt the approaches of the agency whose statutes
15 and practices are best suited to get the job done.

16 Thank you.

17 MR. HARRIS: Thank you, Chairman. Thank
18 you, Chairman Gensler and Schapiro, Commissioners.
19 I'm Larry Harris. I hold the Fred Keenan Chair in
20 Finance at the University of Southern California.

21 My comments today concern clearing
22 systems. They are extremely important now as you

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1 all recognize because they provide an answer to a
2 direction to solving the systemic risk problems
3 that have confronted our economy in the last year.
4 And in particular, they're very important because
5 we now need to address questions of how to create
6 central clearing systems for OTC derivative
7 markets, which is very important.

8 There are two aspects of clearing
9 systems that have been introduced this morning so
10 far. The first aspect was introduced -- actually
11 it was introduced in second order -- by Annette
12 Nazareth where she discussed the question of how
13 clearing ends up controlling marketplaces. And
14 then the other aspect, which was the one that
15 you've provided most attention to so far, is a
16 question of cross-margining and one pool, two pool
17 issues. I'd like to address the first issue and
18 time permitting, or perhaps in questions, address
19 the second issue.

20 So, the CFTC and the SEC share one thing
21 in common and this is a tribute to both agencies
22 and to our system. Both of them have been

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1 extremely strident in the promotion of
2 competition, and I think it's important to
3 recognize that. Where they differ is that there
4 are two competitions that take place in our
5 financial markets. And the two Commissions have
6 tended to focus on the different competitions.
7 One competition is the competition for best price
8 and that is among traders trying to get the very
9 best price. And here, the CFTC has shown more
10 concern -- I don't want to say strength or
11 leadership -- but concern on that. And the other
12 competition is the competition among exchange
13 service providers to provide -- to host the first
14 competition. And there the competition is among
15 exchanges, brokers, and dealers to provide the
16 exchange services that let the system move
17 forward.

18 The SEC has not historically -- in its
19 history was not always very strong in this area,
20 but it has become very strong in the recent past.
21 These competitions become very important or the
22 definition or the lay of the land is defined by

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1 the clearing systems that underlie our exchange
2 systems. And in particular, those clearing
3 systems are essentially the plumbing. You can't
4 do anything without plumbing.

5 We have three models of clearing systems
6 that we should be aware of as we think about
7 regulatory harmonization. One model is the model
8 that we see in the futures industry where there's
9 a single clearing corporation.

10 And that clearing corporation and its
11 associated exchange are linked together. And as a
12 consequence, only trades in the particular
13 contract can be done through that clearing
14 corporation and through that exchange. And so you
15 don't see a number of alternative trading systems.
16 In a sense you have a monopoly or an extremely
17 strong interest in that system.

18 In contrast, on the far extreme in the
19 securities markets you have NSCC, which has
20 provided a relatively level playing field for all
21 participants so that a trade in security can be
22 arranged almost anywhere through a dealer, a

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1 broker, an exchange, an ATS and ECN, and that
2 trade will then be cleared in a common format.

3 In between that there's another market
4 structure which is the Options Clearing Corps
5 where they clear for the five or six options
6 exchanges that we have. The trades have to take
7 place on the exchanges, but the exchanges compete
8 with each other to provide exchange services.

9 The result of this has been an awful lot
10 of market power in the futures markets for those
11 markets that control the very lucrative contracts.
12 And it's essentially impossible for a start-up
13 exchange or alternative trading system to create a
14 similar contract and expect for it to become
15 successful. And as a result there's an awful lot
16 of profit that is extracted -- for lack of a
17 better word, and that's probably a strong word --
18 from consumers and others because of the market
19 power that those exchanges have. On the flip
20 side, the search for best price is often
21 complicated by the fragmentation that we see in
22 the markets that are regulated by the SEC,

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1 although that has been changing recently.

2 With electronic trading coming into our
3 markets, the balance between these two types of
4 competitions has changed. In particular,
5 electronic trading has made it much easier to find
6 the best price. And as a consequence, as we
7 search for regulatory harmonization, I think it's
8 time for the Commodity Futures Trading Commission
9 to start considering more carefully opportunities
10 to allow people to create alternative trading
11 systems that would provide some discipline to the
12 fees that the exchanges and their associated
13 clearing agencies are collecting.

14 MS. SCHAPIRO: Thank you, Larry. I
15 don't think we got a written submission from you,
16 so if you have one we would love to include it in
17 the record.

18 MR. HARRIS: I did, in fact, send it,
19 but it was late last night.

20 MS. SCHAPIRO: Oh, okay. Great. Thank
21 you.

22 MR. LEIBOWITZ: Chairman Gensler,

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1 Chairman Schapiro, SEC and CFTC Commissioners. My
2 name is Larry Leibowitz. I'm group executive vice
3 president and head of U.S. Execution and Global
4 Technology for NYSE Euronext. As our company is
5 regulated under both agencies, I'm pleased to
6 appear before you today to share my views on
7 harmonizing U.S. financial regulation.

8 It's our belief that smart regulation,
9 when properly administered, add value to financial
10 markets and even our own business at the same time
11 by providing investor protection and increasing
12 confidence in market integrity, while at the same
13 time fostering competition and innovation.

14 We applaud your agencies for calling
15 these hearings in an effort to improve regulatory
16 oversight. One of the lessons learned from the
17 recent financial crisis is that the exchange
18 trading and clearing model clearly works
19 extraordinarily well, even as unregulated markets
20 faltered. NYSE Euronext supports the
21 administration's proposal to bring standardized
22 derivatives onto exchanges and clearinghouses.

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1 However, as more products come into
2 regulated markets, the need for enhanced
3 collaboration and cooperation between the SEC and
4 the CFTC becomes increasingly more important.
5 Before we identify areas that require
6 harmonization, we must define the objectives of
7 this exercise. The agencies would benefit by
8 agreeing to a set of common principles that define
9 the rules of the road for effective regulation.
10 For example, we can agree that regulation should
11 promote open, fair, and transparent markets so
12 investors can make confident and informed
13 decisions. We can agree that regulation should
14 promote fair and reasonable competition that is
15 consistent with investor protection. We can also
16 agree that regulation should promote a level
17 playing field for market participants based on
18 risk rather than clever legal structure.

19 Yet, we find that the current rule and
20 product approval process for securities exchanges
21 runs afoul of many of these important concepts.
22 The SEC follows a rule-based regulatory approach

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1 which requires exchanges to file new rules and
2 products and any amendments to those for SEC
3 approval. While a limited number of rules are
4 eligible to be effective upon filing, the vast
5 majority of rules are subject to a sometimes
6 lengthy review process prior to their approval and
7 implementation, resulting in deferral or outright
8 loss of the new unexchanged product innovation to
9 the OTC market.

10 This approach accentuates the unlevel
11 playing field among different trading platforms
12 for securities, many of which do not have SRO
13 responsibilities. Ironically, these filings often
14 tip off market competitors to business ideas that
15 regulated exchanges are trying to implement,
16 allowing them to freely and quickly benefit from
17 the efforts of regulated exchanges without
18 shouldering any of the burdens.

19 NYSE Euronext recommends that the SEC
20 amend its rule and product approval regime by
21 either adopting a certification process similar to
22 the CFTC or amending its current system by setting

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1 hard time limits on approvals and increasing the
2 number of rules or products that are eligible for
3 the effective on filing status.

4 Another suggestion that will increase
5 regulatory transparency in the markets, as well as
6 fair competition among exchanges, is finding a
7 solution to allow futures and securities to reside
8 in the same account. We believe in the concept of
9 portfolio margining so much that we put our money
10 where our mouth is. In June, NYSE Euronext and
11 DTCC announced our intention to form New York
12 Portfolio Clearing, a joint venture that will
13 allow firms to hold both cash fixed-income
14 positions at DTCC and futures positions on NYSE
15 Liffe U.S. to receive risk-based portfolio
16 margining. With this venture, regulators will be
17 able to monitor a more holistic view of the
18 markets and identify positions of firms with large
19 exposures. If OTC products migrate to this
20 clearinghouse, the view of regulators across asset
21 classes will be even more complete.

22 While NYPC will be initially available

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1 only to firm house accounts so as not to run afoul
2 of SIPC or segregation requirements, we eventually
3 hope to expand this benefit to customers and look
4 forward to working with regulators to find a
5 consensus solution that both protects customers in
6 the markets while providing this risk-based
7 portfolio margining for investors.

8 I'll conclude here by restating our
9 commitment to partnering with your agencies as you
10 move forward to reconcile and improve the U.S.
11 regulatory system. NYSE Euronext suggests that
12 joint advisory committees may be an effective
13 mechanism to find solutions for many of these
14 complex issues and we stand ready to assist.

15 Thank you again for the opportunity to
16 testify, and I'll be more than happy to answer
17 questions.

18 MS. SCHAPIRO: Thank you. Mr. Reitz?

19 MR. REITZ: Thank you very much. Good
20 morning. I am Peter Reitz, a member of the
21 executive board of Eurex. Chairman Gensler,
22 Chairman Schapiro, I appreciate the opportunity to

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1 be here today. Like many other non-U.S.
2 exchanges, Eurex became acutely aware of the lack
3 of harmony in U.S. trading requirements when we
4 sought to offer our products in the United States.
5 Consequently, I would like to focus my remarks on
6 just two aspects of the regulatory environment
7 where greater harmonization would remove
8 impediments that U.S. residents face with respect
9 to access to markets and products like those that
10 Eurex offers.

11 U.S. residents have been able to become
12 members of Eurex for more than 13 years. Today,
13 74 of the 405 members of Eurex are U.S. resident
14 entities, meaning that they can access the Eurex
15 trading platform directly from the U.S. under
16 conditions established by the CFTC. We know, for
17 example, that U.S. members are very active traders
18 in our Dow Jones EURO STOXX Index futures, but
19 these same members are currently not permitted to
20 trade directly in the EURO STOXX Index options
21 contract. However, many U.S. firms find products,
22 like the EURO STOXX 50 Index options, so necessary

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1 to their trading strategies that they set up
2 entities abroad simply to trade them. At the same
3 time, there are a number of well-known U.S.
4 financial institutions which conduct the bulk of
5 their trading on Eurex for both their U.S.
6 affiliates and U.S. customers through terminals
7 located outside the U.S. so that they can trade
8 from a single location.

9 I would also like to point out that both
10 Eurex options and futures are overseen by the same
11 regulatory authorities in Germany, with an equally
12 robust level of regulation. Furthermore, both
13 types of contracts are cleared by Eurex clearing,
14 which both the SEC and CFTC recently allowed to
15 clear different types of OTC products on behalf of
16 U.S. residents. Current law and regulatory
17 policies cause U.S. participants in foreign stock
18 options markets to incur higher operational risk
19 and cost. And today, trading by such U.S. firms
20 is not as transparent to U.S. authorities as it
21 could be.

22 These results do not further the public

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1 interest or help protect U.S. investors. As a
2 first step to harmonize U.S. members' access to
3 our futures and stock options, Eurex recently
4 amended its request for an exemption from the SEC
5 registration requirements so that we can provide
6 direct market access to U.S. broker-dealers. If
7 granted, U.S. members would be able to trade index
8 options and options on, for example, liquid German
9 stocks, putting their trade execution on an equal
10 footing with their futures trading and with other
11 Eurex members. Alternatively, Eurex respectfully
12 asks that as a result of this undertaking, the
13 Commissions recommend that Congress codify the
14 current CFTC policies on direct market access and
15 apply them to all exchange-listed derivatives that
16 fall within the Commission's interests.

17 The other issue that I would like to
18 highlight today concerns the growing gap between
19 the procedures for listing of foreign stock index
20 futures contracts at the CFTC and that of all
21 other exchange listed derivatives. It is not out
22 of the ordinary for approval of broad-based stock

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1 index futures contracts to take a year or longer.
2 About 10 years ago, the SEC developed a process
3 where a domestic exchange could list products that
4 met certain criteria that the SEC had previously
5 approved for that exchange. This offers a good
6 model for permitting broad-based foreign stock
7 indexes.

8 Eurex has submitted a petition for
9 rulemaking at the CFTC, which would provide a
10 streamlined procedure for determining whether an
11 index on a foreign exchange qualified as broad
12 based and meets the other criteria to be offered
13 for U.S. persons.

14 Eurex commends the Commissions for
15 holding these joint meetings. We look forward to
16 working together with you and I look forward to
17 your questions.

18 MS. SCHAPIRO: Thank you. Mark?

19 MR. YOUNG: Chairman Schapiro and
20 Gensler, members of the Commissions, I am Mark
21 Young, a partner in the law firm of Kirkland and
22 Ellis, LLP. I am proud to be appearing here today

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1 on behalf of the Futures Industry Association.
2 Thank you for the invitation to testify on
3 harmonizing the federal securities laws and the
4 Commodity Exchange Act.

5 These different laws focus on different
6 forms of economic activity: Cash security, listed
7 options, and futures markets. Each has a unique
8 function and purpose. Capital formation is not
9 price discovery or risk management.

10 Each system of regulation is tailored to
11 its special economic function. FIA knows
12 firsthand how well the futures system weathered
13 the credit crisis last year and how well it
14 continues to serve the public interest in fair,
15 open, and financially secure trading markets.
16 Given this admirable track record, FIA strongly
17 supports the existing futures system.

18 You've asked witnesses to identify gaps
19 in regulation, as well as areas of regulatory
20 difference that should be maintained or reduced.
21 In terms of gaps, FIA believes that both
22 regulatory systems generally overlook the

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1 importance of clearing firms. Clearing members
2 provide the capital and underwriting of customer
3 credit risk, which are the lifeblood of the
4 financial integrity provided by clearing systems.
5 Clearing firms, however, have not always had an
6 adequate voice in how the clearing system is
7 operating, who is admitted to membership, or what
8 products will be cleared.

9 When you review your statutes, we ask
10 that you take this into consideration.

11 What regulatory differences should be
12 retained? There are many. Public disclosure of
13 material market information should continue to be
14 the hallmark of securities regulation, but not
15 futures. Futures regulation should focus on the
16 price discovery process embodied in the
17 interaction of bids, offers, and executed trades.
18 Insider trading should continue to be prohibited
19 by the securities laws, but not the Commodity
20 Exchange Act where hedgers could be miscast as
21 insiders. FIA agrees with the Treasury's New
22 Foundation Report that the goal of harmonized

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1 regulation is well-served by a clear delineation
2 of agency jurisdiction to avoid any overlap. The
3 Commodity Exchange Act's exclusive jurisdiction
4 provision mandates that CFTC regulation is the
5 sole standard applicable to virtually all futures
6 trading. That fundamental public policy has
7 worked well to prevent duplication and
8 inconsistency; it should be retained.

9 What could be harmonized? There are
10 differences in product and SRO rule approvals,
11 margin setting, as well as access to foreign
12 markets and products. FIA agrees with the
13 administration's call for a better process for
14 CFTC approval of SRO rules. Otherwise, FIA
15 strongly favors the futures model in these areas.
16 FIA has long supported fair competition among
17 execution facilities. One aspect of the
18 administration's proposed swaps legislation is a
19 step in the right direction by requiring clearing
20 systems to offset positions established on
21 multiple trading platforms. In our view,
22 competition can lead to innovation and better

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1 service.

2 Portfolio margining is an important
3 issue. A market neutral risk-based system should
4 be adopted that would enable market participants
5 to use their capital more efficiently while
6 preserving customer protection and financial
7 integrity.

8 FIA knows you are embarking on a very
9 challenging undertaking at the president's
10 direction. We look forward to working with you on
11 this effort and to answering any questions you may
12 have today.

13 MS. SCHAPIRO: Thank you, Mark. Wayne?

14 MR. LUTHRINSGHAUSEN: Thank you. Excuse
15 me. Chairman Schapiro and Chairman Gensler, thank
16 you. And Commissioners, thank you for inviting me
17 to participate today on behalf of Options Clearing
18 Corporation.

19 I think it's important -- I kind of
20 listened to the first panel from outside on the
21 television and the differences, I think, are
22 important in terms of what we're structured to do.

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1 OCC, on the securities side, is a national
2 utility, if you will, that clears all of the
3 listed securities options traded on the exchanges
4 in the United States. As such, we create the
5 fungibility that exists in those markets. If you
6 imagine users can open a transaction in an IBM
7 April 110 on one exchange and that individual has
8 six choices to liquidate and that all clears net
9 zero when he does liquidate -- he or she does
10 liquidate.

11 What this has done is not always to the
12 hurrahs of the exchanges, but what it's done is
13 it's created fierce competition among the
14 exchanges to put up better prices, to lower costs,
15 find ways to get order flow into their markets.

16 What we think the cycle has done over
17 the last 30-plus years in this listed options
18 market is to create this cycle, which is
19 fungibility starts it off. From fungibility
20 there's competition which leads to lower cost.
21 Lower cost leads to greater volumes. Greater
22 volumes leads to greater liquidity.

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1 Greater liquidity leads to even greater
2 volumes. And if we, in particular, in exchanges
3 hold your costs in line, those even greater
4 volumes lead to even lower costs. And that's been
5 the experience from the OCC perspective from the
6 beginning.

7 We are trying to bring that form of
8 clearing to the futures side. We clear for a
9 couple of organizations over there now and it's a
10 very small piece of our business, but we remain
11 optimistic going forward. Where margins are
12 concerned, I think we learned last year about the
13 whole importance of margins and risk during a time
14 of crisis or stress, we think -- actually think
15 all of us did markets in clearing organizations
16 and the risk models work very, very well. We were
17 fortunate that we had redone all of our systems
18 for risk three years ago, installing what we call
19 STANS, which is, I think, the only true Monte
20 Carlo simulation system for determining margins.
21 I look back at that from last year. It makes us
22 feel pretty good about how that system was put

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1 together and how it operates.

2 Having said all that, I notice in the
3 other panel that comment as well that where risk
4 is concerned -- and I'll get into this in a second
5 -- but where risk is concerned, keep in mind that
6 we've had a cross-margining system in the S&P
7 complex and the index complex with the Chicago
8 Mercantile Exchange since after the '87 market
9 events. That's worked uninterrupted fabulously
10 well for professionals, market professionals, over
11 all of those years and reduced the dollar value of
12 margins that have to be put up because we've
13 reduced the risk with offsetting spreads of
14 futures against options.

15 And it's worked extremely, exceedingly
16 well. I'd like to comment, if I may, mostly
17 because I think -- first on the issue of putting
18 up new products. If I don't comment, Bill Brodsky
19 will shoot me when I walk out of here. The fact
20 is though that the whole experience with a gold
21 ETF product and trying to put options up on that
22 under the securities side -- I think it took a

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1 total period of time of about three years to get
2 that put together between the SEC and the CFTC. I
3 think that really should be fixed in some way.

4 From OCC's perspective, however, we look
5 at it -- because we're the issuer, because we're
6 the other side of every trade, we look at it from
7 the point of view of we're trying to get statutory
8 assurance. The problem we always have is that if
9 it's not on this side, on the CFTC side, and it's
10 not on the SEC side -- and we list it under one
11 that we presume it is -- we wind up in no-man's
12 land from a statutory point of view with grave
13 potential financial consequences to that. So we
14 need that. We need clarity with that.

15 The other one I'd mention is portfolio
16 margining. I think regardless of what any of us
17 say, the fact is that smart folks using financial
18 markets to hedge their risks or to build certain
19 kind of portfolios use futures, use options.

20 And when the underlines or security
21 types, they put them together. And at the end of
22 the day it seems to me that the system that we

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1 have in this country ought to allow for portfolio
2 margins in one account for an individual, a large
3 investor, or an institution. And we need to do
4 that. We need to change SIPC to allow a future in
5 there, and we need to have the CFTC tell us that
6 we can now put it in that account and be relieved
7 of the segregation requirements because it's in a
8 securities portfolio margining account.

9 With that said I thank you for the
10 opportunity to appear today and I also stand ready
11 to answer any questions you might have.

12 MS. SCHAPIRO: Thank you very much. Let
13 me go ahead and ask the first question to get us
14 started and then I'll call on my colleagues.

15 A couple of you -- Mr. Luthringshausen
16 and Professor Harris, in particular, but others --
17 have talked about the really, very big differences
18 in market structure between the securities markets
19 and the futures markets, and, in particular, the
20 very different models of clearing that we have.
21 And I guess I'd like to ask each of you to what
22 extent these really fundamental differences

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1 represent major hurdles in our ability to achieve
2 harmonization of the basic regulatory structure?
3 In other words, in order for us to make progress
4 -- the two Commissions up here and really getting
5 to a point of harmonization -- do we have to
6 change the market structure on one side or the
7 other or both in a very fundamental way?

8 MR. HARRIS: There are several paths you
9 can take as you think about harmonization. One
10 path would be to grandfather all existing
11 structures so that harmonization only applies to
12 new developments. And then to go back at some
13 point and revisit existing structures to see
14 whether they're in the best interest of the
15 public. That's a function, of course, that both
16 Commissions should be doing independently right
17 now, but as we think about harmonization, as a
18 focal point for moving that forward.

19 A more challenging model, of course, is
20 to try to do it all at once, which is to say if
21 we're going to harmonize we really ought to have a
22 single set of rules that's going to apply to

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1 everybody from the moment that we pull the switch.
2 If that's the approach to be taken then we'll be
3 talking about at least 10 or 20 years of arguing.
4 And those arguments will be vociferous because of
5 the amount of money involved.

6 If you have any question at all about
7 the importance of this issue in terms of money,
8 compare the capitalization of those corporate
9 entities that are running futures markets versus
10 those corporate entities that are running
11 securities markets. The difference in
12 capitalization has everything to do with market
13 structure, and in particular, the consolidated
14 control of the clearing corps and the exchange
15 system.

16 MR. YOUNG: I don't think any of us here
17 would advocate that we have to harmonize
18 everything because first of all, if we do that
19 we'll be waiting until we're all retired.

20 I think what we can do is be pragmatic
21 and have a couple of basic principles. So I think
22 that you shouldn't be able to, by virtue of a

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1 different instrument being a future or security,
2 take advantage of quirks or loopholes. I mean, I
3 kind of laugh when I hear that insider trading
4 shouldn't apply to futures. I mean, the reality
5 is if it's possible to have material, non-public
6 information and take advantage of that, why does
7 it matter whether it's a future or a security?

8 Now, what I'll tell you is it's more
9 likely that in a broad-based future or a
10 broad-based security like an ETF on the S&P 500,
11 it's less likely that insider trading would take
12 place. On the other hand, there was an insider
13 trading case several years ago -- Goldman Sachs
14 and the fixed-income market -- where they knew
15 that a particular security was being discontinued.
16 That was prosecuted. I apologize there, but the
17 point is it didn't matter whether it was a future
18 or a security.

19 MR. GENSLER: I left that firm 12 years
20 ago. Let the record show.

21 MR. YOUNG: It didn't matter that it was
22 a security or a future. The point is it doesn't

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1 matter what the instrument is; the point is what's
2 the effect of the information. Just like --
3 security markets are just as global as futures
4 markets. We fight every day for listings against
5 the London Stock Exchange. We fight against
6 regulation and other things that are going on in
7 other markets that affect us. And so I think we
8 just need to agree on a couple of basic principles
9 and then pragmatically figure out which things to
10 harmonize.

11 MR. COOPER: Chairwoman, I think the
12 solution to your dilemma is to frame the question
13 of harmonization with respect to what the harmony
14 we're seeking is with respect to the outcome of a
15 particular regulation, a particular commodity or
16 market. Honestly, I don't care whether the two
17 agencies treat what they regulate the same way.
18 If they regulate different products and different
19 markets, then there does not have to be harmony
20 between the regulation. In fact, trying to
21 harmonize is going to either under regulate one
22 market or over regulate the other market.

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1 So, the critical question, and as I
2 understand the charge from the president, is to
3 identify the areas where the conflicts are
4 frustrating the public goals versus the area where
5 the difference is simply a means to achieve the
6 end. And I think that's very important. We've
7 heard a lot of examples here of particular things
8 that one type of actor does not like about --
9 would prefer to be regulated by the other guy.
10 But the real question is what is the nature of the
11 product and which is the agency that should be
12 regulating that product. And, again, I'm a person
13 who does physical commodities, farm commodities,
14 and energies. And energies in particular, the
15 physical commodity is so dramatically different
16 than the piece of paper that the SEC regulates
17 that the notion that they have to be regulated
18 identically to the paper products is absurd,
19 frankly. Because the underlying physical
20 commodities have traits of storage and
21 transportation, production and consumption -- I
22 used that example in my testimony -- that make

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1 them a completely different world.

2 So, my caution to you is, yes,
3 harmonization, elimination of conflicts is
4 important, but let's keep in mind the underlying
5 goal of the regulation. And if in the end you
6 tell the President these energy commodities have
7 to be regulated completely different than the
8 financial commodities because that's the way we
9 get a well functioning real economy, then so be
10 it. Don't be afraid of differences because
11 they're not conflicts.

12 MS. SCHAPIRO: Thank you. I'm out of
13 time. Commissioner Casey?

14 MS. CASEY: Thank you, Madam Chairman.
15 I wanted to go back to a point Mr. Hans made with
16 respect to -- I thought it was very helpful
17 actually to hear your analysis with respect to the
18 different competition models. And to focus on
19 risk management, in particular. There has been a
20 lot of discussion here about support for
21 cross-margining, particularly you have the one pot
22 and the two pot models. From a risk management

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1 perspective and broader systemic risk concern, are
2 there benefits to one versus the other?

3 MR. HARRIS: For systemic risk
4 management it's essential that you have some
5 entity that is fully aware of every risk that can
6 be characterized by each entity that's under its
7 umbrella. And so for that purpose you need a
8 great deal of coordination, if not a single
9 entity. So, a single entity will have that
10 responsibility and if you put everything into a
11 single entity, and that really means everything --
12 all these futures, the clearing corps, all the
13 securities clearing corps, and even to some extent
14 things that are going on in the banking system --
15 if you put that all under one umbrella, then
16 presumably you'll at least allocate all the
17 responsibility in a single way and probably
18 provide authority as well. The danger of doing
19 that is that if any of the people running that
20 organization are brain- dead, then the entire
21 economy suffers.

22 Now, in our current system we have lots

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1 of different clearing corporations, each one of
2 which is primarily concerned with managing the
3 risk of the ultimate members who are responsible
4 for performance of the trades. They have a lot of
5 value at risk. It's very important for them to
6 know with whom they are sharing those risks and to
7 whom they're being exposed to the risk. And
8 that's a system that has worked extraordinarily
9 well to prevent widespread performance failures
10 with some notable exceptions in the -- frankly,
11 where the clearinghouses haven't existed. It's
12 absolutely impossible to have portfolio margin
13 without the type of coordination that we've talked
14 about. You cannot have two pots where the two
15 pots aren't coordinated. And the reason why is
16 that if somebody puts a position -- a long
17 position on one side and a short position on the
18 other side, we recognize that they're well-hedged
19 and that's wonderful. But if for some third
20 reason that entity goes bankrupt or perhaps
21 because the market has moved very quickly, then
22 one side has profited and the other side is in a

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1 losing position and has no claim on the profits on
2 the other side.

3 And so if you're going to have any two
4 pool margining system, there has to be some way
5 where simultaneously a claim is written between
6 one clearinghouse and the other clearinghouse so
7 that in the event that that circumstance that I
8 just described takes place, there will be an
9 appropriate allocation of the resources.

10 That's very difficult to do, but there
11 is an alternative that will work with the proper
12 enabling legislation and regulation. And that
13 alternative is to allow portfolio margining to
14 take place underneath the clearinghouses, either
15 at the broker level or at the intermediary level
16 between the brokers and the clearinghouses so that
17 you have some entity that is basically in the
18 business of doing margins or -- a clearinghouse is
19 in the business of ensuring that its clients
20 perform. And so you could have some entity like a
21 brokerage doing portfolio margining as many of
22 them are, and they deal separately with the

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1 different clearinghouses. And they still have to
2 deliver a lot of money to the different
3 clearinghouses, but to the extent that one client
4 of theirs is long and another client is short,
5 they offset in this intermediate entity. And so
6 there's less money that goes out to the
7 clearinghouses.

8 That's a proposal that ought to be
9 enabled. The way to enable it is to address the
10 problems that we have with segregation of accounts
11 and SIPC. With those problems, then many of the
12 issues that we've discussed today will go away.
13 But with that you will also have to increase the
14 capital requirements that we have for the brokers
15 and the supervision of the brokers to compensate
16 for the loss or the erosion of the protections
17 that we currently have through SIPC and the
18 segregation of accounts.

19 So, you can't do one without
20 compensation in some other way, but as the world
21 changes, of course, we have to change accordingly
22 and it may be that we can substitute a little bit

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1 additional capital requirement -- money at risk at
2 the brokerage level or intermediate level -- and
3 then provide for the needs -- the very legitimate
4 needs of the industry participants.

5 MS. SCHAPIRO: Thank you. Commissioner
6 Dunn?

7 MR. DUNN: Thank you very much. I
8 apologize for the rest of the panelists, but my
9 bent is towards consumer protection so I'm going
10 to kind of focus on Dr. Cooper. But you're going
11 to have to answer some of the questions that he
12 raises in his testimony, if you will.

13 Dr. Cooper, you say in your closing
14 paragraph -- and I'm kind of paraphrasing this --
15 what we really need to do is to identify the
16 statutory language, identify the regulations, and
17 identify agency practices that resulted in gaps
18 that opened the door to market failure. Is that
19 -- I think I got the gist of it.

20 I am going to ask not only this panel,
21 but all panels to try to identify those things.
22 And then the second part of what Dr. Cooper puts

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1 in there is that we need to identify steps to
2 close those gaps. And I think it's important --
3 if we don't do anything elsewhere -- is to
4 identify what the broad sector of the universe
5 feels are the culprits in raising those gaps and
6 how we close them.

7 Dr. Cooper also states in his piece that
8 financial innovation, which nearly destroyed our
9 economy, must take a back seat to safety and
10 soundness. Can't we have both? Can't we have
11 innovation and safety and soundness? And I'd like
12 all the panelists to address that.

13 MR. COOPER: I think Mr. Harris just
14 gave you a perfect example of how you need to keep
15 this in perspective.

16 So, he identified a financial
17 innovation, portfolio margining, and he asserts
18 that it will improve the functioning of the market
19 in some fashion, but he then also immediately
20 identified the risk that that would entail and a
21 regulatory response to balance the new, innovative
22 product. He said you would have to raise the

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1 capital requirements on those entities because you
2 had altered the underlying risk.

3 So it's a perfect example. And frankly,
4 for the last 10 years we've had a lot of
5 innovation without the responsibility and it got
6 us into trouble, and so for me, that's the perfect
7 example. The key thing is that someone says this
8 product's innovative, they sort of end the
9 sentence, and, of course, that's their job as the
10 industry to think of things that they want to
11 bring to market. Your job as regulators is to do
12 exactly what Mr. Harris suggested -- or Dr. Harris
13 suggested, that is you have to look at this
14 implication on risk, you have to figure -- and its
15 implication, in my view, on all six of our market
16 imperfections. Systemic risk and risk is
17 important and the mispricing of risk has got us
18 into trouble, but so is perverse incentives. Does
19 it create a perverse incentive for that actor in
20 some way to take advantage of a difference between
21 the exchanges? You have to -- is there an agency
22 problem, a conflict of interest problem? How will

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1 it be disclosed? Is there an information problem?

2 So, I think that you can have both, but
3 the part that we didn't have for the past decade
4 is the balancing part of responsibility and
5 oversight and I take it the charge here is to say,
6 how do we let innovation take place without
7 undermining the possibility of having a sound
8 system, and this is a perfect example.

9 MR. REITZ: Commissioner, in the
10 Congressional Purposes section of the Commodity
11 Exchange Act, It is true, Congress says,
12 innovation is one of the purposes. But Congress
13 says that innovation should be responsible
14 innovation and that's the balance that I think
15 you're trying to strike.

16 I don't necessarily agree with the idea
17 that there has been a market failure in the
18 futures markets or the securities markets or the
19 listed options markets. I think if we leave that
20 impression with people from today's hearing, we're
21 leaving people with the wrong impression.

22 The question I think you're trying to

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1 wrestle with today -- and I believe with Bill
2 Brodsky, it is a question of enormous complexity
3 -- the question you're trying to wrestle with
4 today is, how do you take the best from two very
5 good systems of regulation to make something
6 better? I think that's a separate question from
7 the question of, how do you deal with the
8 regulatory gaps that have been addressed in the
9 Treasury Department's legislation?

10 MR. LEIBOWITZ: I'd like to echo that.
11 I mean, I think what we showed is that both the
12 futures and the securities markets functioned
13 quite well during the recent crisis. The problem
14 was that a gap had arisen that no regulator really
15 felt they had a purview over and by the time
16 anybody realized it, it was too late. So, in some
17 ways what we need is a super structure that can
18 spot these gaps as they arise and then say, okay,
19 well what are we going to do about this before it
20 gets to be too late.

21 I think you're right, that innovation
22 and competition is something we all want and we've

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1 seen it with reckless abandon at times in the
2 securities market, in fact, people really wrap
3 themselves in innovation and come -- and say that
4 anything that's innovative is good, but we can't
5 lose sight of the more important principles of
6 investor protection, what's good for the public
7 and for the public markets. And I think it is
8 that balancing act that is the responsibility of
9 the CFTC and SEC and whatever harmonization takes
10 place.

11 MS. SCHAPIRO: Thank you. Commissioner
12 Walter?

13 MS. WALTER: Thank you, Chairman
14 Schapiro. I'd like to direct my first question to
15 Mark and bring you back to the point I think Larry
16 raised about insider trading. You said in both
17 your written and your oral testimony that hedgers
18 can be miscast as insiders. I'd like to ask you
19 to explain that a little bit more and explain why
20 under the appropriate circumstances extending
21 those principles doesn't just fill a gap in abuses
22 that are occurring today.

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1 MR. YOUNG: I believe there are abuses
2 that are occurring today. There are people who
3 are using the futures markets to hedge price risk
4 based on information that they have from and about
5 their individual businesses and there's nothing in
6 the Commodity Exchange Act that requires
7 disclosure because the Commodity Exchange Act is
8 not built on a disclosure regime. Unlike in the
9 federal securities laws where you were an insider
10 and you have a choice, you can either disclose the
11 information or you can abstain from trading, there
12 is no disclosure of market information under the
13 Commodity Exchange Act. In fact, the CFTC under
14 section 8 of the Commodity Exchange Act itself is
15 prohibited from disclosing material information
16 about business transactions.

17 The place where insider trading under the Commodity
18 Exchange Act does occur or does occur in the statute
19 and does apply in the regulatory regime, is on this
20 side of the table. There's a -- it's a felony for
21 anyone on this side of the table to engage in insider
22 trading based on the information that they have from

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1 their government position about what's going on in the
2 marketplace, but it is not possible to apply that same
3 standard to a hedger without prohibiting a hedger who
4 is trading on the basis of inside information, from
5 taking advantage of commercial information for the
6 good of the company and its shareholders.

7 MS. WALTER: I guess, to me, you're
8 answering a different question than the one I
9 intended to ask. I understand what the legal
10 structure is today, but it appears to me that the
11 concept has a place in the futures world the same
12 way an insider -- classic insider of a corporation
13 can abuse his or her position by trading in
14 straight stock or options. There are hedging
15 instruments that can be used to be abused that way
16 and I hear a resistance on your part to bringing
17 those concepts appropriately. I'm not suggesting
18 that they don't have to be tailored to the
19 circumstances, but the question is, is there no
20 place for those types of consequences in the
21 regulatory structure?

22 MR. YOUNG: Well, other than -- I'm

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1 sorry if I didn't answer the question that you
2 asked.

3 MS. WALTER: It was the articulation of
4 the question.

5 MR. YOUNG: But in the futures world
6 there are insiders, they run exchanges, they run
7 clearing houses where they work as CFTC, they have
8 inside information and they can't trade on the
9 basis of that information. For the rest of the
10 marketplace, for the actual market participants,
11 for people who are at a company and know there's
12 going to be a large grain sale that's going to be
13 made, the company can hedge that sale before it is
14 made public. That's been a founding principle of
15 sound risk management for many, many years.
16 If you apply insider trading concepts to the futures
17 markets, our concern is that you're going to take
18 those people and treat them as if they were felons and
19 we think that's wrong. The Commodity Exchange Act is
20 designed to promote those people and their risk
21 management activities in the futures market.

22 MS. WALTER: Well, let me, in the

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1 interest of time, move on to another question and
2 you and I can debate this at some other point, I'm
3 sure, at great length.

4 I want to go back to a question Chairman
5 Schapiro asked earlier about the distinction when
6 you're talking about, particularly in the product
7 approval area, but I think it can come up
8 elsewhere as well, in cases of approving either
9 new products or changes at exchanges between
10 products that are geared or markets that are
11 geared institutionally as opposed to retail. It
12 seems to me that if our recent past experience
13 over the last two years shows anything, it
14 reaffirms that human beings are human beings and
15 left to their own devices at various points in
16 time, they're going to push the edge of the
17 envelope in terms of showing good judgment and
18 prudence.

19 What I hear people urging, for which I
20 have a great deal of sympathy, is that
21 particularly on the SEC side of the equation, we
22 have to be more flexible in terms of letting

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1 people make changes, either in their market
2 structure or in offering new products, act in a
3 speedier sort of way so that we don't get in the
4 way of appropriate innovation and competition and
5 I agree with that. On the other hand, I think we
6 also appropriately have a statutory responsibility
7 to make sure that these things are appropriate and
8 particularly when it's going to affect retail,
9 that to me is a very important issue and I
10 wondered if some of you want to talk about
11 grappling with that tension.

12 MR. YOUNG: I will. I think that it's
13 unwise to distinguish among products according to
14 whether they are retail or commercial or otherwise
15 and the reason is that the institutional entities
16 will use retail products if they want to and quite
17 frequently, retail can have access to
18 institutional products if the products have
19 nominal values that are within their reach.
20 If you want to regulate in a differential way, you
21 have to regulate not the products, but the sales
22 practices and the responsibilities of the

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1 intermediaries that are introducing the products to
2 the customers. So I think that the proper place to do
3 the regulation is in sales practices and at the broker
4 level, not at the product level.

5 MR. COOPER: I'm agreeing with this
6 fellow so let me pick that up. Going to get in
7 trouble here, but I think the key here then is to
8 recognize that customers are different and we
9 obviously support a consumer protection agency
10 that will in fact do exactly what the professor
11 has suggested. It's a class of customers who,
12 even though the so-called sophisticated actors
13 didn't prove to be so sophisticated in the last
14 couple years, here's a class of customers who are,
15 in fact, unsophisticated, in need of consumer
16 protection. And so for us, rather than do the
17 distinction on the supply side, it should be on
18 the demand side. And we think the principle here
19 should be that consumers, the retail customer in
20 particular, need an agency that is focused on
21 their needs in the marketplace and that expertise
22 will go across products so that whatever the

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1 product being sold to those consumers are, or
2 customers are, that's where the regulation should
3 give us the protection.

4 MS. SCHAPIRO: Thank you. I think we're
5 out of time. Commissioner Sommers?

6 Ms. SOMMERS: Thank you, Chairman
7 Schapiro. I'm going to ask a question of Peter
8 because I think you have a unique perspective on a
9 different regulatory model. As we look towards
10 the goal of harmonization and perhaps to the
11 examples of other regulatory models globally, I
12 was wondering if you could elaborate on the
13 structure in Germany. And the way I understand
14 the differences that the operations of the
15 exchange are regulated by one entity, your
16 intermediaries are regulated by someone else, your
17 clearinghouse is regulated by someone else. But
18 are there differences in the way that you regulate
19 futures and options and securities or different
20 mandates, differences in the way that you look at
21 the sophistication of the customers or those sorts
22 of things that we are, you know, talking about in

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1 other questions here?

2 MR. REITZ: Thank you for that question.
3 I think if you look at the regulatory structure in
4 Germany and also other countries in Europe,
5 there's not a single market where you have
6 differentiation between options and futures
7 regulation. In fact, they're actually traded in
8 the same environment, I think, across Europe. The
9 difference in terms of regulation in the German
10 market is really between regulation of exchanges
11 and regulation of market participants,
12 intermediaries.

13 The clearinghouse is a little bit of a
14 different animal in the sense that it's also
15 regulated by the same entity that regulates
16 intermediaries because it has a banking license
17 and therefore it falls under the regulation of
18 what in Germany is called the "BaFin." But the
19 exchange authorities, exchange regulation, is one
20 that doesn't distinguish between securities
21 market, options markets, or futures markets. It's
22 the same regulator. In fact, it's the same -- it

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1 could be the same exchange trading off three
2 instruments.

3 MS. SOMMERS: Thank you for that. Just
4 to follow up a little bit with regard to the
5 sophistication of customers, are there differences
6 in the way that BaFin looks at that issue?

7 MR. REITZ: In terms of customer it
8 pretty much follows the approach that was just
9 suggested here. It's not on the product level
10 that it is distinguished, but it's on the sales
11 process, so the exchange regulation doesn't have
12 any elements of customer -- distinguish between
13 customer groups or anything. It does come into
14 play when it comes to the regulation of the
15 intermediaries.

16 MS. SOMMERS: Thank you.

17 MS. SCHAPIRO: Commissioner Aguilar?

18 MR. AGUILAR: Thank you, Chairman
19 Schapiro. I'd like to direct a question to
20 Professor Harris, Dr. Harris, Mr. Harris,
21 Professor Harris, and try to get some of your
22 knowledge about how the market data regimes differ

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1 and compare under the securities regulations and
2 the commodities futures regulations and whether or
3 not in your views the different ways that they are
4 -- that the (inaudible) how they can be
5 harmonized. And is there a model that in your
6 view is better for customers and for competition?

7 MR. HARRIS: So, I missed the first
8 sentence, it was market data?

9 MR. AGUILAR: Yeah.

10 MR. HARRIS: Ah, you go to a difficult
11 question.

12 MR. AGUILAR: That's why I went to you.

13 MR. HARRIS: Thank you for that. Very
14 quickly, we have two different regimes for market
15 data and actually more than two even within the
16 SEC side. So on the securities side, there is a
17 minimum level of market data that has been defined
18 to be public data and it's collected in various
19 networks and it's sold on a regulated basis based
20 on the number of terminals. The money that is
21 collected is then distributed to the exchanges in
22 proportion to some very complex formulas. Those

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1 formulas are designed to reward people for -- or
2 exchanges and ultimately the people who provide
3 good, high-quality prices. The formulas are
4 designed to reward people for quoting
5 aggressively.

6 On the futures side, each of the futures
7 markets, to the best of my knowledge and I'm not
8 quite as well as informed, basically is selling
9 their data and on terms that are regulated by the
10 CFTC, but largely their own.

11 On top of this you have value-added
12 products where both agencies have decided that
13 they're not going to exercise a lot of
14 supervision.

15 The problems in all cases are similar
16 here. It would be very difficult to argue that
17 one's an institutional market, another's a retail
18 market, or that one's got issuers and the other's
19 a contract market. This is all market data that's
20 all about who's willing to trade or what
21 willingness is present in the market, it doesn't
22 have to be who, at what trades did things take

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1 place.

2 So if there were a single place for
3 harmonization without concerns about the
4 underlying differences, this would be a sensible
5 place. It's all about market structure and it's
6 ultimately all about regulating power
7 relationships between insiders to the markets and
8 the people who are using the markets. So, those
9 people who know more, end up being more
10 profitable, and those people who know less are at
11 a disadvantage.

12 And then the final issue is, who should
13 bear the costs of providing those systems and who
14 should benefit from being able to sell it. It's
15 my opinion, which is not shared by all, that the
16 people who produce the information that's
17 ultimately of value, ought to have some claim on
18 its value. The people who ultimately produce the
19 information are the traders themselves, through
20 their quotations and through their trades, and as
21 a consequence I'm quite sympathetic to seeing that
22 if market data is being sold, that they are the

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1 ultimate beneficiaries of those sales.

2 MR. AGUILAR: Anyone else have any
3 thoughts? I'd like to ask one question, then if I
4 could change to Mr. Luthringshausen. Since your
5 organization has experienced working both with
6 security option exchanges and commodity future
7 exchanges, from an investor/customer perspective,
8 can you give me a point of comparison about
9 perhaps dealing with the offsetting schemes and
10 the fungibility of securities options and
11 commodities futures contracts? Is there one
12 methodology that works better for investors than
13 others?

14 MR. LUTHRINGSHAUSEN: Actually, you
15 know, we don't have any criticism of the future
16 side of the street, if you will. I mean, the
17 clearing works just as well on that side as it
18 does on our side. We think the way we do it is a
19 better way. It produces different results that
20 potentially would have lower cost in the hands of
21 public investors who are dealing in those markets.
22 On the other side of the equation, though, it's

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1 hard to ignore the scale and size of the Merc and
2 what it's done for bids and offers in terms of
3 getting transactions off and the levels of
4 liquidity. So, I think that it's hard; that's not
5 our suggestion for harmonization. Our thought is,
6 is that both systems have worked quite well, the
7 risk systems have worked well, the processing
8 systems have worked well, and it seems to me there
9 are a lot of clients flocking to both systems.

10 Our issue is where things are similar,
11 products are similar in the systems that the smart
12 folks decide how they want to manage their risk or
13 create a certain investment situation and they're
14 the ones that need to be satisfied. It's the
15 client that needs to be satisfied on that front
16 and that doesn't mean you have to tear down one
17 system in favor of the other to accomplish that.
18 Harmonization can accomplish that.

19 MS. SCHAPIRO: Thank you. Commissioner
20 Chilton?

21 MR. CHILTON: Thank you. I talked
22 earlier about, you know, there were sort of a menu

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1 of things that were good and bad about the
2 different agencies and what we have. I wanted to
3 talk now, specifically, about something that
4 neither of us have. Commissioner Aguilar has
5 talked about this and I have and I know
6 Commissioner Dunn's talked about it specifically
7 in the past, and that's criminal authority for our
8 agencies.

9 For the CFTC, two-thirds of our criminal
10 referrals, whether or not it's to the Department
11 of Justice or local or state law enforcement
12 agencies, are rejected. A lot of times, I think,
13 it's because they're very complicated laws and
14 they don't have the expertise. If you're going to
15 New York or Chicago or Washington, they have that
16 expertise, but they may not in other places in the
17 country, and I understand resources, human capital
18 resources, et cetera. But of those two-thirds of
19 the cases that are rejected, 100 percent of them
20 we prosecute successfully, but nobody goes to
21 jail. Remember Baretta? He said, you know, do
22 the crime, do the time? Well, now they pay the

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1 fine or they get deregistered.

2 And so my question, specifically for Mr.
3 Cooper, we had a hearing that Chairman Gensler
4 called back in August, and Public Citizen, your
5 brother in consumer advocacy organization,
6 supported this and I know you have supported
7 additional regulatory reform in the OTC market, et
8 cetera, but I'm curious if the Consumer Federation
9 of America had a view on giving the SEC and the
10 CFTC criminal authority to actually put crooks in
11 jail?

12 MR. COOPER: We actually supported that
13 well before Public Citizen did. You can go back
14 to my testimony in June when we were looking at
15 what I think is a clear market failure, a horrible
16 commodity bubble on the CFTC side, and we
17 advocated criminal penalties, arguing specifically
18 that the sums of money available in these markets
19 has become just so huge that the fines do not --
20 are not a sufficient disincentive to engage in
21 abusive behavior. So, absolutely. If we don't
22 criminalize clear violations of the law that harm

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1 the public, we will not get them out of these
2 markets.

3 MR. CHILTON: Thank you. You know, we
4 -- you're absolutely right on the deterrent, which
5 particularly as we're talking about potentially
6 getting new areas of oversight, ensuring that
7 people know that we're carrying a big stick, I
8 think, is more important. We had a case earlier
9 this year, it's a forex case where three years ago
10 we fined the wife. This year, the husband did it.
11 So, I don't think there's much of a deterrent.

12 One of the reasons that, you know,
13 people raise, and I have a lot of sympathy for
14 this, against taking that approach of criminal
15 authority, is simply the staff resources that we
16 have here. And I certainly understand that, so it
17 would have to go hand-in-hand with additional
18 resources. So we don't take away from our general
19 market oversight and enforcement functions, but
20 I'm curious if any of the panelists have a reason
21 that I haven't heard of why this would be a bad
22 idea.

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1 MR. HARRIS: I'm extremely sympathetic
2 with the idea, but have the following concern:
3 That if the SEC and the CFTC had these powers, it
4 would bring them closer to looking a lot more like
5 the Executive Branch. I think it's very important
6 --

7 MR. CHILTON: Well, what are we now?

8 MR. HARRIS: You're independent
9 agencies.

10 MR. CHILTON: But we're not the Judicial
11 Branch and we're not the Legislative Branch--

12 MR. HARRIS: That's correct.

13 MR. CHILTON: -- so we're an independent
14 agency. But --

15 MR. HARRIS: You're totally independent,
16 but so far the criminal prosecutions has been
17 reserved for the Executive Branch. And while I
18 might be sympathetic to even taking that out of
19 the Executive Branch and putting that into an
20 independent agency, my fear is that if you put
21 (inaudible) powers into the independent agencies,
22 it will make it easier for the independent

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1 agencies to become -- brought into the Executive
2 Branch, which I think would not be beneficial.

3 MR. CHILTON: That's a good point.
4 Thank you. Talk about a four letter word: Turf,
5 and going to DOJ for something like this. That
6 makes these issues look miniscule, but I don't
7 think that the argument that we have never done it
8 -- I'm not suggesting you're making it that
9 simplistic, but the argument that we have never
10 done it, that it's -- is not convincing to me. I
11 think you're right about the continued need to be
12 independent, but I just think it's about time that
13 we did this.

14 MR. HARRIS: Probably the way to do this
15 is to figure out how to fund DOJ's efforts because
16 you do have a separate source of funding and I
17 suspect that a lot of their reservation is a
18 resource constraint and not a value constraint.

19 MR. CHILTON: Yeah, to be honest, I just
20 care about putting people in jail who violate the
21 law and rip off consumers.

22 MR. HARRIS: I agree with you.

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1 MR. CHILTON: Amen.

2 MS. SCHAPIRO: Thank you. Commissioner
3 Paredes?

4 MR. PARADES: Thanks. Professor Harris,
5 you had mentioned earlier a third option on
6 margining as compared to the one pot/two pot, if I
7 recall correctly?

8 MR. HARRIS: The third option on the
9 margining? So, I'm not --

10 MR. PARADES: I guess my question is, if
11 you could just refresh our memories for 20 seconds
12 to make sure we all have it top of mind, I'm
13 actually curious to get the folks to your right to
14 respond what their thoughts are on this other way,
15 getting at the question of margining.

16 MR. HARRIS: Okay, so I'm not sure what
17 you're referring to, but I'll try to do a quick --
18 a very quick summary.

19 The whole margining system, the whole
20 clearing system is about the construction of a
21 pyramid where at each level of the pyramid, the
22 people above have responsibility for what's

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1 happening to the people below. And we currently
2 have a fragmented system where responsibilities go
3 up through different chains, so that effectively
4 you have multiple pyramids. And our desire is to
5 have some sort of consolidated margining system of
6 some sort so that everything is in one pyramid,
7 but the problem with that is that concentrates an
8 awful lot of power.

9 It works quite well in the securities
10 side because the risks involved are rather short
11 term. In clearing on the securities side, you
12 only have basically three days of risk until a
13 security settles. On the futures and the options
14 side, the risk is very long lived because it lasts
15 as long as the contract is alive and some of those
16 liabilities become very great. They're mitigated
17 by variational margins and so forth.

18 So I think the third possibility that I
19 had mentioned was the creation of intermediary
20 entities that can do some of the consolidation on
21 their own accounts for their clients, and then
22 based on that consolidation and the natural

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1 tendency for long positions to offset with short
2 positions, they then relate to the existing
3 clearing agencies as clearing members. But the
4 only way that would work is for them to have
5 capital at risk.

6 The whole pyramid, or the multiplicity
7 of pyramids, this system only works because at
8 each level people are responsible for the people
9 below them, and there's enough capital at each
10 level so that the responsibility is meaningful, so
11 that people take seriously their responsibility to
12 make sure that the people for whom they are
13 guaranteeing, are actually going to perform.

14 MR. PARADES: Exactly. That's what I
15 was getting at. I was curious if other panelists
16 had any reactions or responses to that as a way of
17 thinking about it?

18 MR. LUTHRINSGHAUSEN: I'm not sure I
19 totally understand the level. I mean, I've come
20 to understand one pot/two pot, as the simple fact
21 that it's what Larry in NYL and DTCC are doing.
22 We see it today, specifically in the Treasury and

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1 the Treasury futures, the Treasury cash market,
2 repo market, and the Treasury futures.

3 There is a two pot approach between
4 clearing corps for clearing members and it doesn't
5 work. It doesn't work because the reality is, is
6 if you take this pot and you look at the assets
7 and liabilities in this pot, then you go over to
8 the other pot in the other clearing and you look
9 at it in that pot, you're using up assets that
10 would better fit in the other pots. And it's
11 partly because we trade futures over here and
12 clear it over here, and we trade cash and repos
13 over here and clear it over here. So the reality
14 is, is that we're losing the value and
15 particularly in times of stress, it helps to
16 create more risk in the system because you don't
17 have assets that mitigate against the liabilities
18 over here. You've got them being wasted in other
19 systems. And at the end of the day, I don't hear
20 many users that see this as an issue, proposing
21 that we have two pots or any other kind of pot
22 approach. The one pot approach solves the

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1 problem. And I don't know if that's responding
2 adequately.

3 MR. HARRIS: Perhaps a very simple
4 example of how this would work. Okay, so see
5 imagine you've got a large institution, has a very
6 large securities position and a very large futures
7 position, and the two positions offset each other
8 and right now those two positions have to go into
9 two different pots. And suppose instead of
10 sending those positions immediately into two
11 different pots, you had a third entity, like a
12 bank, that was going to stand as a guarantor of
13 the performance of that institution. So, both
14 positions go into the bank and then the bank
15 stands and the positions go from that bank out to
16 the two clearing agencies.

17 Now, the bank has many other clients.
18 This particular client is long the securities and
19 short the futures, but some other client might be
20 short the futures and long the securities, and so
21 the bank is able to net those two positions within
22 the bank allowing -- providing portfolio margining

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1 for the clients and essentially solving the
2 problem to the extent that the positions met.

3 MS. SCHAPIRO: Yeah, let's take one more
4 minute. Yeah.

5 MR. LEIBOWITZ: I don't think that we
6 have any religion on how we accomplish this.
7 We're all going for the same goal which is allow
8 offsetting positions to increase capital
9 efficiency while still maintaining investor
10 protection and risk mitigation. That's sort of
11 the goal here.

12 The challenge is really just because the
13 different insurance methods are different in the
14 two markets, right? It's the SIPC versus seg. In
15 the -- you know, we're calling ours a one pot
16 approach, but it's really not. It's one pot for
17 firm accounts where there isn't SIPC and there
18 isn't those issues, but when we go to customer
19 accounts it'll have to be more like a virtual one
20 pot because they are still sitting in the
21 different insurance methods. What we want to do
22 is work with the regulators and the others in the

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1 industry to figure out a better way to do this.
2 We don't really care how it happens. We
3 understand what the underlying goals are and the
4 balances to be struck.

5 MS. SCHAPIRO: Thank you. And I will
6 turn the podium back to Chairman Gensler.

7 MR. GENSLER: Thank you, Chairman
8 Schapiro. I have three questions, so I'm going to
9 ask, if we don't get to them, at least those
10 representing the exchanges, if you wish, to follow
11 up with at least two of these in writing, if
12 that's possible.

13 One question is, I'd like to know
14 whether we have consistent or inconsistent
15 approaches to co-location issues and flash
16 trading, where both of our agencies right now are
17 seriously looking at exchanges. I know we are in
18 the exchanges we regulate, but I'd like to
19 understand if we have differences and how you
20 co-locate the -- you're familiar with the issues
21 and flash trading.

22 Secondly, I'd like to know, anybody can

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1 comment, since the SEC has an approach to funding
2 which charges, and this is a congressional mandate
3 that has a -- funds the agency in part and the
4 CFTC doesn't, just your views on whether that's a
5 difference that makes sense in our history and
6 statute.

7 But the one that -- the third question
8 that I'm certainly looking a little bit to Larry
9 and Peter on, but I'd like Wayne's view is this,
10 something that's happened in the last eight years
11 is fundamentally shifted in the marketplace, is
12 that you all are for-profit enterprises now:
13 NYSE, Eurex CME, so forth. The OCC is sort of a
14 public utility function.

15 And when we grapple together on issues
16 of fungibility, whether to make products fungible
17 in the clearing, when we've grappled with
18 cross-margining, the self-regulatory organization,
19 or even product approval, how much does that -- do
20 you think that changed that you all are
21 for-profit, sort of shift a little bit how we
22 should take a look at this? Ms. Nazareth said we

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1 should go to fungibility, but it goes to the core
2 of the business model. It's how one exchange, I'm
3 sure, is followed by the markets. You all have in
4 front of us credit default swap clearing and you
5 all want to compete in something that might end up
6 being a natural monopoly one day, the clearing
7 model.

8 So, I'm curious, how do we grapple as
9 regulators -- we're not looking after your
10 shareholders, by the way, we're looking after the
11 shareholders called the American public?

12 MR. LEIBOWITZ: Yeah, I mean, I think
13 it's a very good point. I think what you have to
14 do is return back to your first principles, which
15 is what's the best for the market? It's our
16 challenge to -- what we want is consistent and
17 fair regulation, meaning across different entities
18 and different instruments so that we're not facing
19 uneven regulation, for example, in rulemaking, in
20 the securities side, or a difference between
21 futures versus securities. We understand that we
22 have to deal with whatever regime we have and we

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1 understand that there's no sympathy for the
2 profits of exchanges, and rightly so. I think
3 what you've got to figure out is, is it a fair,
4 transparent market? Is it offering the right
5 amount of investor protection? And then within
6 that, allowing sufficient competition that brings
7 innovation to those investors.

8 MR. GENSLER: But should we go as far if
9 we jointly thought the right thing was to accept
10 some of the recommendations, whether it's on
11 cross-margining or fungibility? I mean, in 1974
12 or '75, there was a public utility model set up in
13 options clearing, but now we're in a context where
14 everybody's for-profit and they're trying to have
15 derivatives clearinghouses that are for-profit.
16 We have got four or five that are competing.
17 Peter?

18 MR. REITZ: I think when it comes to
19 harmonization and regulation, I think you need to
20 set the standards and then let people compete and
21 let people compete on all levels.

22 I mean, the CDS clearing example is a

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1 very good one, I think. In the futures market,
2 especially, like it was mentioned on the previous
3 panel, competition is on the product more than on,
4 you know, market model, so the whole concept of
5 fungibility always implies that you have
6 standardized products that are all exactly the
7 same across exchanges. That's not necessarily the
8 case in the futures market and, therefore, this
9 whole concept of shall we also change the market
10 structure, will not work or it will come at a very
11 expensive price of innovation and customization of
12 products that then will have to be agreed for the
13 whole market as a structure.

14 So, I think setting the right
15 environment in terms of the market regulation
16 approach and then letting people compete both on
17 the trading layer and also on the clearing layer,
18 is certainly the right model for the futures
19 industry.

20 MR. GENSLER: But Wayne, I mean, how do
21 we square yours and Ms. Nazareth's recommendation
22 that we were -- others would say you have to let a

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1 lot of competition go on in clearing?

2 MR. LUTHRINSGHAUSEN: I think that
3 history shows that it's not -- the issue isn't so
4 much about competition and clearing, it's the way
5 you think of competition and clearing. We had
6 competition and clearing in the stock clearing
7 world for years and years in this country. The
8 Midwest Stock Exchange had a clearing corporation,
9 the Philadelphia Stock Exchange, the Boston Stock
10 Exchange, NSCC, in New York, which is the
11 survivor. And what we found is over a period of
12 years, competing for orders and having locals be
13 very close to those individual clearing
14 corporations, at the end of the day, we wound up
15 with NSCC and the reason is, is that one or the
16 other of those winds up with an economy of scale.

17 So, I don't know that opening it up to
18 that kind of competition achieves much of
19 anything. I do know that from our perspective and
20 from the board of directors that I have to deal
21 with, going public is a no-no. It's a no-no
22 because why charge me higher fees so that you can

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1 have earnings, so that you can pump the stock,
2 which you have to deal with the analyst? And we
3 don't want you, Luthringshausen, and your
4 management team dealing with analysts every
5 quarter or whatever. We want you worried about
6 cross-margins and risk and processing the stuff
7 every night.

8 So I'm not sure that -- I know that our
9 system does what it does. I'm not -- I don't
10 stand ready to criticize other systems for being
11 inadequate. I think the other systems are
12 adequate and I think -- it's just not that
13 separation.

14 MS. SCHAPIRO: I think we are out of
15 time. I wonder if it would be all right if we
16 promise not to overburden panelists if we could
17 submit just a few records to -- questions to you
18 for the record and ask you to provide us some
19 written thoughts on maybe some of the areas we
20 didn't quite get through, which would be most of
21 the areas today? And I guess we're going to take
22 a break now?

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1 MR. GENSLER: We're going to take a
2 break and convene promptly at 2 o'clock in the
3 chairs, if that's all right. And we thank all of
4 you for your forbearance and this panel was
5 terrific. And I thank my fellow commissioners and
6 chair.

7 MS. SCHAPIRO: Thank you.

8 (Whereupon, at 12:50 p.m., a
9 luncheon recess was taken.)

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1 right you were talking about, Ed. But Ed Rosen
2 from Cleary Gottlieb, Yvonne Downs from Newedge,
3 Stephen Merkel from BGC Partners -- it's still
4 Cantor in my mind -- Brandon Becker from
5 TIAA-CREF. Stephen, can you pronounce just so I
6 --

7 MR. LUPARELLO: I'll take a shot.
8 Luparello.

9 MR. GENSLER: Luparello. I believe an
10 alumna from both agencies, but from FINRA. And
11 then Brian Nigito from GETCO. So, we thank you
12 all and the little lights will help you. The
13 yellow will tell you you're getting close.

14 Ed, if you want to go first?

15 MR. ROSEN: Thank you. So, why do we
16 want to harmonize the --

17 MR. GENSLER: You might want to touch
18 the button there and --

19 MR. ROSEN: So why do we want to
20 harmonize these regulatory regimes? One answer,
21 perhaps the somewhat politically sensitive answer,
22 is that you can put two agencies in the same

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1 building, put a single name over the front door.
2 But you will not have accomplished very much,
3 possibly you will have accomplished a tiebreaker
4 for jurisdictional conflicts. But without
5 harmonization, you can't effectively integrate the
6 statutes and accomplish some of the other
7 objectives that are available.

8 And that presents some difficult
9 challenges, but also some very significant
10 opportunities. I mean, questions like, do we
11 ultimately want to retain FCMs and broker-dealers
12 as separate regulatory categories or do we want to
13 have a single category of brokers and then maybe
14 qualify employees based on the activities that
15 they engage in and the policy issues and expertise
16 that is relevant to that activity? Same question
17 with investment advisors and commodity trading
18 advisors. Is there a reason to retain two
19 different regulatory regimes for them? We
20 regulate funds under the '40 Act and we regulate
21 pool operators under the Commodity Exchange Act,
22 and there are very significant and, in some cases,

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1 consequential differences that arise from that
2 approach, from those two different approaches.

3 And you can ask similar questions with
4 respect to the range of registrant. Now, those
5 are obviously, if there is a political appetite to
6 do that, much longer term objectives, but there's
7 a lot that could be accomplished in the near term.

8 There are equally obvious limits to
9 harmonization. Some rules and policies are driven
10 by product differences although I suspect that
11 these are really in the distinct minority. People
12 often talk about price bias and price neutrality
13 as differentiating characteristics, but I think
14 neither product category should defy the laws of
15 gravity, certainly not as a result of regulatory
16 engineering.

17 But on the other hand, there is no
18 futures analogue to the capital raising formation
19 function that the SEC oversees and corporate
20 governance as well. And corporate insiders do
21 raise unique issues that do and should drive
22 differences in what intermediaries can do with

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1 information and the capital market's orientation
2 of the securities law generally has driven some
3 consequential differences. Since the '70s,
4 there's been no bias favoring exchange trading
5 under the securities laws, but the CEA does tend
6 to favor exchange trading and indeed require it
7 and pending legislation, as I'm sure everybody
8 here knows, would further that trend.

9 And these differences do have -- lead to
10 differences in the treatment of financial
11 products. Think about warrants, index notes,
12 passive funds, the trick asset categories and the
13 like, you can obtain very stark differences in the
14 two regimes with respect to very closely related
15 products. Take a warrant on Treasury yields that
16 can be issued as a securities in the capital
17 markets, distribute it on a retail basis. But if
18 you do a warrant on a rate that is abstracted from
19 any security, that may be a commodity option, and
20 if it's a commodity option, couldn't be offered at
21 all without some specific relief from the CFTC.
22 And you have to ask yourself whether the

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1 differences in those products justify the
2 different outcomes.

3 Commissioners obviously are all aware of
4 the commodity ETF issue and I think measures need
5 to be taken to eliminate these kind of regulatory
6 discontinuities on a more systematic basis not
7 just on an ad hoc basis. These products should be
8 allowed to be sold and sales forces and
9 distribution channels should be able to be used
10 that are appropriate for the relevant products.

11 Obviously harmonization means more
12 efficient use of resources and lower costs for
13 registrants and also better use of the limited
14 resources that the agencies have, but it is more
15 than just cost savings. We have too many
16 disparate regulatory regimes and too many rules
17 and too many rules that are addressed to the same
18 policy objectives, but that prescribe different
19 approaches and very specific approaches to
20 compliance and these require different policies
21 and procedures and they require different systems
22 to implement, and they require large numbers of

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1 expert, highly specialized compliance staff. And
2 this costs more than just money, although money's
3 not a trivial part of it. This is the recipe for
4 what we witness daily in the industry press day
5 after day, firms fail in ways small and large to
6 comply with bread and butter regulatory
7 obligations and more frequently than not, it's not
8 willful. The number and complexity of rules, the
9 nuances and their interpretation, is itself a
10 source of a serious challenge to the ability of
11 firms to manage their compliance risk.

12 Opportunities exist to reduce the number
13 of differences. They begin with things as simple
14 as harmonized registration requirements, even
15 registration forms and processes, entitlements to
16 exemptions, record keeping requirements and
17 formats, reporting, filing and noticing
18 allocations, capital computations, order handling
19 and customer property rules. There's so much that
20 could be usefully done to eliminate historical
21 differences in the rules even before wrestling
22 500-pound gorillas like market structure and

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1 clearing.

2 In this process, there will be a
3 temptation to achieve reconciliation by
4 aggregating rule requirements and this temptation
5 needs to be resisted. I think the goals of the
6 Commissions should be not just to reduce costs,
7 but also to come up with harmonizing solutions
8 that are likely to increase effective compliance,
9 not to make it ever more challenging to comply.

10 There's an old aphorism that the most
11 complex solution to a problem is probably not the
12 best solution.

13 Just a quick word on margin. Everyone
14 is aware that the statutes adopt different
15 approaches to margin. Pending legislation will
16 increase the importance of a coherent approach to
17 margin, but the starting point is that
18 intermediaries are in the business of providing
19 financing to their customers and capital
20 deductions exist to account for those credit
21 exposures. The Commissions and Congress need to
22 decide what their margining objectives are. Is it

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1 to dampen speculative pressures --

2 MR. GENSLER: You might want to
3 summarize.

4 MR. ROSEN: Okay, one last point beyond
5 the need to decide what the objectives of
6 margining levels are is insolvency. This is not a
7 harmonization issue; this is just something that
8 needs to get done. Dual registrants are subject
9 to potentially conflicting insolvency regimes.
10 And if there is a major insolvency of a dual
11 registrant and both regimes apply, we do not know
12 how their assets are going to be allocated across
13 the customer claimants. That needs to be handled.

14 MS. DOWNS: Thank you. I'm Yvonne
15 Downs, senior director of Newedge USA. It's an
16 honor to appear before this important assembly.
17 As you may know, Newedge has consistently
18 supported efforts to harmonize CFTC and SEC rules
19 and has been an advocate for the creation of a
20 single financial services regulator.

21 Given the political reality that a
22 single regulator will not be created,

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1 harmonization of the CFTC and SEC rules is the
2 next best thing.

3 In our opinion, it is an important step
4 in the management of market risk. In addition,
5 it's good for business in the U.S. Currently, too
6 much of our institutional business needs to be
7 directed to the U.K. and elsewhere where the
8 regulatory environment is less complicated, but
9 requires portfolio margining of multi-asset
10 accounts.

11 As background, Newedge was created
12 through a merger in 2008, and we are now one of
13 the world's top derivatives brokers handling
14 directly or indirectly all types of financial
15 assets for our institutional clients across more
16 than 85 different markets worldwide.

17 From this global viewpoint, we are able
18 to think about the potential harmonization of U.S.
19 financial regulations with a unique perspective.
20 Although we do not handle retail clients, we at
21 Newedge have always been struck with the idea that
22 in theory we might be required to decline a

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1 customer under (inaudible) rules as unsuitable, to
2 buy or sell shares in an ETF like U.S. soil, but
3 could offer that same customer the opportunity to
4 buy and sell crude oil futures or options.

5 Generally, we operate in the U.S. as if
6 we have only one set of regulations, namely the
7 toughest of the applicable rules of either
8 regulator. However, just because a rule is the
9 toughest does not mean it's the best.

10 In our opinion, the most critical area
11 for harmonization is portfolio margining. Newedge
12 has been a leader in providing this service on
13 equities and options to its customers under
14 various SRO rules. It has reduced our customers'
15 risk to us, to themselves, and to the markets. It
16 allows customers to maintain both their equities
17 and options positions in one account and to obtain
18 the benefit of any offsets. However, in the U.S.,
19 true portfolio margining combining futures and
20 securities products in one account has not gained
21 traction because the CFTC and the SEC have not
22 recognized each others' good customer funds

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1 location. This has prevented the advance of a
2 program that is beneficial for both the customers,
3 the brokers, and perhaps most importantly, could
4 reduce systemic risk.

5 Comprehensive portfolio margining is
6 critical to encourage some brokers such as Newedge
7 to participate in the clearing of credit default
8 swaps and other OTC products. CDS products are
9 anticipated to have higher margin requirements
10 than traditional futures, thus holding them out
11 right over the long term for customers would
12 generate significant capital requirements for the
13 firm. This is because our capital requirements
14 are driven by our customer's capital requirements
15 as we operate under the futures model today.

16 The higher these requirements are, the
17 more capital we must maintain. And in a near zero
18 interest rate environment, the opportunity cost of
19 maintaining a large amount of capital is not
20 attractive. However, with true portfolio
21 margining, holding credit default swaps with their
22 offsetting hedges, could potentially moderate our

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1 customer margin requirement, could reduce our
2 customer's overall risk with us, and could reduce
3 our potential capital requirements. Thus we hope
4 the CFTC and the SEC will expedite the resolution
5 of any issues that have prevented comprehensive,
6 multi-asset portfolio margining.

7 There are several other areas that we
8 believe harmonization should occur. In the area
9 of books and records and disclosures all
10 requirements should be simple, consistent and
11 identical across both agencies. Client type
12 definitions, there are too many types of
13 sophisticated and institutional definitions under
14 both the SEC and CFTC. For example, ECPs, QIBs,
15 accredited investors. These should be simplified
16 to two or three types and made consistent for both
17 agencies.

18 In the area of customer funds
19 protection, we've already addressed this in the
20 context of portfolio margining. There should be
21 one way the customer assets are protected, this
22 one (inaudible) the fair and prompt distribution

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1 of customer assets if a combined broker-dealer FCM
2 were to file for bankruptcy.

3 And access to foreign markets, the
4 institutional clients -- again, institution
5 clients should be given the equivalent access to
6 non-U.S. traded products. This should be through
7 overseas brokers who are subject to comparable
8 regulations, whether the products are securities
9 or futures.

10 In addition there are two areas driven
11 by public policy considerations and they include:
12 manipulation and anti-fraud. Policy in this area
13 needs to be harmonized. However, new rules should
14 not inhibit transactions done for bona fide
15 hedging or risk management purposes.

16 And lastly, suitability. All private or
17 retail clients should be protected from brokers
18 selling unsuitable products no matter what type of
19 product.

20 I'd be pleased to take any questions,
21 and thank you for providing this forum and for
22 seeking input on this important discussion.

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1 MR. MERKEL: Good afternoon. I'm Steve
2 Merkel and I'm pleased to be here today to share
3 my experiences as general counsel of BGC Partners
4 and Cantor Fitzgerald.

5 I wanted to point out that I'm also a
6 founding board member of the Wholesale Markets
7 Broker's Association, Americas, which represents
8 the largest global interdealer brokerage firms
9 that operate as intermediaries in North America.

10 I am supportive of the legislative and
11 agency initiatives to more effectively oversee the
12 over-the-counter markets for financial products.
13 To that end, I see the administration's proposed
14 Over-the-Counter Derivatives Markets Act of 2009
15 as an important step in bringing additional
16 regulation to the over-the-counter derivatives
17 markets and believe that many of its requirements
18 will integrate smoothly with the current practices
19 of many interdealer brokers.

20 I would like to leave you, hopefully,
21 with the following impression: Everything that
22 the CFTC and the SEC seeks to accomplish in

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1 connection with reduction of systemic risk caused
2 by uncollateralized bilateral transactions,
3 enhanced price trade, and regulatory transparency
4 for swaps, and market oversight, can be achieved
5 utilizing the OTC market structure. The
6 interdealer brokers are prepared to help advance
7 that cause.

8 I think the example of the United States
9 Treasury securities market makes the point
10 perfectly. It is an over- the-counter market.
11 There is no exchange trading. On the wholesale
12 level, it has long operated as a central
13 counterparty cleared system in which the
14 over-the-counter trades are novated within minutes
15 of execution. The clearing corporation becomes
16 the counterparty to the trades, with the ability
17 to require margin payments to secure the pre-
18 settlement mark to market risk. This system
19 accommodates multiple competitive execution
20 platforms, interdealer brokers, such as my firm,
21 which provide varying levels of electronic, voice,
22 or hybrid execution. Also the market, still

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1 entirely over-the-counter, is well overseen with a
2 high level of transparency.

3 Finally I note, and this will come up
4 later, the central counterparty clearing facility
5 does not operate a competing execution platform.
6 It is a neutral site providing such services with
7 non-discriminatory access.

8 I have four brief thoughts on the
9 proposed legislation that I would like to share
10 with you. First, the existing interdealer broker
11 networks and execution platforms are ideal,
12 innovative, and competing existing pools of
13 liquidity for swaps which currently and in the
14 future can meet the objectives of the legislation
15 in the form of alternative swap execution
16 facilities, or I'll call the ASEFs.

17 Second, it is crucial that CFTC and the
18 SEC ensure that any implementing or regulations do
19 not prohibit voice or broker interaction in the
20 trading process as we use both electronic and
21 broker-assisted means to effect transactions.

22 Third, the proposed legislation

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1 creations, ASEFs, can be many things, but may not
2 be the proper entities to undertake the
3 enforcement or SRO, self-regulatory organization,
4 type responsibilities if we want to see ASEFs
5 operate as multiple competing execution platforms.

6 Finally, a vertically linked derivatives
7 market, or a central counterparty providing
8 clearing services, also provides trade execution
9 services would be uncompetitive and ultimately
10 hurt market participants. To be clear, this is
11 not a product fungibility point; this is an
12 execution platform point.

13 I strongly urge you to consider a more
14 horizontal structure that fosters competition. I
15 believe that both the proposed legislation and
16 subsequent regulation must ensure non
17 discriminatory access to open and neutral clearing
18 facilities which are unaffiliated with execution
19 platforms that arrange transactions in the same
20 financial product being cleared. The U.S.
21 Government securities and equity and options
22 markets are strong and pro-competitive models to

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1 follow.

2 I very much appreciate your invitation
3 to take this opportunity to share my thoughts on
4 this subject. Thank you.

5 MR. BECKER: Good afternoon. I am
6 Brandon Becker, chief legal officer for TIAA-CREF,
7 an organization dedicated to serving those who
8 work in the academic, medical, and cultural
9 fields. Previously, I served as director of the
10 Division of Market Regulation at the SEC.

11 I would like to thank the CFTC and SEC
12 for affording us this opportunity to share our
13 views regarding how the current regulatory
14 structure might be better harmonized to facilitate
15 efficient trading by investors and improve market
16 integrity.

17 TIAA-CREF is one of the world's largest
18 retirement systems with \$363 billion in combined
19 assets under management and 3.6 million
20 participants. As a large institutional investor
21 and provider of defined contribution retirement
22 plans for over 90 years, TIAA-CREF is an active

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1 participant in the derivative markets in the
2 United States and elsewhere. TIAA, as an
3 insurance company, is regulated by the New York
4 State Insurance Department among others. CREF is
5 a registered investment company.

6 We support efforts to harmonize the
7 regulatory structure for the derivative markets
8 both because we believe it will enhance market
9 efficiency, but, more importantly, we believe it
10 will strengthen market integrity and insist in
11 mitigating systemic risk. We note, however, that
12 harmonization efforts have been ongoing for
13 decades. As long ago as the Futures Trading Act
14 of 1982, Congress called for a joint study by the
15 SEC, CFTC, and Federal Reserve of derivative
16 markets. The study concluded in 1984 that there
17 is a need for close harmonization of federal
18 regulation of derivative markets. Accordingly, we
19 welcome the current efforts by the Commissions to
20 jointly focus on these issues.

21 Nevertheless, in view of the
22 difficulties over the last 25 years to achieve

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1 meaningful progress toward harmonization, we
2 believe future progress will require sustained and
3 detailed attention at the commission level to make
4 the difficult decisions necessary to find a way
5 forward. In this regard, while there are many
6 significant issues concerning intra- and
7 inter-industry competition that arise under the
8 rubric of harmonization, we urge the Commissions
9 to concentrate their time and energy on those
10 issues that address systemic risk such as margin
11 clearing and bankruptcy.

12 As an institutional investor, we use
13 derivative markets for a variety of perhaps most
14 commonly for managing various kinds of financial
15 risk such as market and credit risk. In that
16 regard we find the customization and flexibility
17 provided by over-the-counter products to be very
18 valuable. Indeed, because of the individualized
19 tailoring provided by OTC products, such products
20 are enormously valuable for various portfolio
21 management purposes. Accordingly, while we
22 support efforts to mitigate systemic risk and

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1 enhance transparency, we also believe it is
2 important to maintain the significant benefits for
3 investors that flow from the customization
4 available through OTC products. Specifically, we
5 believe that the various prudential reforms that
6 are under discussion, such as enhanced
7 transparency and clearing, can be achieved without
8 precluding the use of OTC products.

9 More broadly, as an investor, we find
10 the inefficiencies that result from the
11 disparities between and among markets largely a
12 cost of doing business. Efforts to minimize those
13 costs will enhance market efficiency. Of course,
14 from an investor protection perspective, we
15 generally expect intermediaries to provide us a
16 comparable level of service. In this regard, as
17 the events of the last two years have highlighted,
18 clarifying margin and bankruptcy regimes not only
19 will improve prudential oversight, but also
20 mitigate systemic risk.

21 TIAA-CREF, on behalf of its
22 participants, appreciates the opportunity to

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1 participate in this hearing. I am happy to answer
2 any questions you may have.

3 MR. GENSLER: Just before we go forward,
4 I don't think I have your statement or Mr.
5 Rosen's. It may, again, be in my daughter's book
6 bag, but to the extent you wanted the public to
7 see it rather than her friends, if you could still
8 submit it and then all the commissioners probably
9 would get the benefit of seeing that, too.

10 MR. BECKER: Certainly.

11 MR. GENSLER: I think that's probably
12 true.

13 MR. NIGITO: I was going to say, Mr.
14 Chairman, the only excuse I can offer is that my
15 son is also starting kindergarten this week if
16 you'll accept that one.

17 MR. GENSLER: It's an excuse that works
18 with me, for sure.

19 MR. LUPARELLO: I have no
20 kindergarten-related jokes so I'll just get --
21 thank you, Mr. Chairman, I'm Steve Luparello, vice
22 chairman of the Financial Industry Regulatory

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1 Authority, or FINRA.

2 FINRA is the primary securities SRO for
3 U.S. firms conducting a business with the public.
4 We regulate over 4,800 firms, 600,000 registered
5 representatives, and 173,000 branch offices. We
6 brought around 11,000 disciplinary actions in
7 2008, and are on a pace to exceed that number this
8 year. Of our 4,800 firms, approximately 230 are
9 duly registered as FCMs.

10 Despite the well-known differences in
11 the underlying statutes, securities and futures
12 SROs historically have found ways to work together
13 through both formalized mechanisms and outreach on
14 particular issues and areas of concern. And FINRA
15 enjoys a strong working relationship with the
16 primary futures SRO, the NFA.

17 That said, certain inefficiencies will
18 always exist in such a bifurcated structure. A
19 timely example of both the risks inherent in
20 fragmented regulation and the benefits of
21 functioning cooperative relationships involves the
22 recent increase in the number of firms actively

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1 marketing retail foreign currency trading. Retail
2 forex, especially in its current form, includes
3 opaque pricing, high leverage, and non-transparent
4 activity and is an area ripe for fraud and
5 customer harm.

6 In 2008, Congress, at NFA's request,
7 increased capital requirements for FCMs that
8 conduct an off-exchange retail forex business
9 creating the possibility for a significant
10 migration of forex business to FINRA-registered
11 broker-dealers. In no small part thanks to a
12 series of meetings between NFA and FINRA staff,
13 FINRA has been able to stay in front of this
14 issue.

15 In November 2008, we issued a regulatory
16 notice reminding broker-dealers that a number of
17 our rules apply to that activity irrespective of
18 the fact that it was not securities activity and,
19 in June of this year, we proposed changes to our
20 margin rules relative to the product. Those
21 changes, still pending, would require a customer
22 to post a substantial amount of the notational

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1 value of the forex position.

2 Each SRO has taken aggressive steps to
3 limit customer harm in this area and we have
4 appreciated the willingness of NFA to share with
5 us some of their lessons learned. Nonetheless,
6 this is a useful example of how our current
7 regulatory system creates the potential for gaps
8 and arbitrage that can be exploited as
9 participants move almost effortlessly from one
10 statutory scheme to another.

11 The differing regimes also complicated
12 efforts this year by market participants pursuing
13 efforts to move clearing of credit default swaps
14 onto centralized clearing facilities. These
15 efforts were impeded in part because transactions
16 affected by broker-dealers would not, absent
17 specific rule making, be subject to the same
18 margin levels as those affected by FCMs.

19 After much discussion and some delay,
20 FINRA launched a pilot program establishing margin
21 requirements for firms affecting transactions and
22 CDS contracts that are cleared through a central

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1 counterparty clearing service ensuring the
2 transactions affected by broker-dealers are
3 subject to margin requirements comparable to those
4 of the clearing facility.

5 I appreciate that Brandon's been quiet
6 during that little section.

7 Another significant challenge presented
8 by the current bifurcated system of regulation and
9 securities and derivatives is overseeing the
10 trading activity on these markets. Chairman
11 Schapiro noted again last week that regulators
12 need increased access to data across cash and
13 derivatives markets to conduct more meaningful
14 surveillance.

15 The review of trading activity across
16 cash markets and futures markets generally has not
17 been integrated. Where there has been a need to
18 share information, either on a product specific
19 basis or to assist in reviews and investigations,
20 there has always been good cooperation between
21 futures and cash regulators, but ad hoc approaches
22 to market oversight will become increasingly

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1 inadequate in the light of new trading patterns.

2 While there has yet to be a proven case
3 of manipulation based on an allegation that swaps
4 trading, move the market in the related equity,
5 there can be no doubt that such a fact pattern is
6 possible. With the increased standardization of
7 OTC derivatives as well as the clear linkage
8 between the derivatives and the cash markets, it
9 is obvious that audit trails of different quality
10 are restricted to certain types of products will
11 no longer reveal the full picture of trading
12 activity that affects the marketplace and will
13 interfere with our ability to combat illegal
14 activity.

15 Other panelists today will cite examples
16 of how dual regimes interfere with or layer costs
17 onto the products and services they offer. These
18 are legitimate issues and worthy of your attention
19 and we strive to ensure that any costs we impose
20 do not unnecessarily contribute to that burden,
21 but our primary focus has been and will continue
22 to be ensuring that we have the tools, knowledge,

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1 and information required to ensure investor
2 protection.

3 Thanks again for the opportunity to be
4 here and I'm happy to answer any questions.

5 MR. NIGITO: Thank you, Chairman
6 Gensler. I'm happy to be here with the
7 distinguished group of panelists. I would also
8 like to thank Chairman Schapiro as well as the SEC
9 and CFTC commissioners for inviting us to take
10 part in this discussion.

11 Regulatory harmonization is a laudable
12 goal worthy of both the SEC and CFTC's efforts.

13 I thought I would begin by providing a
14 brief overview on GETCO, the Global Electronic
15 Trading Company, and my own professional
16 background. Mine is in market technology and
17 quantitative investment strategies having worked
18 at some of the largest ECNs and proprietary
19 trading firms. It is my sincere hope that
20 amongst this esteemed panel of legal professionals
21 I may answer some of the more mundane nuts-and-
22 bolts questions of how these different markets

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1 operate and make both my own and GETCO's
2 experience available to you.

3 If you are already familiar with GETCO,
4 please indulge me for a brief moment as I give a
5 bit of our background and the role we play in our
6 capital markets. GETCO is just over 10 years old,
7 and the firm's primary business is electronic
8 market making and liquidity provision. We have
9 offices in Chicago, New York, London, and
10 Singapore. As active, bona fide market makers,
11 GETCO makes two-sided markets, bids and offers, on
12 over 30 markets in North America, Europe, and
13 Asia.

14 We trade in four major asset classes --
15 equities, fixed income, commodities and currencies
16 -- in the cash, futures, and options markets.
17 Though GETCO does not have any direct retail or
18 institutional customers, per se, we are registered
19 as a broker-dealer and regulated in accordance
20 with the SEC and SRO requirements.

21 GETCO also operates our own SEC
22 registered alternative trading system, GETCO

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1 Execution Services. As such, GETCO has
2 significant experience operating under a
3 rules-based regulatory framework. GETCO also has
4 extensive experience trading on venues that
5 operate in a principle space regime, such as the
6 CME and the Intercontinental Exchange, and have
7 had a very positive experience operating in this
8 arena as well.

9 Over the past few years, GETCO has
10 worked to share our global perspective with
11 regulators through comment letters and increased
12 engagement over critical market structure issues
13 such as the options penny pilot, short sell
14 requirements, and the now infamous flash order
15 type.

16 Whether it be on principles or
17 rules-based regulatory regime, GETCO is core
18 trading strategy remains constant. We engage in
19 market making and liquidity provision to help
20 investors efficiently transfer risk.

21 To unpackage the last statement somewhat
22 as the concept of efficient risk transfer is not

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1 something you hear every day, it is GETCO's view
2 that one of the functions of a financial market is
3 to allocate risk to those persons or entities best
4 able to bear it. As those entities do not always
5 meet in time, GETCO commits capital and assumes a
6 variety of financial risks until a natural
7 counterparty is found.

8 GETCO has invested heavily in technology
9 and human capital to create a platform for
10 liquidity provision at low cost. By continuously
11 providing two-sided markets, GETCO and its
12 competitors facilitate price discovery, reduce
13 volatility, and help maintain orderly liquid
14 markets for investors.

15 Market and regulatory structures play an
16 important role in our ability to provide this
17 service effectively. It is our view that
18 regardless of the regulatory approach, be it rules
19 or principles, the overall objective should focus
20 on several fairly simple, but essential core
21 values and philosophies: Efficiency,
22 transparency, innovation, fairness, and above all,

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1 competition; all principles that I think everyone
2 here agrees make up the core underpinnings of a
3 healthy, vibrant market.

4 And the good news is that here in the
5 U.S., it's been our experience that even though
6 our market structure has dramatically changed over
7 the last decade, the differing regimes of the SEC
8 and CFTC have matured and adapted to foster
9 growth, promote transparency, product innovation,
10 and competition. They have coexisted quite
11 effectively and given investors the ability to
12 transfer risk even in times of significant stress
13 and volatility.

14 Last fall during the financial crisis,
15 opaque and complex over-the-counter derivatives
16 caused panic in credit markets. While it's hard
17 to overstate what the financial crisis did in
18 terms of harm to investor confidence, it is
19 important to highlight the fact that both our SEC
20 regulated cash markets and the CFTC regulated
21 futures markets functioned exceptionally well in
22 times of great uncertainty, anxiety, and

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1 volatility.

2 Securities and futures markets opened
3 every day with firm prices and liquidity. In past
4 instances of market stress communication broke
5 down, markets stopped functioning, and it was
6 difficult, if not impossible, to trade. By
7 contrast, asset prices may not have been what any
8 of us liked, but the markets themselves held up
9 remarkably well.

10 One of the great attributes of the U.S.
11 capital markets is that we routinely scrutinize
12 our structure and regulations for ways to improve
13 and make them more efficient, transparent, and
14 competitive. This segues nicely into our topic
15 today, SEC and CFTC harmonization.

16 GETCO often experiences firsthand the
17 costs and burdens associated with duplicative and
18 inconsistent regulations. As a firm that places
19 great value on efficiency, competition, and
20 innovation, the prospect of regulatory
21 harmonization is something GETCO warmly welcomes.

22 We understand, however, that harmonizing

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1 elaborate regulatory structures covering complex
2 and very different products can be more difficult
3 to accomplish than is probably realized.

4 To that end, the simple question
5 remains, what should be done to make our
6 regulatory structure more harmonized? In the
7 broadest sense the most direct thing to do is
8 simply collaborate more as both agencies bring
9 expertise that can complement the other. The
10 current environment will likely produce new,
11 innovative products that address the many facets
12 of risk investors face today and a good example is
13 commodity-related products. A smooth
14 harmonization will prepare the SEC to understand
15 the nature of these products --

16 MR. GENSLER: If you can just --

17 MR. NIGITO: -- and assess their
18 suitability for retail investors. While the SEC
19 --

20 MR. GENSLER: The whole thing will be
21 submitted into the record.

22 MR. NIGITO: Sure. Fair enough --

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1 prepares for the pressures that come with enhanced
2 retail participation. Thank you for allowing me
3 the time to provide this insight. I look forward
4 to your questions.

5 MR. GENSLER: I thank you and I'm going
6 to turn to Commissioner Dunn and I guess I get to
7 play wrap up at the end.

8 MR. DUNN: Good, I'll take all your
9 great questions. Steve, I'd like to start with
10 you, and I'm sorry that we don't have NFA on the
11 panel here as well because I've got a little
12 ambush for Dan Roth as well, but let me start with
13 you.

14 When I was acting chair, I received a
15 referral from FINRA that was over a year old and I
16 think all of us agree that that is too much of a
17 length of time and to sort through these
18 referrals, who they should go to, and you've
19 talked about meeting with our staff. How can
20 FINRA, NFA, SEC and CFTC enforcement work together
21 to ensure that we have a quick referral of these
22 particular leads?

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1 MR. LUPARELLO: I think you raise a
2 great question. I'm happy to take the bullet for
3 Dan or at least give him a little time to prepare
4 before tomorrow.

5 I think we always strive to make sure we
6 do our investigations as expeditiously as we
7 possibly can. And if we don't have jurisdiction,
8 to get them to folks that do have jurisdiction as
9 quickly as we possibly can.

10 That said, sometimes it's hard and I
11 don't know the specifics of the one you're talking
12 about, but it is especially in areas where it's
13 not clear what the jurisdiction is or what the
14 product is, that it sometimes gets -- it takes a
15 long time to get to the point where you've decided
16 you in fact don't have the jurisdiction because
17 all of us, whether it's on the government side or
18 the SRO side or on the futures side or on the
19 securities side, we want to bring our own cases.
20 We want to find any way possible to claim
21 jurisdiction if we can and it's only when we
22 realize that at the end of the road, we can't,

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1 that referrals become sort of a second
2 alternative.

3 I think, you know, I hate to say it, but
4 I think, you know, more meetings and more
5 cooperation across, not just futures and
6 securities, but government and SROs would allow us
7 to sort of flesh out those issues earlier and make
8 quicker decisions on fundamental jurisdictional
9 issues, which I think gets those referrals into
10 the hands of people with the jurisdiction sooner.

11 MR. DUNN: I hate to preempt my fellow
12 Commissioner Chilton, but I have long advocated
13 for Justice to have a liaison person with the
14 Commissions for criminal. What has been your
15 experience of working with Justice on criminal
16 cases?

17 MR. LUPARELLO: Our experience has been
18 good in isolated circumstances and other times
19 it's been hard to get our issues to be on the list
20 of the many, many things that a given U.S.
21 attorney is interested in. So we've had some real
22 great successes where we have found fact patterns

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1 that were outside our jurisdiction, we were able
2 to get both the SEC and the Justice Department,
3 the FBI or the U.S. Attorneys Offices interested
4 in it. But it is, frankly, episodic and it is
5 case-by-case. And I think adding some structure
6 around that, that allows us to develop the working
7 relationships on a routine basis as opposed to
8 just on a fact-specific basis, where you're trying
9 to get a U.S. attorney who's got a thousand other
10 things to think about interested in a specific
11 case, I think would really facilitate that.

12 MR. DUNN: Again, I'm picking on you.
13 Could you elaborate a little bit on the difference
14 between NFA's "know your customer" and the SEC's
15 investment suitability?

16 MR. LUPARELLO: Well, it's our
17 suitability rule. I think the basic difference
18 between us is that the "know your customer" rule
19 makes these determinations on a customer-
20 by-customer basis while on the security side, the
21 suitability rule, is either on a
22 product-by-product or strategy-by- strategy basis,

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1 so it is a more frequent analysis on the
2 securities side than I think traditionally it has
3 been viewed on the future side. I think there are
4 arguments to be made that given the breadth of
5 products that can be offered in the context of a
6 securities relationship requiring it on that
7 discrete a basis maybe makes more sense than in
8 the futures context.

9 MR. DUNN: And now for the big one,
10 Steve. What's your thought on the creation of a
11 customer protection agency?

12 MR. LUPARELLO: I think at this point,
13 the FINRA has not taken a position on the pending
14 legislation and I think we are supportive of any
15 way customers can be protected. I think the
16 current legislation speaks about non- securities
17 products, which makes me, I think, a dilettante
18 and not an expert, and on that I'd probably decide
19 not to answer.

20 MR. DUNN: Thank you. I'm about to run
21 out of time, but I did want to ask about
22 collocation and flash trading of some of the

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1 members of this panel, but I'll do that in a
2 written follow-up.

3 MR. GENSLER: Thank you, Commissioner
4 Dunn. Commissioner Casey?

5 MS. CASEY: Thank you very much, Mr.
6 Chairman. I actually would just like to follow up
7 on the line of questioning that Commissioner Dunn
8 was directing to you, Steve, and actually I would
9 encourage other panelists to jump in if they would
10 like as well.

11 In recognizing the differences between
12 the customer protection regimes for broker-dealers
13 and FCMs, suitability standards for
14 broker-dealers, "know your customer" risk
15 disclosure approach for FCMs, obviously this is an
16 area where there has been a discussion about
17 whether or not you should have a harmonized
18 standard. And I guess I would ask the question
19 whether or not this should be one standard and, if
20 that's the case, whether the suitability standard
21 is appropriate. And if it is, what kind of
22 considerations should we take into account to

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1 reflect the differences between the market,
2 functions of the markets, and the market
3 participation, particularly institutional versus
4 retail?

5 MR. LUPARELLO: That's a complex
6 question. We clearly are -- believe that the
7 suitability standard works well in the securities
8 distribution chain. I think it's something that
9 can always be improved. I think we have made the
10 point recently that there is -- we believe that if
11 there's not, that there should be a fiduciary
12 overlay in that relationship and that we continue
13 to look at our suitability rule to see whether
14 there are certain ways it needs to be enhanced and
15 strengthened and I think sort of clarifying that
16 it extends to a variety of things, including
17 strategies, has been an important part of what
18 we've done. We've also opined a lot over the
19 years in terms of things like institutional
20 suitability.

21 So, we think suitability is an organic
22 thing. It's something that we try to take either

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1 new products or new structures in relationships
2 and make sure that the suitability structure is,
3 is one that is designed and the guidance is there
4 to ensure investor protection.

5 Whether the "know your customer" regime
6 on the futures side is -- would be considered
7 similar to or appropriate if you were extending
8 the suitability analysis to FCMs and their
9 customers, I think is an interesting question. I
10 think there is a lot about the "know your
11 customer" rule that is very similar in terms of
12 how it provides customers the information they
13 need and how it provides guidance to FCMs working
14 with customers to make sure that they're making
15 the right analysis.

16 Again, I think the timing issue is the
17 one issue that continues to be something that is a
18 fundamental substantive difference and I think we
19 would probably think that that ongoing assessment
20 on a product-by-product basis is one that would
21 make sense.

22 MS. CASEY: Do any others have comments

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1 as well on this topic?

2 MR. ROSEN: Yeah, I think one of the
3 differences -- I don't mean to be crass about it,
4 but when you look at the range of securities
5 investments, there are significant differences in
6 terms of investment objectives and results between
7 high yield bonds versus investment grade bonds
8 versus government securities versus highly
9 speculative equity as opposed to equity that is
10 more stable and dividend producing and so making
11 judgments about aligning those individual types of
12 categories, of transactions within customers'
13 investment objectives makes more sense. You also
14 have to layer in the fact that the suitability
15 obligation only attaches when you're making a
16 recommendation, it doesn't attach in the abstract.

17 And I think that, on the other hand, on
18 the futures side and on the options side, you're
19 talking about a category of investment activity
20 that is inherently highly leveraged with a very
21 significant likelihood of loss. And as a result
22 of that, it's almost as though your betting are

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1 the circumstances of this client such that they
2 ought to be invested in this kind of an
3 instrument. Not so much whether or not, you know,
4 if they're okay to invest in equity index futures,
5 are they okay to invest in interest rate futures?
6 I think that's one of the product differences that
7 does inform the differences in approach.

8 MS. DOWNS: Yeah, I think we've used
9 suitability more as a retail or private client
10 issue. We think institutional investors are smart
11 enough and sophisticated enough to be able to make
12 better judgments about the nature of the product
13 and the strategies being deployed. So, I think we
14 as firms and FCMs and broker-dealers who operate
15 in both, we view that more as a retail issue and,
16 yes, the suitability or "know your customer," more
17 suitability is okay on the retail side. But,
18 again, I would distinguish it at the nature of the
19 client as opposed to just product.

20 MR. GENSLER: Thank you, Commissioner
21 Casey. Commissioner Sommers.

22 MS. SOMMERS: Thank you, Mr. Chairman.

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1 I'm going to go back to an issue that we talked
2 about in the last panel, but I think almost every
3 one of the witnesses and the five panelists have
4 included in their written statements a
5 recommendation to urge us to find a way to
6 accomplish portfolio margining, so I'm going back
7 to that issue.

8 In trying to resolve some of the
9 comprehensive issues that have prohibited us from
10 moving forward on this issue in the past, I want
11 to ask this panel if you could talk specifically
12 about some of the operational issues that may
13 prohibit futures from sitting in securities
14 accounts, securities from sitting in futures
15 accounts, and to get specific about how we can
16 look at those issues to find resolution.

17 MS. DOWNS: We're a big proponent of
18 portfolio margins because our clients, which are
19 institutional in nature, we need to see the
20 different aspects they're trading and what their
21 offsets are. So whether we do a CDS with a future
22 and an option component or various combinations

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1 thereof, it's important to be able to look at all
2 three of those components and know what their
3 overall exposure to us is. And, therefore, it's
4 not so much whether it's a securities account or
5 futures account, it's more that it needs to be so
6 that you can see both sides of it and look at the
7 overall exposure of that client.

8 The systems that have been set up,
9 everybody's got older systems, but even now,
10 today, if we have a client that's trading equities
11 options and futures, we give them a statement that
12 looks almost identical. It lists their futures
13 then it lists their equities, so they too get that
14 same perspective that I'm looking for as an FCM
15 and broker- dealer and that is to look at
16 everything they're trading with us and what's
17 their exposure.

18 So, although there are two pots, from a
19 customer perspective, they want to see it as one.
20 Yes, there's mechanical issues of flowing it
21 through either system. I think the technology has
22 evolved that more and more you can put it just

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1 about anywhere, you just have to walk through.
2 It's more the money and where's the money, to be
3 honest.

4 MR. NIGITO: As market makers, we do
5 take advantage of some of the strategy-based
6 margining and would support the expansion of
7 portfolio margining for our customers that we
8 provide liquidity to. I will point out though
9 that there are definitely some issues around
10 settlement with returns to the staggered
11 settlement where some things will settle T plus 1,
12 some T plus 3, and so the amount of cash necessary
13 to clear products is sometimes a little awkward.

14 And if you want details on that, I think
15 we can follow up another time with the more
16 comprehensive list.

17 MS. SOMMERS: I just wanted to -- you
18 know, more specifically and, Ed, if you have
19 thoughts on well, to be specific. There are -- if
20 I'm understanding Yvonne's answer correctly, there
21 are not, you know, any plumbing issues that would
22 prohibit one solution over the other --

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1 MS. DOWNS: More and more everybody's
2 developed their systems to be able to do so many
3 things that it's less of an issue than it used to
4 be a few years ago.

5 MR. GENSLER: Commissioner Sommers,
6 thank you. Commissioner Walter?

7 MS. WALTER: Thank you, Chairman
8 Gensler. I guess the first thing I'd like to ask
9 about is market surveillance and what I would call
10 not quite the best of all possible worlds. And
11 one of the reasons that I had supported the
12 politically infeasible merger of these two
13 agencies is my very strong feeling that excellent
14 market surveillance really requires real-time
15 information coming from across the markets.

16 We're not there and I wonder if any of
17 you has pragmatic advice about how we can do the
18 best job possible in the next best of all possible
19 worlds where we're willing to harmonize to the
20 greatest extent possible, cooperate to the
21 greatest extent possible?

22 MR. LUPARELLO: I figure I'll go first.

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1 We are absolutely not there. We're not there on
2 the securities side as far as we'd want to. We're
3 not there between cash derivatives and cash
4 equities and we're certainly not there on the
5 issue of futures versus cash. And there is,
6 clearly, much greater interrelation between those
7 markets now than there ever has been historically.
8 And there's also, as Brian, I think, well knows,
9 many more locations for basically the same
10 economic bet, and we have been moving
11 expeditiously on the cash side to come together.

12 We've done so in the context of insider
13 trading and certain other upstairs activity to
14 consolidate all equities activity, irrespective of
15 where it is, into single surveillance systems.
16 And we need to take the steps that are then the
17 next steps after that in terms of the derivatives
18 to make sure we're aggregating information at the
19 surveillance stage not at the investigation.

20 MS. WALTER: But would you say, Steve,
21 that it's really a question more of working
22 through the pragmatics of it? There really aren't

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1 any legal impediments that are insurmountable in
2 terms of getting there.

3 MR. LUPARELLO: Well, I think that's
4 right. And by the practical, I think it's the
5 technological. It's also exactly how do you share
6 information, how once you've made your
7 determinations you route them back out for
8 investigations. But those can all be -- all of
9 those practicalities can be solved with agreements
10 among the different participants.

11 MS. DOWNS: Can I just say that the cost
12 of sending information back and forth to the
13 Commissions, though, it's not a small effort to be
14 able to integrate all your systems and report them
15 in the different formats. And so if you're going
16 to collect more information to do this, there
17 needs to be some coordination on the information
18 that needs to be collected. Because right now,
19 they're not saying we report to both and the
20 ability to produce the information is difficult if
21 you keep going through different situations for
22 each regulator.

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1 MR. LUPARELLO: Well, Yvonne raises a
2 great point. Not only is there different types of
3 information, but it's often information in
4 completely different formats. So I think one of
5 the key things that a centralized regulator would
6 have to accomplish is how do you take information
7 that is coming in in its native format -- that
8 native format has been developed for a variety of
9 reasons, including the business the people are in
10 -- and get that data to look alike for the
11 purposes of surveillance? I think that's
12 obviously something we've been thinking about for
13 a while and I think that's one of those essential,
14 practical next steps that has to happen.

15 MR. NIGITO: Commissioner, I would just
16 suggest that you speak to the brokers and such
17 that offer sponsored accesses. They need to track
18 their customers' activity in real time across a
19 multitude of venues. And so this is probably a
20 problem that they deal with and would be very
21 familiar with the practicalities of it.

22 MS. WALTER: I guess, Brian, I've got a

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1 question that I want to at least direct in the
2 first instance to you with respect to high-speed
3 trading and, in particular, with respect to the
4 latest hot button issue, namely flash orders,
5 which we are looking at very closely at the SEC.
6 My question is whether you find that there are
7 comparable potential -- I'm going to use a loaded
8 word -- inequities in the futures market that
9 ought to be looked at as well or whether that's a
10 difference between the two markets and whether are
11 there consequences in one market that will slide
12 over into the other market?

13 MR. NIGITO: Well, I would say there are
14 substantive differences. I think that the
15 enhanced retail participation has put additional
16 pressures on the equity side that has manifested
17 itself in pre-routing display facilities, like
18 flash and that level of competition. Without the
19 fungibility and the ability to internalize, a lot
20 of those pressures aren't there and so there may
21 have been inequities, you know, as a result of
22 floor processes. I think that as more of the

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1 futures go electronic you don't find the same
2 market structure elements there.

3 MS. WALTER: One other quick question.
4 There is a regulatory structure distinction in the
5 way our two agencies treat introducing brokers,
6 and, on the one hand, clearing brokers and, on the
7 other hand, FCMs. And I guess my question is, is
8 that a real distinction with two categories of
9 registrants at the CFTC and one with the SEC and
10 with FINRA, with an allocation of
11 responsibilities, but -- an allocation of
12 function, but not necessarily responsibility? Is
13 that a real distinction or is it really more an
14 apparent distinction?

15 MR. ROSEN: I'll respond to that,
16 Commissioner. The important thing, obviously, is
17 that the oversight and the requirements are
18 appropriate in light of the scope of the
19 activities that distinguish an introducing broker
20 from a full broker or clearing broker that's
21 accepting customer funds and engaged in a broad
22 range of interactions that give rise to a whole

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1 set of other issues. It is more a difference of
2 form over substance, but it is one of the things
3 which it would be worthwhile harmonizing on
4 because there's not -- there's no compelling
5 reason to treat them differently under the two
6 regimes. But I would agree that at bottom it
7 becomes more a question of form than substance,
8 one having its own category and one being a subset
9 of broker-dealers that's regulated under somewhat
10 different requirements.

11 MR. GENSLER: Commissioner Walter, thank
12 you. Commissioner Chilton.

13 MR. CHILTON: Thanks, Mr. Chairman. Mr.
14 Nigito, congratulations on your success. You're
15 one of the few companies that can boast
16 significant profits last year.

17 You know, I think we're both -- both
18 agencies are, you know, looking at flash trading
19 and algo trading. And to be honest, I'm not sure
20 I quite get it like I should, so maybe you can
21 help educate me.

22 I understand what you say in your

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1 testimony about bringing liquidity into the
2 market, but you're really in for a short period of
3 time. You're making -- you're getting a
4 differential on tiny price moves by arbitraging
5 between different platforms. Is that generally
6 right or -- I mean, you're not staying in
7 overnight, you're not in it for the long term.
8 These are quick inputs of liquidity, right?

9 MR. NIGITO: Well, I don't think that
10 that would be an accurate characterization, no.

11 MR. CHILTON: How would you characterize
12 it?

13 MR. NIGITO: You have about -- you have
14 several different questions, I think, in there.
15 And so for me to separate flash, algo trading, and
16 liquidity provision I think is necessary.

17 MR. CHILTON: Well, you said you added
18 liquidity to markets. Are you in the markets long
19 term? Are you in overnight?

20 MR. NIGITO: Dictated by the products.
21 I mean, for example, for options where you have
22 people demanding liquidity across a matrix of

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1 strikes and terms, we carry those positions from
2 day to day through expiration. In a very, very
3 liquid stock, you know, we have no fundamental
4 position. So if we have the ability to trade in
5 and out and maintain a position near zero, we'll
6 do so. In those positions that we do carry
7 overnight, and we do, our aim is not to take any
8 particular bet. We're trying to hedge ourselves
9 perfectly. We really have no position on that
10 company.

11 And so I would say that our holding
12 period is dictated by the liquidity in that
13 instrument. And as our business grows, we tend to
14 go down towards products that are less and less
15 liquid.

16 MR. CHILTON: If you had to equate
17 yourself with other traders, not that you know all
18 of their business models, but you've been around
19 the industry for a while, would you say -- is it
20 fair to say that you're in it for short -- in
21 these markets for a shorter period of time than
22 most other traders?

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1 MR. NIGITO: No, I wouldn't say that. I
2 mean, given my experience at ECNs, I'd say that
3 it's a comparable holding period to people who
4 engage in similar levels of liquidity provision.

5 And I would also point out, I mean,
6 somewhat selfishly, we have shared with the
7 Commission and we'd be happy to share it with the
8 Securities and Exchange Commission, we'd be happy
9 to share with you as well, some of the reports we
10 put showing our market share and the amount of
11 liquidity provision and our depth at the inside
12 through last year. And to counter some of the
13 criticisms of high- frequency liquidity or
14 electronic market makers not being there, our
15 share of liquidity provision and trading actually
16 increased over that period.

17 MR. CHILTON: That's helpful and we'd
18 appreciate getting that.

19 MR. NIGITO: Certainly.

20 MR. CHILTON: So accepting what you say,
21 and I do, are there new rules that we need to --
22 at either commission, but specifically (inaudible)

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1 in CFTC, are there new rules that we need to put
2 in place to ensure that when there's bursts of
3 trading activity that are computer-generated, that
4 isn't a guy on the trading floor making this, but
5 it's an electronic trade that these certain
6 attributes are in place and then a large trade is
7 made, that that doesn't move markets? I talked
8 earlier in the other panels about how I like the
9 SEC's definition of "manipulation" because it is
10 "reckless." And I'm not suggesting that you're
11 reckless. And that ours you have to prove intent.
12 Well, it's pretty hard to prove the intent of a
13 computer-generated program. That doesn't mean
14 that you couldn't theoretically make a trade based
15 upon these certain programmatic data that could
16 move markets. I'm not saying it's illegal under
17 our laws. But are there new rules that we need to
18 put in place or consider to ensure that there's
19 not inordinate price moves from this sort of
20 trading?

21 MR. NIGITO: Well, I certainly don't
22 presume to know the strategies of all market

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1 participants out there. I mean, only a few. To
2 the extent that you want to explain them to me,
3 everything you learn, I'd be happy to gain any
4 insight.

5 No, I will say that, you know, the
6 majority of what we're doing is trading counter
7 market moves. You know, we're posting passive
8 bids and offers. And it's pretty hard to push the
9 market when one is, by nature, non-marketable. Is
10 that conceivable? I suppose it is, but I think
11 anybody who would attempt to do that in some of
12 these, you know, liquid futures products and such
13 would be running tremendous risk, and I think that
14 it is somewhat self-policing in that regard.

15 To the extent that you have specific
16 behavior price moves that introduce, you know,
17 market impacts that very quickly reverts, I think
18 statistically you could devise ways to search for
19 extreme instances of that. But it has not been my
20 experience that that is a rampant problem.

21 MR. CHILTON: Thank you.

22 MR. NIGITO: Certainly.

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1 MR. GENSLER: Thank you, Commissioner
2 Chilton. Commissioner Aguilar.

3 MR. AGUILAR: Thank you, Chairman
4 Gensler. I want to revisit some grounds from a
5 different perspective that was trotted by
6 Commissioner Walter's questions about markets
7 surveillance and that is the -- which I view as
8 sort of proactive. And my question has to do with
9 the audit trail and maybe some discussion as to
10 the, you know, current audit trail and how they
11 differ in the securities world, securities
12 intermediaries, and future intermediaries, from
13 order receipt to execution to clearing and, you
14 know, how they could be harmonized. And I'm not
15 sure who to go to. I'm looking at Steve, I'm
16 looking at Yvonne who's sort of nodding. It's a
17 jump off. Somebody get to it.

18 MR. LUPARELLO: I'll start and ask you
19 to bail me out.

20 MS. DOWNS: Okay.

21 MR. LUPARELLO: I can speak to the
22 securities side. There is still some

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1 inconsistencies on a market-by- market basis in
2 terms of audit trails. The equities audit trails,
3 as a general matter, are very robust. They
4 include all the pre-trade transparency, all the
5 post-trade transparency down to the executing
6 broker. For NASDAQ listed stocks, there's also
7 basically an on-the-run order audit trail. That
8 doesn't extend to the New York Stock Exchange or
9 AMEX listed stocks, and so there is that little
10 bit of a discrepancy. And then there's the
11 aggregation of the equities audit trails across
12 all markets, but at somewhat of a higher level.
13 So there's something called the Intermarket
14 Surveillance Group, the ISG, that serves as the
15 aggregator of audit trails. But when it does so
16 on the equities side, it does so with less of a
17 level of detail than each of the individual
18 markets do themselves.

19 So you've got each of the markets with
20 wonderful comprehensive information about what's
21 happening on their markets, but not necessarily a
22 full picture of what's happening on the other

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1 markets as they trade in the same instruments.
2 The options markets parallel the equities markets
3 and they share information, again, at a higher
4 level, but not at a detailed level.

5 I'm going to sort of look down the Panel
6 to see how that compares to the futures audit
7 trail, but I can also say that there is only, at
8 basically the investigative level, routine
9 information sharing between the securities side
10 and the futures side.

11 MS. DOWNS: Because we're a
12 broker-dealer FCM, we run different electronic
13 models in-house to look at our own trading
14 activity. I'm a little more familiar with this
15 than some because that's one of the things I do at
16 Newedge, but the audit trails are very different.
17 And it's not so much that they're different -- and
18 ultimately, if you collected all the pieces of
19 information from all the different systems along
20 the path, you ultimately would get to the same
21 audit trail. But the actual fact is none of that
22 information flows down the path in the same manner

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1 between those two.

2 On securities, for example, we routinely
3 get blue sheet requests. Those blue sheet
4 requests mean that on the audit trail that
5 generally is out there for the securities
6 regulators you know who the firm is and you know
7 the trade that was done, but you can't get all the
8 way down easily on a more real-time basis, down to
9 who actually placed the trade and who the owner is
10 behind that trade. On the futures world, we do
11 know who placed the trade, who the ultimate
12 account number is, and so it's more -- it's
13 generally more readily available to me to look and
14 see exactly who placed that trade down the chain.
15 So the audit trails ultimately are the same; they
16 come from different places.

17 One of the things that's also missing
18 sometimes on the audit trails is the timing
19 information. A lot of times, for me, I need to
20 know when an order was placed, when it was
21 executed, and all the component parts. For me to
22 go get that information from even the futures side

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1 today, generally the exchanges and their
2 clearinghouses can tell you exactly what the time
3 the trade was executed, but they don't all capture
4 all the way through the trail when the trade was
5 originated.

6 So some of those component part
7 differences make it just very simple components
8 that make it hard to follow this path on both
9 sides together in one place to know what you're
10 doing from a market surveillance perspective. I
11 used to work at exchanges as well, so I'll just
12 tell you that I'm familiar with it from both
13 sides.

14 MR. LUPARELLO: And again, the other
15 point is that each exchange or, in our case,
16 (inaudible) for the over-the-counter markets,
17 have built unique surveillance systems that rely
18 on their data. And so each of their systems is
19 independent and each of their systems has been
20 structured somewhat differently based on the
21 unique components of the data as it comes to them.
22 So aggregating of data and aggregating of

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1 surveillance is something that we consider to be
2 very important. But given that it's more than
3 just getting all the data in the same location,
4 it's getting surveillance systems to look at that
5 consolidated data in a single way is a fairly
6 complex endeavor.

7 MR. MERKEL: I was just going to talk a
8 little bit about our experience with respect to a
9 product that is currently not a focus of either
10 agency, which is -- or one that has a hell of a
11 lot of enforcement investigation, namely credit
12 default swaps. We'll see what we may say a year
13 from now, but, at the moment, it's just not an
14 area that has been the subject of much agency
15 action. And our experience has been in the
16 wholesale market that we have been called upon by
17 all sorts of regulators: By the SEC, by FINRA, by
18 various state attorneys general to provide the
19 information. And it is my sense that the
20 wholesale markets have been able to provide a
21 great deal of information that's been useful in
22 connection with those various investigations,

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1 notwithstanding the fact that they're -- those
2 markets are currently not regulated and there were
3 no recordkeeping requirements for the most part.

4 MR. AGUILAR: I think my time is up.

5 MR. GENSLER: All right. Earliest on
6 this round and this panel. Thank you,
7 Commissioner Aguilar.

8 Commissioner Paredes.

9 MR. PAREDES: Thanks. Brandon, if I
10 have this right, in your remarks you highlighted a
11 few different areas of key concern: Margin
12 clearing and bankruptcy. I was curious if you
13 could perhaps dive down a little bit deeper on
14 those and perhaps, in particular, focus on if
15 there's something concrete that you think is the
16 right thing to do to address what you see as the
17 concerns in each of those areas.

18 MR. BECKER: Well, thank you for the
19 invitation. I think it's fair to say that you've
20 heard this morning the conversations on margining,
21 the portfolio margining effort to try and get that
22 resolved, strikes us as a very sensible approach.

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1 I won't try and get in the middle of the one
2 pot/two pot issue. But as an individual investor,
3 if I have one pot, that seems enough pots for me.

4 With respect to clearing --

5 MR. GENSLER: There's the headline.

6 MR. BECKER: You always have to be
7 careful when you go for the joke.

8 With respect to clearing, certainly the
9 cross margining exercises that have been put in
10 place have provided some benefits, but we think
11 that you could strengthen the ability to bring
12 greater prudential oversight by moving more
13 products into a clearing environment. What we're
14 worried about is taking them not only into a
15 clearing environment, but also into exchange
16 trading. So that the benefits of centralized
17 clearing seem well-founded to us. We just don't
18 think that you necessarily have to take exchange
19 trading with that because we have found that the
20 customization from OTC products is to benefit in
21 managing our portfolios.

22 The bankruptcy regime issues I would, of

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1 course, defer to Ed and his colleagues on. But as
2 a practical matter, one of the difficulties with
3 the accounts and what ends up in either account,
4 as Ed's testimony highlighted, are that we don't
5 have good bankruptcy answers if any of those large
6 firms go down. And as much as, you know, we would
7 like to think that those aren't realistic
8 alternative, the last two years have just brought
9 that to the forefront where we now have to put, as
10 it were, for lack of a better description,
11 bankruptcy risk and the uncertainty related
12 thereto into counterparty assessment in a way that
13 you'd like to think, in a mature legal structure,
14 you didn't have to take -- at least you would know
15 what your outcomes were as opposed to the level of
16 uncertainty.

17 So I will pause there and see whether Ed
18 wants to chime in. I'm sorry.

19 MR. PAREDES: I was going to ask it
20 anyway, so.

21 MR. ROSEN: No, I agree with those
22 remarks. And I think one of the things that I

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1 think is important and I noted in your -- in
2 Chairman Gensler's follow-up letter on the
3 legislation, the focus on insolvency. But in
4 connection with the pending legislation and
5 increased clearing, I think it's very, very
6 important to make sure that we have the insolvency
7 analysis right. That seems to me to be relatively
8 non- controversial. Your only objective is to try
9 to make sure that it works the way the rules
10 approved by the Commissions have articulated the
11 result, and I don't think we have that level of
12 certainty today. And I think if we're going to be
13 in a world where the volumes of transactions and
14 relationships that are cleared are going to expand
15 significantly, it really behooves us to address
16 those issues.

17 MR. PAREDES: So do you have any
18 concrete suggestions on how to achieve the kind of
19 certainty that's important?

20 MR. ROSEN: Well, I think it's a
21 question of modifying a range of existing
22 statutes, basically, that would deal with --

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1 eliminates some of the problems that have arisen
2 because of the new paradigms that are being
3 created, new kinds of products being traded by
4 non-conventional market participants, perhaps in
5 clearinghouses that they haven't historically
6 cleared through. And you need somebody to look at
7 the permutations that will arise and parse
8 through. It'll be a function of FIRREA and FDICIA
9 and Part 190 and the bankruptcy code and SIPA, all
10 of those will need to be reviewed to make sure
11 that we get the results that we're engineering for
12 and not a surprise because of a clever litigation
13 strategy and insolvency.

14 MR. PAREDES: I see I have the yellow
15 light, so in the interest of not asking a question
16 and not having a chance for the answer to be
17 offered, thanks a lot.

18 MR. GENSLER: Thank you, Commissioner
19 Paredes. I wanted to associate myself with a
20 couple of comments and then ask a question that
21 you all need a pen for. I don't know if Ms. Downs
22 has a pen, but. So I wanted to associate myself,

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1 Stephen, you mentioned about FX, retail FX. I do
2 think that we need to do a better job, probably
3 both Commissions, but certainly the CFTC. This is
4 foursquare in our jurisdiction. Probably working
5 with Congress as well to better protect the public
6 against retail fraud in the FX markets.

7 I'm associating myself a little bit with
8 Steve Merkel and others who think that in a new
9 world of over-the-counter derivatives that we
10 should have a non-discriminatory clearing that
11 accepts open access to competitive exchange
12 models. I've sometimes used the word
13 "fungibility." Sometimes people say that's a
14 fighting word, but I think that that's an
15 important thing.

16 I'm not sure I would associate myself
17 with Ms. Downs earlier when you said institutional
18 clients are smart enough to take care of
19 themselves. I think last year's crisis, with all
20 respect, showed that maybe smarts wasn't always
21 running strong on Wall Street. So I do think that
22 we have to, as regulators, protect against

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1 manipulation, fraud, and other abuses, even at an
2 institutional level, may be different than the
3 retail public.

4 So here is my question, not with those
5 three points in mind, but the question is: If you
6 can write down areas -- and I'm going to quickly
7 do it because I still have a green light -- but I
8 recognize that some people think these are
9 evergreen issues. I think that there's no sacred
10 cows. I think we have to have open discussion as
11 to what we should change and what we should leave
12 as differences, but 12 things I've heard today.

13 One, product certification or approval.
14 Two, rule certification or approval, different
15 than product certification. Three is this whole
16 topic of cross and portfolio margining. Four is
17 fungibility; still a green light. Five,
18 segregation/solvency. Six, there was some
19 discussion about market structure/national market
20 system, so forth. Seven, manipulation standards.
21 I remember Commissioner Chilton raised this a
22 number of times. Seven, insider trading; the SEC

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1 has it, we kind of don't. Eight, suitability
2 versus disclosure regimes, where the SEC has one
3 and we have a different thing. Next I have
4 fiduciary, you know, the difference between
5 investment advisors, broker-dealers, and CTAs and
6 so forth. Another one is mutual recognition.
7 CFTC does more of that than the SEC.

8 Principles versus rules. I don't know,
9 I meant to have 12, but if it's not, it lists 12.

10 My question really starting with Ed and
11 we're going to go straight across the Panel, so
12 all six of you, which of these would you rank as
13 the first two or three that you say, look, the SEC
14 and CFTC's got a golden opportunity. The
15 president's called for it. We just lifted the
16 worst crisis in 80 years. Rahm Emanuel said, you
17 know, not to waste a good crisis. But if we can
18 address some of these things and actually do
19 benefit for the American public, and which, on the
20 other end of the spectrum, where you say it either
21 should be different or don't pursue it. So -- and
22 if you have two or three on one end, what are the

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1 two or three on the other end?

2 MR. ROSEN: I think sometimes
3 (inaudible).

4 MR. GENSLER: Your mike. Hit your --

5 MR. ROSEN: I'm sorry, fungibility in
6 national market structure, I think the
7 reconciliation of those is very important. I
8 think the cross-margining, portfolio margining, is
9 something that also needs to be done, but I see
10 that as part of insolvency reform. And I think
11 mutual recognition is very important. If we're
12 going to have a coordinated global approach, we
13 have to have standards that enable us to recognize
14 each other because a siloed approach just isn't
15 going to work.

16 MR. GENSLER: We're going to need to get
17 across the hold. Any of those you wouldn't hit?
18 Any of the issues you looked at and said those
19 should stay different?

20 MR. ROSEN: Well, no.

21 MR. GENSLER: Okay. Yvonne?

22 MS. DOWNS: Cross-margining, portfolio

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1 margining I think is number one. We think
2 principles versus rules, but principles should
3 apply to intermediaries, not just the markets
4 themselves since we compete with them. Mutual
5 recognition, we do think that we've got to
6 recognize other markets and not be identical on
7 all of them.

8 Those are my top three.

9 MR. GENSLER: Any that you would just
10 leave different and say that's a good thing, to
11 leave them different?

12 MS. DOWNS: No, I think they all need
13 some modifications, so.

14 MR. MERKEL: I would say at top would be
15 fungibility and market structure and sort of
16 getting that right. The fact that we have just
17 completely different ways of operating, clearing
18 and the securities head options field that we have
19 in the futures area, is a very important issue we
20 have to wrestle with. And if your going to now
21 get to derivatives, which are in either world, you
22 have to figure out which one makes more sense in

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1 terms of harmonization. I advocate strongly
2 towards the security side and to ultimately
3 rationalize all of them.

4 With respect to suitability and
5 disclosure issues, I think I would ask the
6 Commissions to consider pulling it back from the
7 SROs and looking at it anew. It has pretty much,
8 to a large extent, been an area outside of fraud
9 that the agencies have stayed away from, and
10 they've given it to the SROs. And it may be time
11 to look at it in our own right.

12 MR. GENSLER: With permission from my
13 fellow commissioners, we'll just hear what you
14 think are the top ones.

15 MS. CASEY: No, I think it's a very
16 important question. I think we should allow the
17 panelists to take their time to answer it.

18 MR. GENSLER: Oh, all right, good.
19 Good. There, you're getting more time, so -- all
20 of you. And if we cut you off, you just keep
21 going.

22 MR. BECKER: Segregation/solvency as

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1 part of a bankruptcy regime assessment would be my
2 number one because I think it most directly
3 correlates to systemic risk issues on a
4 going-forward basis. Then cross-margining and
5 portfolio margining because, again, I think that
6 goes to risk issues that are important across the
7 board. And finally, fungibility and market
8 structure, I think, will have to do with
9 competitiveness and the ability to bring out new
10 products in a sensible way and maintain innovation
11 in the over-the-counter market.

12 I, oddly enough, would leave principles
13 and rules for another day because I think it's an
14 empty vessel. You need both. But what I would do
15 is urge the SEC to figure out how to get new
16 products approved faster. That's not a
17 harmonization issue so much as it's an internal
18 bureaucracy issue within that commission.

19 MR. LUPARELLO: As a regulator on the
20 Panel, the intermediaries all give the regulators
21 answers.

22 Market structure and, I think, in that,

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1 the market surveillance structure is an important
2 and fiduciary standard. I think those basic, you
3 know, market integrity issues I think are the ones
4 that are most -- we would most, I think, benefit
5 from, from getting some level of harmonization on.
6 And the ones I would be quickest to leave on the
7 wayside, not that they are on -- all aren't where
8 they would -- I agree with Brandon, principles
9 versus rules and mutual recognition.

10 MR. NIGITO: I think personally it seems
11 like product approval is tractable and laudable.
12 Cross-margining and portfolio margining, I think,
13 is a constant amongst everybody.

14 Market structure I think is a hard one
15 to disentangle unless you solve some of the
16 fungibility issues and you deal with some of the
17 pressures and the competition.

18 The competitive aspects, I don't see a
19 lot of ease there. And as to what to leave on the
20 table, I would certainly have to defer to some of
21 my colleagues around things like principles versus
22 rules-based.

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1 And mutual recognition, I wouldn't want
2 to let it go, but if we give it up, we give it up.

3 MR. GENSLER: Some children just don't
4 get as much. But we may have cut Ed or Yvonne
5 off, so was there anything? No?

6 MR. ROSEN: No, that's fine. I actually
7 share the consensus of the Panel.

8 MR. GENSLER: Well, I want to thank my
9 fellow commissioners, both from the SEC and the
10 CFTC and Chairperson Schapiro. I think it's been
11 a very full day and excellent witnesses. I thank
12 you all.

13 For those of you who have not yet
14 submitted written testimony, please do because
15 we'd like the public to get benefit from what
16 you've all shared with us.

17 We're going to reconvene tomorrow
18 morning at 9:00 a.m. at the SEC's hearing room,
19 which I believe, as you go into the building, then
20 you go down into the basement. And we, again,
21 have three panels tomorrow.

22 And we thank you all and we thank the

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1 commissioners and everybody's staff here at the
2 CFTC and SEC staff. Thank you and see you all
3 tomorrow.

4 (Whereupon, at 3:20 p.m., the
5 PROCEEDINGS were adjourned.)

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